Chapter Six

The Institutional Approach to M&A in China

Introduction

The last chapter investigated M&A activities from 1997 to 2003 in China. The empirical study revealed a number of similarities between China's M&A with those in developed markets. First, the market appears to view the announcement of a takeover as a positive news event and is prepared to grant the shareholder a high premium. Second, takeovers appear to be mainly directed at poorly performing companies. And third, takeovers appear to play disciplinary role, while managerial objectives appear to play a role as well. Based on this empirical evidence, the Chinese takeover market appears to be no special case. Looking one layer deeper, however, China does appear to contain a number of peculiarities that are very different from Western markets. First, targets continue to exist as a separate company, even though the bidder gains control over the target company through the purchase of a large equity stake in the target. Targets are not absorbed by the bidder or even delisted from the stock market. Second, the government plays a very important role in the process of takeovers, and government-related agencies or companies remain the largest shareholders of the company after the transaction. In general, the government appears to use M&A as a specific instrument in the transition process and the process of negotiation and implementation is very different from Western countries. And third, the empirical results suggest that insiders are able to realize the abnormal returns, while the rest of the market is too late.

The question is how these similarities and differences can be explained. Are the similarities due to the introduction of market institutions and the differences simply the result of China being in a transition stage towards a real market economy? Are differences also to be found among market economies themselves due to institutional peculiarities that make every economic system unique? Is the process of institutional reform path-dependent and will China never become like the West?

Based on our findings in the previous chapters and based on other comparative institutional research done in transition economies (Whitley, 1999), we make an attempt in this chapter to answer these questions and to further develop the theoretical framework discussed in Chapter 1. The conclusions of Chapters 5 and 6 will be blended together in the final chapter.

As explained two streams of Institutional Economics will form the pillars of the framework: the New Institutional Economics (NIE) is discussed in 6.1.1. Because Masahito Aoki and Douglass North can be depicted as builders of bridges between the two streams, specific attention is paid to their work in 6.1.2. The Original Institutional Economics (OIE) is discussed in 6.1.3. Because China‘s transition is gradual and shows elements of path dependencies Section 6.2 is specifically devoted to that type of change. In Section 6.3 the theoretical framework is applied to the case of M&A in China. Much of the findings discussed in previous chapters will also be part of that section, but from a more comprehensive perspective. Concluding remarks follow in Section 6.4.

6.1 Institutional Economics

The Chinese experience in changing institutions is interesting because apparent inconsistencies in the institutional structure (mixed bag) produce nevertheless impressive economic results (see Chapter 3). Below we first discuss the insights offered by NIE.

6.1.1. New Institutional Economics

Referring to Figure 1.1, the NIE focuses on the property rights (Level 2) and on the institutional arrangements (Level 3) as endogenous variables. The institutional environment (part of Level 2 and all of Level 1) are the exogenous variables. Davis and North (1971, p.5-6) distinguish between the two as follows:

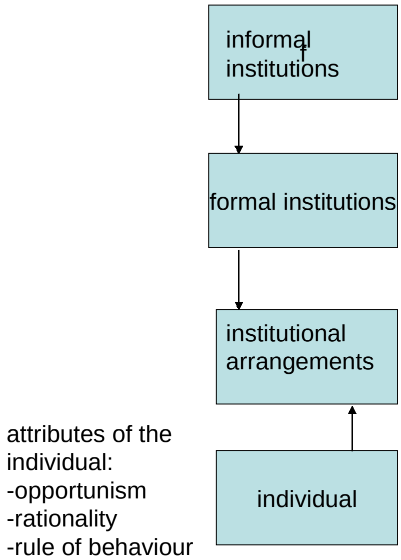
> *“The institutional environment is a set of fundamental political, social and legal ground rules that establish the basis for production, exchange and distribution. … An institutional arrangement [on the other hand] is an arrangement between economic units that governs the ways in which these units can co-operate and/or compete. It [can] provides a structure within which its members can co-operate … or [it can] provides a mechanism that can effect a change in laws or property rights”.*

Institutions guide behaviour on the one hand and are instruments of actors on the other. In neoclassical economics the analysis is focused on calculating the equilibrium, which is assumed to be the outcome of an anonymous process in which individual actors realise their own preferences. These processes work well if a number of conditions is fulfilled, among which the existence of an efficient institutional structure. In Figure 6.1 three categories of institutions are depicted: at Level 1 the informal institutions of values, norms, attitudes, and the like. At Level 2 the formal institutions of laws and regulations, as well as the public and political institutions like bureaucracies, political parties, ministries and parliament. At Level 3 the institutional arrangements are located: contracts and private organisations that coordinate transactions among agents. At Level 4 we position the individuals that are members of families, private and public organisations and larger national and international communities. Figure 6.1 is based on Williamson (1993 and 1998) (compared to Chapter 1).

More and more empirical studies support the importance of informal and formal institutions. For example, analysing the sporting goods industry, Van Tulder (2001) found that companies tended to adopt codes that were less pronounced than in case codes were the result of interaction with other stakeholders. Nowadays, it will be difficult to find an economist, who will deny “institutions matter”. However, the role of institutions in the economic analysis differs strongly among the neoclassical economics (NCE), the New Institutional Economics (NIE) and the Original Institutional Economics (OIE). The former do not really discuss institutions: it is assumed that the (in)formal institutions and arrangements are “right”, that is to say: institutional structures make an efficient allocation in markets possible. In NCE the building block of the model is the individual agent characterised with specific preferences, attributes and a rule of behaviour. In the analysis the preferences and attributes do not change: they are given and constant (methodological individualism). Together with substantive rationality (Simon, 1976) and the availability of all relevant information, individuals can calculate optimal equilibriums as end states. The processes to realise those end states are no subjects of analysis: it is assumed that competition gives actors no other choice then to make the optimal decisions, otherwise they will not survive. So, as far as institutions matter in NCE, it is in the sense that they are assumed to be there and to be as efficient as assumed in the theory.

NIE explicitly aims at explaining institutional arrangements given the (in)formal institutions, given technology and preferences. The individual agents are modelled as cost minimising actors that have no other option because competition forces them. This is visualised in Figure 6.1.

Figure 6.1. Institutional Layers



NIE is not any differently constructed than NCE: all three elements of NIE (property rights, agency theory and transaction costs economics) conceptualise the change in property rights, principal-agent contracts or governance structures as the result of maximising or minimising behaviour of individual agents, what have sufficient information to calculate *ex ante* the optimal combinations, or it is assumed that *ex post* the optimal alignment between transactions and governance structures will emerge. Preferences are exogenous and outcomes of selection processes are equilibriums. Explanations are in terms of causes (individual actions and selection mechanisms) and consequences (efficiencies).

In this model, the relation between the layers is one of the higher levels constraining the lower ones: the informal institutions constrain the formal ones, which set boundaries for institutional arrangements to be established. Note that no feedbacks are analysed and that individuals are isolated from institutional structures. The NIE is designed for specific research questions (optimalisation under constraints), the models are methodologically individualistic of nature and the research method of deductive axiomatic testing fits the construction (Wilber and Harrison, 1978).

Institutions emerge and existing structures are improved due to the actions of wealth maximising individuals. They bargain with each other on changing property rights, changing contracts or creating new arrangements and when situations can be improved in a Pareto sense then this will happen. Institutions are privately created within the public boundaries, or when formal institutions or public organisations need change then the suppliers (mostly the state at different levels) are assumed to satisfy that demand (“get the (in)formal institutions right”). So the NIE fits well in the picture of mainstream economics with independent actors, anonymous markets, selections processes and equilibriums.

The NIE claims to provide insights into the reasons why institutions will change, and what kind of changes might be expected. Wealth maximising agents will improve institutional arrangements (renegotiate contracts) when there is no Pareto optimum (a “misalignment” of transactions and governance structures). Then the content of the contract is changed which is then not a change of the institutional arrangement itself. But also the arrangement itself can be subject to change by individuals aiming to maximise their welfare: when a new type of contract (a relational one instead of a classical one), or a new type of hierarchy (with more decentralised autonomy), or a new type of hybrid (strategic alliances), can improve the allocation (can reduce production and/or transaction costs), then individual actors will establish those institutional arrangements. The same approach is used for explaining changes in property rights. In the NIE framework institutional change is not being due to trial and error and learning, but is caused by exogenous changes in informal institutions (values, norms, attitudes), by changes in formal institutions of laws and regulations, or finally by changes in technology. Often the NIE is criticised for its static analysis and lack of analysing the processes of change. In replying the critics Williamson (1998, p. 33) claimed TCE to be “of an adaptive nature”:

> *"What I should like to emphasize are that 1) theories of organization that feature adaptations should not be described as 'static' (….)”*

A close look at the heuristics of NIE shows that the rules of application allow for a static comparative analysis, (adaptation toward a new equilibrium after an exogenous shock), but not for a process analysis showing how - if at all - an equilibrium is realised (Groenewegen and Vromen, 1996).

The NIE provides insights in the importance of incentives at individual level to search for cost reducing solutions: the cost and benefits should be located at individual level. Also of great importance is the existence of an institutional environment that is stable and predictable; uncertainties are minimal then, which reduces the transaction costs of contracts and organisations. Especially North (1990) elaborated that issue. The questions and issues for which NIE seems to be relevant concern optimal allocations, aligning transactions and governance structures in an efficient way. The conditions under which the NIE framework seems relevant concern the attributes of actors, the information available and the existence of competitive pressure. Williamson (1998, p.30) stated:

> *"As compared with other interesting contracting issues – for labor, with consumers, as for capital- contracts between firms in intermediate product markets have the advantage that the two parties can be presumed to be risk-neutral and*

> *roughly, to be dealing with each other on parity. Each has extensive business experience and has or can hire specialized legal, technical, managerial, and financial expertise. Attention can therefore be focused on the attributes of the transaction and the properties of the alternative modes of governance- rather than be deflected by differential risk aversion or by competence disparities between the parties (as might arise, for example, with contracts between firms and inexperienced consumers)".*

It seems that Williamson is making the conditions under which TCE is relevant more explicit: two parties are involved with the same characteristics (risk neutral) and the same resources ("on parity"). Information is objectively available for them (same experience and entry to experts). This suggests when conditions are not like that, TCE is less relevant.

In sum we conclude that for understanding institutional change in China - and specifically with respect to the restructuring of SOEs, which takes M&A as the instrument - NIE has relevant insights to offer, but researchers should be well aware for which specific type of questions NIE is designed and under what kind of specific conditions the insights hold. As Eggertson (1996) rightly formulated the constraint of NIE is most strongly felt when issues of dynamics are at stake.

It is evident that when the process of institutional change is studied taking the interdependencies of all layers of Figure 6.1 into account, a different theoretical framework is needed. The analysis would become extremely complicated and standard economic tools would be inadequate. Chapter 3 and 4 show that an interaction between the political and economic institutions exists, that the historical roots and established informal institutions have a strong guiding influence, that the "shared mental maps" of bureaucrats, politicians and management play a crucial role, that power positions and vested interests facilitate or block institutional changes, that unintended consequences occur, and that large differences exist between sectors and regions. In Chapter 1 we briefly outlined the contributions of OIE to understand those complexities. Before going into the details we briefly pay attention to the work of Aoki and North because these two authors seem to build a bridge between NIE and OIE.

6.1.2. M. Aoki and D. North

Two problems are central in Aoki's (2001, p.6) analysis:

> *" first the complexity and diversity of overall institutional arrangements across the (contemporary) economies as an instance of multiple equilibria of some kind (the synchronic problem) and second to understand the mechanism of institutional evolution/change in a framework consistent with*

> *an equilibrium view of institutions but allowing for the emergence of novelty (diachronic problem)".*

Like Williamson (1993), Aoki wanted to keep the analysis in the traditional equilibrium framework of economics and suggests applying evolutionary game theory. In the analysis of Aoki the existence of multiple equilibria is central. According to him it is very unlikely that even in a globalising world institutional arrangements will converge; on the contrary there is strong empirical and theoretical evidence that make a convincing claim for divergent systems (Whitley, 1999).

> *"Rather we ought to admit the diversity in economic systems and analyse their sources and evolution, the comparative advantages and disadvantages of different systems, and the possible gains from diversity. In doing so it will not be sufficient to analyse market institutions alone, but it will be necessary also to analyse the interdependencies of institutions mutually interwoven in complex ways. Because of the variance in historical conditions among economies and the need for structural consistency between regulations and other institutions, a convergence towards a universal model would be difficult"(Aoki, 2001,p.xi).*

Williamson (1993) also acknowledged the importance of different institutional contexts resulting in different governance structures: the same type of transaction is then efficiently coordinated by different governance structures because of divergent institutional environments. Sometimes the institutional environment does legally not allow for a specific governance structure (close subcontracting networks are uneasy with US anti trust laws), sometimes governance structures do not correspond with the mental maps of management (subcontracting relations were not part of the range of alternatives for American car manufactures in the 1970s). For identical transactions in the institutional context of Japan, the governance structure of subcontracting can be the efficient transaction cost minimising governance structure, in China that is an integrated SOE and in the US an integrated private firm. However, Williamson did not explain why multiple equilibriums could exist (he labelled the issue as "a shift parameter" to be studied by other disciplines), whereas Aoki did so using evolutionary game theory in which equilibrium is central. (Aoki, 2001, p.47 and p.50) stated:

> *"Under Darwinian dynamics, the situation in which the expected payoffs of every member of the population are equal, that is, the situation in which the possibility of changing strategies through imitation of the fittest no longer exists, is called an 'equilibrium'".*
>
> and:

> *"If the dynamics of an economy that starts out with a fixed set of historical conditions reinforces the complementarity between specific strategies and approaches the corresponding equilibrium situation, establishing rules to enforce the adoption of those strategies will serve to reduce social and individual costs".*

Aoki explained that institutions can be considered as equilibrium outcomes of a process to be analysed with evolutionary game theory. Individuals have limited information processing capabilities and the existing institutional structure and organisational modes influence the strategy of individuals. In evolutionary game theory each economic agent will strategically choose a skill type and industry that optimises his payoffs given the constraints of his bounded rationality. Close to the equilibrium especially information costs for agents will decrease, because expectations converge. Social cost of rule enforcement will be relatively low for agents close to the equilibrium. "Institutionalisation" can then be conceptualised as "the codification of evolution equilibrium strategies".

Aoki (2001, p.142) was clear about the need for a complementary approach to game theory in which the historical specificities are analysed:

> *"(....) we cannot predict endogenously which of those equilibria will be chosen without some other information, such as history, or institutional environments surrounding the domain of the game (institutions existing in surrounding domains). This implies that, in spite of the development of the game theory on which institutional analysis relies, game theory alone cannot provide a complete, closed frame for institutional analysis. The analysis of historical and comparative information must be essential complementary".*

The upshot of the approach of Aoki is the opening of the economic analysis to the explanation of several equilibriums each with its own path of development, in the explanation of which initial historical conditions play an important role (see for instance his differences between American and European firms respectively the A-mode and the J-mode). In the meantime, Aoki claims to maintain the rigorous economic analysis as presented in the game theoretic modelling. However, the question arises whether and how the two can be combined. Contributions of North (1990) and especially Denzau and North (1994) might offer valuable insights to analyse deeper the process of institutional changes and to show that things are probably more complicated then suggested above.

Political scientists like Lindberg, Hollingsworth and Campbell (1991), have shown how such a process analysis might look like. Especially Campbell (1997) discussed the "interaction, interpretation and bricolage", in which the preferences and cognitions of actors become endogenised. In economics especially North made in recent years important steps in that direction. In Denzau and North (1994) the "intimate relationship" between mental models and institutions is discussed. With mental models (internal) individuals interpret the environment, whereas institutions (external) are created by individuals to structure and order the environment. The conceptualisation of time is important: logical, or discrete time is used in neoclassical and new institutional economics, whereas "real", historical time is used in Denzau and North, which implies a fundamental change in conceptualising the evolution of institutions. Mostly changes in historical time are incremental: over time elements are added to the existing structure in such a way that there is continuity (see "on path development" below). The new system that results from that adding of elements beholds the possibilities of changes in the future. In situations of incremental change there certainly is change, but the nature of change is a specific one. Incremental change can only be understood in relation to what preceded, while such a change implies the possibilities for the future. Also in situations of incremental change the system as a whole can fundamentally change over time. It seems relevant to make a distinction between the nature of the process of institutional change (radical or incremental) and the outcomes of the process (evolutionary "on path", or revolutionary "off path").

According to North (1990), institutions are "humanly devised constraints that shape human interaction" (p.3). However, this should not be understood in the way mainstream economics conceptualises the construction of institutions (optimalisation under constraints). In North there is room for interaction: institutions constrain, but are also "devised". In the terminology of the agent-structure literature: "agents and structures are mutually constituted". In that constitutive process learning takes place, which "represents" and "re-describes" the "priors" (initial structure of ideologies, habits, etc.). The world of Denzau and North is a world of procedural rationality, perceptions, historical time, and re-description of the past. The priors generate the "event space", the past that is recalled, but at the same time it is "represented", it is newly re-described.

This perspective has large implications for the relations between the layers in Figure 6.1:

1. Actors cannot be presented anymore as agents with "attributes", but preferences and mental maps are endogenous. Actors interact and interpret, while their interpretation scheme evolves.
2. The institutional environment of formal and informal institutions is not objective, but interpreted; the world is socially "constructed".
3. Evolution, incremental change, is the "normal" kind of development due to switching costs involved and the difficulties in fundamentally changing related mental maps of actors. However, the result of cumulative incremental changes can be a revolutionary change; incrementally the process changed from "on path" to "off path".
4. The relation between mental maps and institutions make actors change institutions, actors "represent" and "re-describe" them. Institutions then are

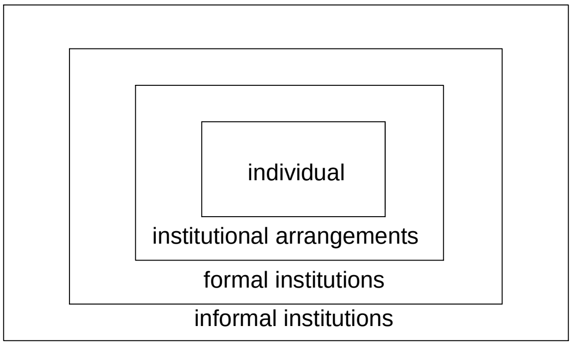
a “reflection”, “the inter-subjective manifestation of perceptive frames” (North, 1990, p.26).

The question now arises how this incremental change takes place. What is the driver, what about power and control by vested interests, what about the efficiency of the evolution? Moreover, how to understand more fundamental changes in which one can identity a rupture with existing practices?

6.1.3 Original Institutional Economics

In OIE the layers of Figure 1.1 are interdependent (see Chapter 1) and visualised in Figure 6.2: individuals, organisations, contracts, formal and informal institutions are mutually constituted.

Figure 6.2. Embedded Layers of Institutions



In OIE the dynamics of institutions is central: also in this paradigm individuals exist, who attempt to improve their situation by investing in changing institutional arrangements and if necessary also by investment in changing the formal institutions. Although also efficiency is an important driver of change in the OIE paradigm:

- more drivers of change are analysed and studied in an interdependent way: values and norms, political conditions, as well as economic ones are woven into the analyses. Efficiency certainly plays a role but the general concept of minimal production and transaction costs gets a specific meaning of time and place: efficiency in China 1978 is very different from efficiency in China 2004 (efficiency is contextual).

- individuals are differently constructed: there motivation can certainly also be to produce in an efficient way, but their values and preferences are formed over time and are endogenous. Individuals interact and in the process construct the institutional arrangements, as well as the (in)formal institutions. Rationality is not only bounded, or contingent, but is procedural and of a "learning" nature.

  "In that process the attributes of self-interest and power of individuals play an important explanatory role, but obviously, humans are also motivated by considerations such as altruism and ideologies that stress values other than narrow self-interest, (…)" (Eggertson, 1996,p.17)

  " It is conceivable that future scholars studying the economics of institutions will use models of the individual in various degrees of sophistication, depending on the nature of their work. For some purpose the narrow neoclassical rational choice model might be appropriate, for other uses the bounded rationality/transaction costs models, and in yet other situations models involving learning"(Eggertson, 1996, p.20)

- institutions are a mixed bag, a result of improving efficiency, of trial and error, and of bargaining between unequal parties.

How this process develops and how it can be analysed is a complicated question because all elements of Figure 6.2 are involved, including the "inner psychology" of the individual and the "shared mental maps" of groups.

In this OIE paradigm causes are not deduced from the consequences and the functionalist approach is abandoned: instead of explaining the causes of institutional change by their consequences, an approach to look at the independent causes of the birth, life, and death of institutions is suggested (Eggertson, 1996). Moreover, the change is often the result of a bargaining process of which the outcomes are difficult to link to intentional actions of actors because of the power differences. Finally, a functionalist approach is often not adequate because institutional change is often the result of unintended consequences.

The shared mental model gives the rationalisation at any moment in time of the way people act, interact and evaluate the process and the outcomes. It is then of great importance to study the past in which mental maps and institutions are mutually constituted. Inefficiencies or inconsistencies between values and norms and actual performances, are drivers of change. When people perceive the performance of the system as very inefficient (like in China at the end of the 1970s), or when large parts of the population perceive the outcome of the economic and political system not matching their values and norms (in terms of democratic decision rights, or in terms of material wealth), then these inconsistencies will drive individuals and groups to invest in changing the system. The outcome of the political and economic system is constantly evaluated, which can lead to reinforcing existing structures, but also to changing the system. When a gap exists between the norms and facts different types of actions are possible. How actors react to the evaluation of the performance of the system largely depends on their type of conduct that "fits" the system; Hirschman (1970) distinguished "loyalty, exit or voice". The first refers to behaviour of members who stay member of the organisation and supporter of the goals despite failures of the organisation. The opposite is exit, and voice refers to behaviour of members who actively invest in improving the organisation by participation. The values and norms largely influence the type of behaviour that prevails in a society or organisation, which can largely differ between economic sectors and regions. The reaction of China's large SOEs to the opening up of the firm for foreign investors can be very different from the reaction of management of small SOEs. Also differences between sectors and regions should be expected, because of the differences in history.

Generally speaking the following scenarios could be distinguished:

1. the rings in Figure 6.2 are in harmony; a process of reinforcing institutions and consistent behaviour drives people to improve existing structures. Higher aspiration levels drive the system to perfection. Institutions guide behaviour and largely determine the outcomes. All this is "neutral": if the institutional matrix creates incentives for piracy, North (1990) observes, then people will invest in becoming good pirates.

2. the rings are not in harmony: inefficiencies exist, large part of the population feels deprived of goods and services that should be provided according to the values and norms. Then processes to change institutional arrangements (contracts changing the distribution of wealth, organisations allocating more power to employees) within the existing formal structures emerge.

3. When improvements are not possible within the existing structures and people are not able and willing to adjust their preferences further in a downward direction, then pressure to change the formal institutions is built up. Individual actions become collective actions. The process starts at the bottom.

4. The process can also start at the top: the suppliers of formal institutions (the state at different levels) take initiatives to change the formal rules of the game expecting a better performance of the system of which individuals and groups will benefit. The status and legitimacy of the politicians will

then improve. The role of politicians in China as initiators of the reforms is a case in point. North underlines that in history changes made by the ruler were mostly meant to serve the interests of the ruler and of powerful interest groups.

5. Also informal institutions change, a process about which still very little is known. It seems useful to distinguish between the "deeper", fundamental beliefs in a society and more superficial norms and attitudes. Deeper ideologies seem to allow for a variety of norms for instance concerning individual profit making in a society that is built on collective values. China 2004 is an interesting example.

6. Chapter 3 and 4 indicate that from the top fundamental changes in the system can be initiated, but that the process towards the new institutional structure can be designed as an incremental one: step by step towards a socialist market economy which is fundamentally different from a CPE.

7. Gradual change can result in a fundamental change in (in)formal institutions. This can be a smooth process without shocks, but it is also possible that over time such tensions are built up to the so-called bifurcation point at which the system collapses. In the Chinese case: How long can the state keep central control over investments and M&A and at the same time continue to release market forces? The existing external institutional structure then does not correspond anymore with the internal mental maps shared by large parts of the population. Instead of gradually "getting the institutions right", alignments are then the result of shocks and revolutions.

6.2 The Theory of Path Dependency

6.2.1 Path dependence

A "path" of development is widely used in economic and sociological studies. Several definitions exist. "Path dependence means that history matters" (North, 1990, p.100). Paul David carefully defined the notion of "path dependence" as "a property of contingent, non-reversible dynamic processes, including a wide array of processes that can properly be described as 'evolutionary'" (David 2001, p.15). But it is not easy to predict precisely the course of a path. "Path dependence is a way to narrow conceptually the choice set and link decision making through time. It is not a story of inevitability in which the past neatly predicts the future" (North, 1990, p.98-99). Path dependency is also widely used in the social science to explain the type of institutional change. In the broader version, path dependence refers to the causal relevance of preceding stages in a temporal sequence (Pierson, 2000). William Sewell (1996, p.262-3) suggested path dependence means "that what happened at an earlier point in time will affect the possible outcomes of a sequence of events occurring at a later point in time." In the narrow version, Margaret Levi (1997, p.28) stated: "Path dependence has to mean, if it is to mean anything, that once a country or region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice." Deeg (2001) gave a definition that referred to its logic: a path is "(….) a distinct pattern of institutionally-root constraints and incentives that create typical strategies, routine approaches to problems and shared decision rules that produce predictable patterns of behaviour."

The issue of path dependency has arisen from the study of the evolution of technology. "Technological change and institutional change are the basic keys to societal and economic evolution and both exhibit the characteristics of path dependence" (North, 1990, p.103). The article that first called the attention of economists is Paul David's "Clio and the Economics of QWERTY" (1985). He explained how accidental set of happenings affects the final result, even if it turns out to be inferior compared to other more efficient alternatives. Arthur (1988) developed David's argument. He asserted that after one technology wins out over another, it will maintain a monopolistic position and influence the future for a long time. Arthur (1994, p.112) argued that increasing returns could result from: large set-up or fixed costs, large set-up or fixed costs, coordination effects and adaptive expectations. With a large set-up or fixed costs, individuals and organizations have a strong incentive to identify and stick with one option. The learning ability of people is likely to spur further innovations in related activities. Dijk (1999, 2003) developed an evolutionary perspective on the cluster study. He illuminated the stages from locational clusters to industrial district. Coordination effects are especially important when a technology has to be compatible with a linked infrastructure, which in turn attracts still more users of the technology. Adaptive expectations lead individuals to adapt their actions in ways that help make those expectations come true.

Not all technologies, however, are prone to increasing returns. Arthur (1994) addressed not only the characteristics of such processes but also the conditions that give rise to them. Understanding these conditions is essential, as we shall see, because analytically similar circumstances occur frequently in the world of politics. Arthur's characteristics provide a foundation for developing hypotheses about when increasing returns processes are likely to operate in the social world.

Economists have applied increasing returns arguments to economic change more broadly. The most prominent development in recent discussions of economic growth centres on "endogenous growth" theory (Romer, 1986, 1990). Economists in the 1980s were puzzled by growth rates (notably in developed countries after World War II) far greater than could be explained by measured increases in inputs of capital and labour. Romer and others argued that increasing returns associated with economic applications of knowledge help account for the anomaly. Unlike capital and labour, many aspects of knowledge are non-rival—their use in one firm does not prevent their use in another. A single gain in knowledge can be applied in many settings and can lead to dramatic improvements in productivity. Economic growth generates the positive feedback that results in increasing returns. A somewhat different analysis of growth based on increasing returns emphasizes the importance of complementarities (Milgrom and Roberts, 1990). Various economic activities (e.g., in information technology) are complementary to other related activities. Improvements in a core activity can spill over by improving related parts of the economy (lowering costs or increasing productivity). These improvements in turn may increase the attractiveness of the core activity.

North (1990, p.95) argued that all the features identified by Arthur in investigations of increasing returns in technology could be applied to institutions. In contexts of complex social interdependence, new institutions often entail high fixed or start-up costs, and they involve considerable learning effects, coordination effects, and adaptive expectations. Established institutions generate powerful inducements that reinforce their own stability and further development.

North extended David's and Arthur's arguments of technological change to institutional change. According to North (1990), there are two forces determining the path of institutional change: one is increasing returns, where organisations get feedback about the continuous changes between them and institutions. These organisations learn by doing, and increase the profitability of their businesses. Increasing returns could also be described as self-reinforcing or positive feedback processes; the other is imperfect market characterized by incomplete information, where transaction costs are important and the behaviour of agents is affected by ideology and limited information. These two forces are going to determine what North called "path dependence" in order to define the limitations of the choice set that agents face through a process of "linked-decisions" through time. As events move down the path, change becomes more limited.

With increasing returns, institutions can shape an efficient long-run path (North, 1990). But when the markets are incomplete, the information feedback is fragmentary and transaction costs are significant, both divergent and inefficient paths are possible. In the process of economic growth, every point offers choices. "Path dependence is a way to narrow conceptually the choice set and link decision making through time" (ibid., p.98). "Once a path is set on a particular course, the network externalities, the learning process of organizations, and the historically derived subjective modelling of the issues reinforce the course" (ibid., p.99)

North emphasised that not just single institutions are subject to increasing returns. Institutional arrangements induce complementary organizational forms, which in turn may generate new complementary institutions. "The interdependent web of an institutional matrix produces massive increasing returns" (North, 1990, p.95). Path dependent processes will often be most powerful not at the level of individual organizations or institutions, but at a more macro level that involves complementary configurations of organizations and institutions (Hall and Soskice, 2000; Katznelson, 1997).

North's insight is crucial for two reasons. First, he highlighted the parallels between characteristics of technology and certain characteristics of social interactions. In this context, it is worth noting that Arthur's arguments about technology are not really about the technology itself but about the characteristics of a technology in interaction with certain qualities of related social activity. Second, North rightly emphasised that institutional development is subject to increasing returns. Indeed, it is the role of path dependence in explaining patterns of institutional emergence, persistence, and change. Patterns result from many small steps. North (1990) concluded: "long-run economic change is the cumulative consequence of innumerable short-run decisions by political and economic entrepreneurs that both directly and indirectly (via external effects) shape performance." (p.104)

The central puzzle motivating North's inquiry is the limited convergence of economic performance across countries over time. Neoclassical theory suggests that laggard countries should readily adopt the practices of high performers, which would induce fairly rapid convergence, but this does not happen. According to North, path dependent development of institutional matrices explains the anomaly of continued divergence in economic performance. Once in place, institutions are hard to change, and they have a tremendous effect on the possibilities to generate sustained economic growth.

6.2.2 "On-path" and "Off-path"

The concept of path dependency is not crystal clear yet, especially when questions about "on path" and "off path" developments are discussed. Confusion arises when radical changes are introduced or when revolutions appear on the scene. It can be argued that when all elements of Figure 6.2 are interdependently analysed, all events, also the revolutionary ones, are "path dependent". They arise from the past and are in one way or the other always the result of the past. However, for our analysis we consider it useful to make a distinction between developments "on path" and "off path".

"On path" refers to the situation, in which the "logic" of the system is reproduced. There can be change, but the change does not affect the "nature", the "logic" of the system. The logic can be defined in terms of the consistency between the elements of Figure 6.2. In ideal types of economic systems, like the Anglo-Saxon system, or the Asian system, a strong consistency exists between the (in)formal institutions and the institutional arrangements (Groenewegen, 2001). For instance in a CPE collectivistic values correspond with a central role of the planning bureau and ministries and the transfer of information through a system of directives, whereas a market system is built upon individualistic values and contracting. Neuberger and Duffy (1976) pointed to the need of consistency between the motivation-, information- and decision structure of economic systems. This holds for macro systems (like for instance national systems of innovation) and micro systems (like firms).

In real economic systems, especially in periods of transition, there will be tension between the elements of Figure 6.2: individualistic values emerging in collectivistic systems supported by new laws with respect to companies, bankruptcies, and contracting, do not correspond then well anymore with the powers at central level. “On path” refers to a strong consistency of the elements of Figure 6.2 and “off path” means that a fundamental step is made towards another type of consistency. The decision made by the Chinese government to implement a “socialist market economy” with all consequences at the levels of (in)formal institutions and institutional arrangements, is considered to be a decision to bring the system on a new path. Often there will be disagreement among analysts about the system being “on path” and “off path”, but a discussion in those terms in itself is considered valuable, because it makes explicit what the intention of the political and economic actors is and what the implications are in terms of the consistency of the system.

Individuals make their decisions within an existing institutional framework, no matter the framework is efficient or not. Organisations formed by groups of individuals act in a given institutional framework. The longer institutions have been in place, the more resilient to change they will be and the more likely that any changes will be incremental (Deeg, 2003). Institutions persist over time not only because of legitimacy, but also because powerful individuals and groups have a vested interest in maintaining the status quo. Moreover, like organisations, institutions face powerful inertial forces that are not only interest-based, but also locked into inter-related institutional structures (Nee and Cao, 1999). The powers to keep the system “on path” are strong.

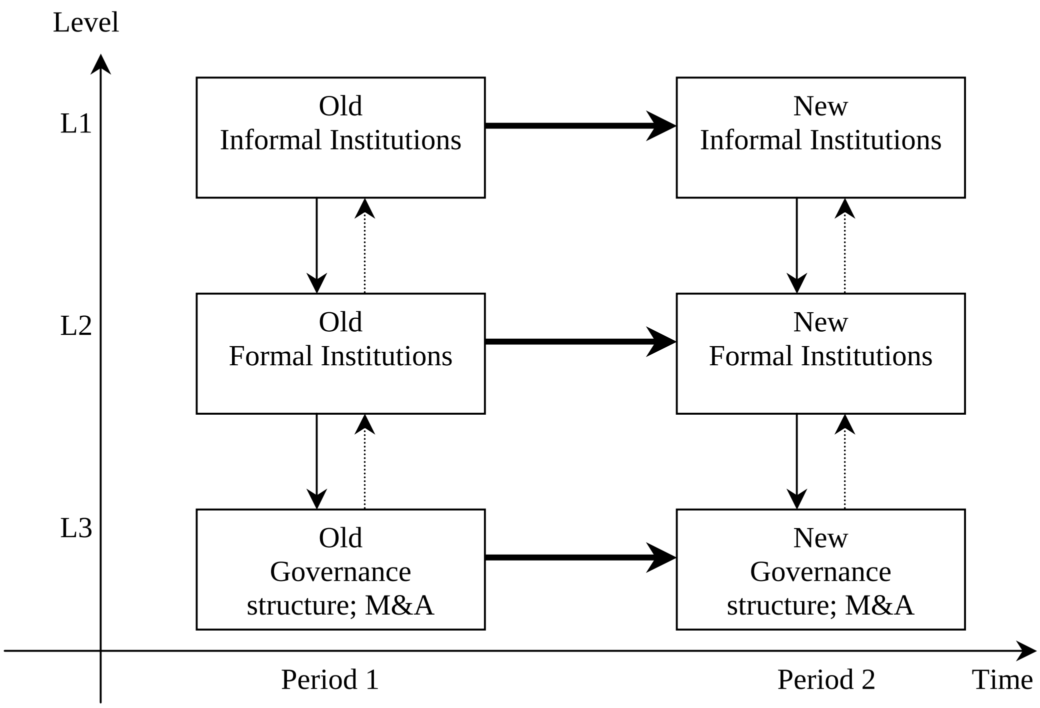
What brings the system off path? A strong version (Pierson, 2000) suggests that only an “exogenous shock” – an event outside the path that radically alters the incentives/constraints confronting actors on the path – can lead to the end of path. Short of this, change is incremental or “on-path”. Actors may gradually modify aspects of the path, but the overall trajectory, its “logic”, is unchanged. In this version of path dependency an “off-path” switch only comes about from an exogenous shock that renders the existing path unviable.

But Deeg (2003) and others argued that empirical research showed more complicated developments. On the one hand endogenous change can bring about “off path” developments, whereas it also seems possible that parts of the system follow “off path changes” and other parts stay on the trajectory, following the existing logic of the system. Deeg (2003) referred to the developments in the German banking system, which was replacing the long-term intimate relations with industry for more Anglo-Saxon types of contracts, while the labour system remained on the old path. The theory of institutional change has not been developed yet in such a way that these types of empirical phenomena can be understood. Is the German example showing world wide convergence towards the Anglo-Saxon system, or does the German system allows for elements with a different logic, or is the German system following its own path and will it find a new, more or less unique consistency between the elements of Figure 6.2. An analysis in which the process of institutional change is carefully analysed might offer insights into those complex questions.

6.2.3 Towards a dynamic framework

As explained the NIE and the OIE provide useful insights in the dynamics of institutions. Figure 6.3, following Williamson's (1998) schema, provides the starting point for a dynamic framework. For our analysis of the Chinese case, we include the (in)formal institutions and focus on the governance structure (specifically on the role of M&A) at the level of institutional arrangements. We discuss the role of informal institutions (strong "on path" force), the role of formal institutions (central government can be an important initiator besides private actors) and the role of corporate governance (inertia and reasons for change).

Figure 6.3 A Dynamic Framework for the Change of Governance Structure[26]



[26] This figure is based on the discussion with Prof. John Groenewegen.

6.2.3.1 Informal institutions

In every economy, actors have to cope with uncertainty, but in transformation economies actors are often facing an unprecedented level of uncertainty. Van de Mortel (2002) named this kind of uncertainty “framework uncertainty”, which is “ the kind of uncertainty following from the collapse of the formal institutional framework” (p.18). The change in the formal institutions should be analysed in relation with the path dependent forces related to the informal institutions in society. Informal institutions are complex, changes take place over relatively long periods of time and are not subject to public or private interventions as formal institutions and institutional arrangements seem to be.

North (1990) referred to informal institutions as “ideologies” (“belief structures”) and the complementarities between different ideologies. Wartick and Wood (1999) summarised the complementarities between economic, political and social ideologies as shown in Figure 6.2. Strong complementarities between the different ideologies make the informal institutions sticky.

Figure 6.4 The Complementarities among Ideology

Free Market Capitalism	Regulated Capitalism	Mixed	Socialism	Utopian Communism	

THE RANGE OF ECONOMIC IDEOLOGY

Anarchy	Negotiated Consensus	Simple Democracy	Republican Democracy	Social Democracy	Totalitarianism

THE RANGE OF POLITICAL IDEOLOGY

Individualism	Collectivism

THE RANGE OF SOCIAL IDEOLOGY

Source: Wartick, S.L and Wood, D. J. (1999, p.26).

It is suggested that government (and powerful interest groups) can influence the legitimacy of the existing ideology and accompanying values and norms. This influence can be effective the more the government is considered the legitimate institution to inform the people about the “right” ideology and the appropriate values and norms. For example, in China with the “high power distance” culture, with a great respect for strong vertical order, founded in the Confucian tradition, the state is assigned the role of initiator and instructor (Redding, 2002). Thus in

China, the CPE apparatus was one in which paradoxically the older Mandarin structures were perpetuated. The CPE ruled by seizing monopoly power on the interpretation of the state ideology, and justified its position on the basis of the preservation of order (Redding, 2002). Nothing had fundamentally changed from earlier centuries as far as the basic logic of the structure was concerned, as the earlier Mandarin state apparatus had ruled by monopolizing the interpretation of the Confucian ideology. What kind of actions government is supposed to undertake with respect to changing the formal institutions, is largely determined by the pressure large parts of the population put on government. When Chinese people learn that their declining wealth is related to the inefficiency of SOEs, they will invest in attempts to make the government change the laws and regulations concerning SOEs and private firms.

The learning process is a critical factor with respect to the choice and the adjustment of private and social rules (Van de Mortel, 2002). North (1994) stated that learning is a function of "(i) the way in which a given belief structure filters the information derived from experiences and (ii) the different experiences confronting individuals and societies at different times…" (p.364). It is a matter of motivation (how big is the gap between what is felt to be the norm and reality?), the information (do people know about the causes?), the alternatives (do people know about alternatives and is government prepared to implement them?) and of resources (are economic and political resources available to build pressure? see also Seo and Creed, 2002).

To understand the role of informal institutions in staying on the path, the concepts of OIE as developed in Bush (1987) and Bush and Tool (2003) are of great value. The distinction of Veblen between ceremonial and instrumental values is further developed by Paul Bush to understand how innovations in society are often blocked with large negative consequences for the possibilities of societies to solve problems and to create and distribute wealth in such a way that large parts of the population benefit. The ceremonial values serve the vested interests, whereas instrumental values increase the problem solving capacity of society. That is why the latter is also called "progressive". Technological or institutional innovations that increase the knowledge fund of society to solve problems correlate with instrumentally warranted patterns of behaviour. In existing systems with established values and norms and rules of the game serving the existing interest groups, the introduction of an innovation that implies another distribution of social and private costs and benefits, will be blocked by vested interests. Ceremonial adequacy, that is to say, coherence with the received customs and practices, as well as the prevailing patterns of power and status in the community, will hinder many technical and social innovations.

> *"Ceremonial encapsulation prevents any aspect of technological innovation not consistent with the status quo from being utilized in the problem-solving processes of the community. In other words, it*

> *creates an artificial 'scarcity' in the availability of knowledge for problem solving. In economic terms, it limits the application of technology, thus preventing cost-reducing innovations, thereby lowering the productive potential of the economy. It contributes to path dependency, a reduced rate of diffusion of technology, and a lower rate of economic growth" (Bush, 2004).*

However, when an innovation is encapsulated it can have unintended consequences and a "demonstration effect":

> *"No matter how vigorous the effort to encapsulate the technology, to the extent that any new instrumentally warranted behaviour is permitted, this creates the potential for a 'demonstration effect' of the efficacy of the application of new instrumentally warranted patterns of behaviour in other areas of the community's problem-solving activities, permitting a 'trans-situational transfer' of instrumental standards of judgment in the correlation of behaviour elsewhere in the institutional domain of the community (including the institution in question)" (Bush, 2004).*

Another concept of OIE that seems useful in analysing institutional change and is related to the concept of encapsulation, is the "principle of minimal dislocation". Bush uses the concept of encapsulation in the positive sense of describing how processes evolve when innovations are introduced. The normative implication is:

> *"The basic policy lesson to be drawn from all of this is that the diminution of ceremonial dominance, by reducing the reliance on the criterion of ceremonial adequacy in the correlation of behavior, considerably enhances the efficacy of technological innovation to bring about 'progressive institutional change'" (Bush 2004).*

Certainly the effects on existing progressive institutions should be minimised:

> *"The principle of 'minimal dislocation' is premised on the notion that, at any given time, instrumentally warranted patterns of behaviour are encapsulated by the ceremonial practices of the institution. Therefore, to the extent that technological innovations involve the displacement of ceremonial practices by instrumental practices, due care must be taken to minimize the dislocation of existing instrumental practices that are ceremonially encapsulated. Let me use a historical example. In the effort to dismantle the authoritarian structure of the Communist state in Poland, East Germany, and elsewhere in Eastern Europe, it would appear that many instrumental practices of those regimes were dislocated along with the ceremonially warranted patterns of political, economic, and social power. The result of, for example, introducing Western*

> *'market shock' policies without adequately considering the dislocating effect on previous instrumentally warranted practices in industrial production, food distribution, health care, and so forth, led to severe hardships on the populations in those countries. This involved 'maximum' dislocation, not 'minimum' dislocation, with the consequent social costs" (Bush 2004).*

The concepts of ceremonial and instrumental values, as the principle of minimal dislocation, seem useful for understanding the role of (in)formal institutions in the Chinese reforms. In the case of for instance TVEs it seems that government with the introduction of TVEs purposefully aimed at maintaining and reinforcing regional structures that contributed positively to the "problem solving capacity" of the Chinese society.

There is evidence that another policy seems to be at stake in the Chinese case: Chapter 3 and 4 indicate as if government purposefully designed institutional innovations that minimally disrupted existing power structures and status positions in order to have minimal opposition of the interest groups. Because of the One Party system, government seems to have been able to minimise the "ceremonial encapsulation" and powerful individuals and groups could be used for the implementation of new policies.

6.2.3.2 Formal institutions

Also formal institutions have a strong "on path" tendency. Firstly, sunk costs and complementarities can induce efficient persistence. Bebchuk and Roe (1999, p.25) stated:

> *"Existing legal rules might have an efficiency advantage because institutions and structures might have already developed to address needs and problems arising under these rules. In such a case, replacing the existing rules might make the existing institutional and professional infrastructure obsolete or ill fitting and require new investments. Various players—managers, owners, lawyers, accountants, and so forth— might have invested in human capital and modes of operation that fit the existing corporate rules. Replacing these rules would require these players to make new investments and to adapt to the new rules. Thus, which rules might be efficient for a country now might depend on which rules it had in the past and what institutions and practices developed in reaction to these rules. This factor would often reinforce existing rules and, in turn, existing ownership structures".*

Secondly, once a country has legal rules that enhance for instance the private benefits to controlling shareholders and thus encourage the presence of such controllers, the controllers' political power will also increase the likelihood that the country would continue to have such rules. The controlling shareholders, therefore, as an interest group, would make full use of its political influence to impede the changes of the related legal rules (Bebchuk and Roe, 1999). The economy's formal institutions at any point in time might be heavily influenced by the ownership patterns that one had earlier. All the legal rules, including not only corporate law but also securities law and investors' protection law, which affect governance structures, will depend on the corporate structures with which the economy started. Initial ownership structures can affect both the identity of the rules that would be efficient and the interest group politics that can determine which rules would actually be chosen.

The change of formal institutions is a political process, which combine public features (knowledge fund available to solve societal problems) with interest group politics. Interest groups will mobilize and exert pressure in favour of the change of formal institutions that favour them or against the change that disfavour them. The existing governance structure reflects the distribution of social wealth and power. In particular, the existing ownership structure will affect the resources (and then political influence) that various players will have (Bebchuk and Roe, 1999). So formal institutions will depend on the economy's existing governance structure in earlier periods. For example, the legal rules in China favour the concentration of corporate ownership. Controlling shareholders in most companies are the state or its representatives. The rules favouring these groups will be maintained at any time in the transformation until the existing pattern of ownership structure is broken.

Thirdly, the formal institutions are path dependent because of the influence form the informal institutions. When people find that the formal institutions are changed and in conflict with their norms, then an effective enforcement becomes very difficult (Redding, 2002). With respect to the Chinese case this seems important when introducing the "private enterprise" and "profits". According to the informal institutions of the old regime private enterprises were connected to "cheating" and "poor quality"

6.2.3.3 Governance structure

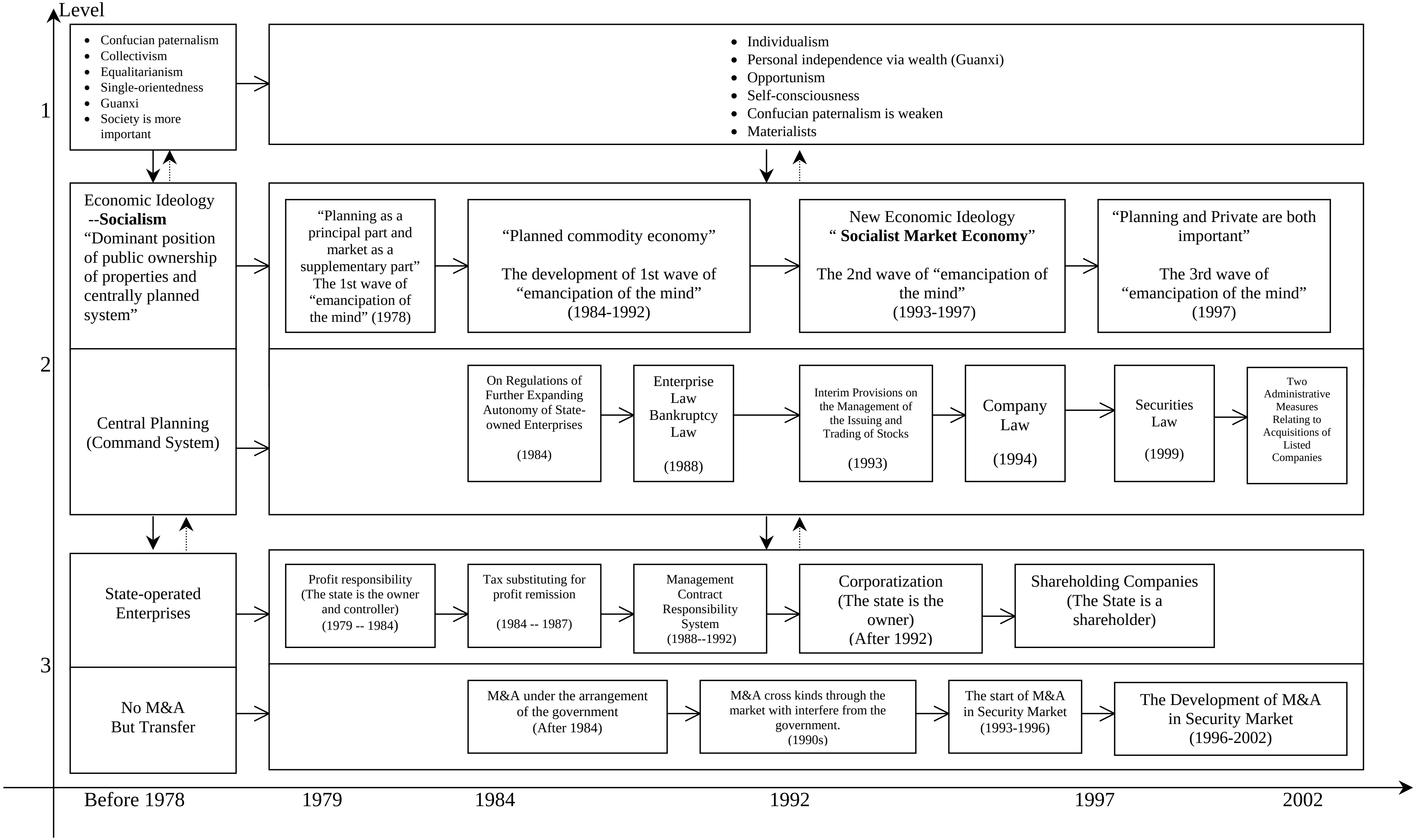
Also at the level of corporate governance strong powers keep the changes "on path". On the one hand such an evolution is efficient, on the other it serves the interests of the powerful. The former are discussed in Bebchuk and Roe (1999). Sunk adaptive costs, network externalities, complementarities, and multiple optima, are four efficiency reasons to stay on the path. The latter refer to the actions of interest groups. It is the government who appoints, motivates and disciplines managers and finances firms' projects. In reality, bureaucrats hold control rights of the firm in name of the state; the residual belongs to the state. Moreover, these bureaucrats typically have different goals from the state because of the different political and economic interests (Zhang, W., 1998). The government, bureaucrats and managers who participate in corporate control under an existing structure often have the incentives and power to impede changes that would reduce their private benefits of control even if the change were efficient.

6.3 The Application to the Process of M&A in China

While a market compatible institutional framework is evolving in China, some firms are still stuck in legacies of the old system. Chapter 5 focused on M&A from 1997 to 2003 in two national stock markets. As has been said there the research found that acquisitions in China were directed at poorly performing companies and have a disciplining role. The turnover rate of the top management of target firms increased dramatically after a takeover and most of newly appointed chairmen of the board and the top managers came from outside the company. After takeovers, the target companies' accounting performance was improved. We interpret it as the speculation for the "government remedy". Secondly the analysis showed that the mergers did not bring any benefit to the bidding company in both financial indicators and stock return, but increased the cash compensation of management. It is confirmed that managerial objectives may drive mergers that reduce bidding firms' profitability and shareholders' wealth; the managers seem not to be strongly motivated to increase firms profitability because of the small share ownership managers have.

M&A in China got a specific function: a tool for changing the corporate governance system. It had unique characteristics (showed in Chapter 4 and 5) and also showed similarities with systems in more mature market economies. In this paragraph we will explore the institutional changes in China (especially the role of M&A) utilising our dynamic framework. The original path of China's transformation is characterised by the dominating public ownership structures. We will argue that the emergence of M&A is closely related to the Chinese institutional change towards the new path of the socialist market economy, but that the powers of "ceremonial encapsulation" were strong. However, it seems that the reformers were able to design a "road to the socialist market economy" that "minimally dislocated the existing instrumental institutions" and minimised obstruction from vested interests. In Figure 6.3 an overview of the process is described.

Figure 6.5 The Path Dependency of China's M&A in a Dynamic Framework



6.3.1 Pre-reform

Ranging from 1949 to 1978, a unique cultural tradition mix of the planned-economy and Confucianism formed China's economic system. Especially, the values of collectivism, equalitarianism and single-orientedness exerted a strong impact on China's economic activities.

1. Both communism and Confucianism promote the values of collectivism. They emphasise the priority of the "public", while rejecting the pursuit of personal benefit. The planned-economy inherited these values from the Confucian tradition, which underlined the value of considering individuals, organizations and the nation as a whole (Earley, 1993).
2. Equalitarianism is regarded by China's cultural tradition as a feature of an ideal society (Yuan, 1999). In the planned economic mechanism employees received their income according to the national income level with no relation to their performances.
3. The value of single-orientedness means that the Chinese people respect authority. It is one of the most important factors in Chinese culture and makes government very powerful. Because of thousands of years of strong centralisation of state power, people were used to accept the statements, guidelines and plans rather passively from the government. Redding (2002, p.238-239) wrote:

    > *"This a 'high power distance' culture, with a great respect for strong vertical order, founded in the Confucian tradition which determined the design of both the state, and roles learned by individuals. The primary moral basis for authority is paternalism, and concern for employees and their welfare will legitimate the holding of power, and the exercise of discipline. The equivalent at the state level is patrimonialism. Socialization into clearly understood role behaviour vis-à-vis authority has been apparently maintained. Communal norms governing authority relations remain strong, and serve to preserve vertical order along recognizably traditional lines, albeit with new social structures incorporating the tendency."*
4. *Guanxi* is a special kind of culture in China. It refers to special relationships two persons have with each other (Chen, 1995). Two people enjoying a *Guanxi* means that each is consciously committed to the other. They can lead to undertake exchanging favours, which even may contradict official policies. In the Confucian system, man is a relation-orientated being who has an inherent interest in cultivating his *Guanxi*. In the pre-reform period, the Chinese would be keen on expanding their *Guanxi* network (*Guanxiwang*) as much as possible to compensate for the inefficiencies of system. Especially, *Guanxi* was important with respect to the bureaucratic

hierarchical system and the distribution of rare resources. *Guanxi* helped many Chinese to survive the hardship of deficient supplies during the planned-economy period (Chen, 1995).

The basic features of corporate governance in that period were:

1. Both the residual claim and control rights of SOEs were almost completely held by governments. The whole economy of the state sector was organised like a single giant company with almost all decisions of production, investments and employment centrally planned (Wu, 1994). Revenues and cost budgets were also centralised by the state.
2. Managers did not have any operating rights. The enterprise did business under the administrative control: government distributed raw materials among enterprises and commanded the delivery of goods and services produced. The government also drafted the employment plan and determined the salary system.
3. All “members” of the enterprise were compensated through a centrally set hierarchical wage-fringe benefit system, which was hardly related to firm performance (Zhang, W., 1998). Only the central government leaders and top bureaucrats had incentives to make the economy better, because they were the residual claimants. The promotion of their position in the cadre system depended on their performances in the political-economic system.
4. The advantage of central planning was that the agency problem of managerial theft and expropriation of funds at the firm level was tightly restricted since management had little freedom to make discretionary decisions (Zhang, W., 1998). However, the efficiency of resource allocation and production was very low. In the bargaining managers tended to ask for more resources to produce a lower output.

The separation of ownership and control is the basic feature for SOEs when they were created (Lin, Y., 1995). Nominally the owner of all enterprises is the “whole Chinese people”, while the government represents the Chinese people in the “public ownership of properties”. In the pre-reform period, it was the government who appointed, motivated and disciplined managers and financed enterprises' projects. In reality, the state (or government) was a pseudo-player because principalship of the state was delegated to governmental bureaucrats through a hierarchical structure (Zhang, W., 1993). So *Guanxi* was a very important factor in the system. Bureaucrats held control rights of the firm under name of the state; the residual belonged to the state. Moreover, these bureaucrats typically had different goals than the state because of the different political and economic interests (Zhang, W., 1998). So a special “principle-agent” relationship took shape among the state, bureaucrats and managers.

6.3.2 Fourteen years' of incremental reform ("on-path")

6.3.2.1 The start of the reform

Above we discussed incremental change and path dependency. How an exogenous shock can bring the system "off path", whereas this might also happen as the result of a number of endogenous incremental steps. After the death of Chairman Mao in 1976 great changes took place in ideology, which is called the emancipation of the mind (see Figure 6.3), leading China to a new path.

In China, the transformation from the end of 1978 obviously began with the change of ideology, which was motivated by the government. Consistent changes in the formal institutions of laws and regulations were initiated. The reforms in the formal institutions evolved in constant interaction with the informal institutions. The informal institutions (collectivism, equalitarianism and single-orientedness) made that the changes should be initiated and guided by the state. Government was seen as the principle interpreter of the values, norms and other elements of the "ideology".

6.3.3.2 The path description

The original path of China's reform can be described as the incremental reform of the relationship between the state and the enterprises without changing the ownership structure. With a 30-year CPE history, the Chinese government retained the dominating public ownership structure. Ideology, switching costs, vested interests, and the results during the process, all played an important role in following the path of collective ownership.

Because of the continuities in the underlying institutional arrangements, the communist party could maintain considerable power and privileges, resulting in persistent or even augmented cadre advantages under conditions of market reform. The Chinese case seems to indicate that the protection of vested interests after the reforms is a crucial element for the effectiveness of the reforms. In Figure 6.3, it is shown that before 1992 the basic policy of enterprise reform was concerned with granting more operational autonomy and sharing profit (*Fangquan Rangli*) to the management level.

The first wave of "*emancipation of the mind*" at the end of 1978 made "planning as a principal part and markets as a supplementary part" acceptable. In other words, the national economy was still firmly founded on SOEs. In October 1978 six enterprises from Sichuan, a province in the southwest of China, were selected to experiment and afterwards more enterprises joined. They obtained limited autonomy, such as the right to produce and sell products in the market after fulfilling the plan quotas, and the right to retain some extra profits meant that management had to allocate the money into three separate funds for welfare (e.g. housing), bonuses or production development.

The economic system was still under the control of the government. The government (especially the local government) was directly involved in corporate governance through its ownership and control.

Encouraged by the extraordinary success of agricultural reform (see Chapter 3), on October 1984, the Third Plenum of the 12th Party Congress adopted a decision on reform of the economic system aimed at the urban area. This document made a significant ideology shift, from "plan as a principal part and market as supplementary part" to "planned commodity economy," which firstly admitted the role of market to the economy. “Planned commodity economy” was a strange name for such a reformed system, but was chosen because of the fit with the ideological terminology. In 1985, the State Commission for the Restructuring of the Economic System announced the "*Interim Regulation on Vitalising State-operated Enterprises*". According to this announcement, enterprises could decide the type and quantity of their products by themselves as far as the state quota could be achieved. The setting of quota was not only according to the national plan but also subject to the negotiation between the bureaucrats and managers. *Guanxi* played an important role in the process due to the lack of laws and regulations. In the next few years, some new laws and interim regulations were announced specifying and formalising the rights to be granted to enterprises to affirm and increase their autonomy. The *Enterprise Law* (1988) identified 14 rights to define the SOE sphere of autonomy: production decision, pricing decision, sale decision, purchase decision, export/import decision, investment decision, etc.

In this 14-year period (1979—1993) different types of corporate governance were tested. It was a process of trial and error; because government kept a strong control the lessons learned could be implemented from the top, which was consistent with the existing ideology.

From 1979 to 1987

The reform has two stages in this period. From 1979 to 1981, the profit responsibility was promoted on a large scale. Sharing profits meant that enterprises could share a part of profit with the state if the quota were achieved. The enterprise handed in a fixed amount of profits and shared the above quota with the state. From 1983 to 1985, the tax system was set up nation-wide. The distribution of income between the enterprise and the government was settled by the introduction of tax substituting for profit remission (*Li Gai Shui*).

The heart of the reform aimed at expanding SOE autonomy and increasing their profit incentives. The most important decisions about appointments and finance were still in the hands of government, which maintained the ultimate authority over enterprises through its sole ownership. The basic feature of corporate governance in this period included (He, 1999):

1. Operating decision rights and residual control rights were gradually transferred from the government to the enterprises. Managers began to

share control rights and residual rights with the government. The enterprise owned some properties and became a relatively independent business entity.
2. Granting autonomy and sharing profit implied a revolutionary change in China’s corporate governance. The redistribution of enterprise incomes gave managers and employees a strong incentive resulting in an improvement of both the performance of enterprises and incomes of individuals.
3. The reform in this period did not change the ownership structure: bureaucrats remained principals and managers the agents. Government could not really control the bureaucrats effectively, whereas bureaucrats could not effectively deal with the larger management autonomy.

In this stage, M&A was directed by the government, including the selection of acquiring companies, the target companies and the determination of the transaction price. The purpose of M&A was to lower the burden of loss-making SOEs by merging them with profitable SOEs.

During the first stage of reform, the Chinese economy grew strongly and outperformed other transition economies. GDP grew fast and the living standard of ordinary Chinese improved significantly. For example, an average Chinese consumer increased his/her consumption about three times for edible vegetable oil, seafood, and eggs. The number of people living in absolute poverty was substantially reduced from 250 million to less than 100 million. By the end of 1993, reforms were supported by people in all walks of life simply because everybody benefited from it.

The type of reform is often labelled as “on path” because the logic of the CPE was maintained: government controlled as owner large parts of the economy and decided about structural developments. It was consistent with the informal institutions, but also with the formal institutions in those days. However, the institutions were “imperfect” (insecurity of property rights, imperfection of capital markets, and the problematic taxation system) forcing government to fill the institutional gaps (Qian, 2002).

(1) A Lack of Rule of Law in Securing Property Rights

In studying the ownership of firms in rural industries, many scholars have recognised the critical role the local community government played in protecting their firms in an environment lacking a rule of law (Chang and Wang, 1994; Li, 1996; Che and Qian, 1998a and 1998b). In China, private property rights were not secure. Indeed, the state did attack private enterprises during several general political campaigns such as the "anti-spiritual pollution campaign" of 1983, the "anti-bourgeois liberalization campaign" of 1987, and most recently, after the Tiananmen incident of 1989. Facing such uncertainties, private enterprises have reacted by withholding investments or seeking protection. For example, some private enterprises sought protection by converting their firms into Town and

Village-owned Enterprises (TVEs) after 1989. In those firms the management retained all profits after turning over a fixed premium to the local government.. Many of these collective enterprises were called “red hat” firms, which were nominally owned by the collective, but were really owned and managed by a small private group, or individual.

(2) A Lack of a Functioning Capital Market

In transition and developing economies, capital is one of the scarcest resources. Its efficient use is a major source of growth (Qian, 2002). In particular, new firms have great difficulty in obtaining capital to start and to expand their businesses. One fundamental reason for the capital constraint is the uncertainty and risk underlying the ventures because of an information gap between investors and entrepreneurs induces the problems of adverse selection and moral hazard. The problems become even worse in developing and transition economies for two additional reasons: the underdevelopment of market institutions for monitoring behaviour and enforcing contracts, and the lack of resources by the entrepreneurs to finance part of the investment or to put up as collateral. As a result, credit is rationed, in the sense that either loans are not available or they are available only for a smaller amount (the under investment problem). Thus, the entry of new private enterprises is capital constrained and firms are forced to start with small and less capital-intensive projects. Only after the accumulations of retained earnings over time are they able to raise more capital, increase the scale of projects, and shift to more capital-intensive technologies.

(3) A Lack of Adequate Taxation and Fiscal Institutions

Another missing institution is an adequate taxation system for generating revenues for the government and a good fiscal system to use the revenues. These are two related problems. On the revenue side, all transitional economies have been experiencing sharp government revenue shortfalls because of the erosion of monopoly profits from SOEs and the great difficulty of taxing new private firms. In a centrally planned economy, taxation was simple: the government used distorted prices to concentrate most surpluses in the industries of final goods and to extract revenues from there. After the liberalisation of prices and ownership, profits are more equally distributed among different sectors and the government looses revenue, especially in enterprises it does not control (McKinnon, 1993). On the expenditure side governments in developing countries for political economy reasons often bias the use of revenues toward certain groups (Bates, 1987). This can be considered a commitment problem: after taxes are collected, the government is unable to credibly commit to spend some of it on local public goods in rural areas, because of a stronger political lobbying from the urban areas.

Both problems hurt rural industrialisation and development, and both are due to a lack of appropriate government institutions. Local government control in TVEs mitigated both problems. With the ownership and control rights over firms, the local government had a less costly way to extract revenues from these firms than from private firms. For the same reason it is harder for the central government to extract revenue from locally controlled firms.

To the end of 1987, the benefits of the government control of firms tended to decline or disappear. The reforms brought some serious problems, such as agency problems and corruption. Contracts between firms and governments were likely to be incomplete for a variety of reasons, such as transaction costs, measurement costs, and monitoring costs (Hart, 1988). Contracting is more likely to be incomplete in developing and transition economies for additional reasons: imperfect state and market institutions. Another important reason for the decline of the benefits of government control of firms is due to an increased, especially international competition, when the domestic economy became more integrated into the global economy.

From 1988 to 1992

The high inflation and widely spread corruption slowed down the reform process. An austerity program was implemented in 1989 and 1990 to cool down the over-heated economy. Unhappy with the economic slowdown (the GDP growth rates of 1989 and 1990 were, respectively, 4,4% and 3,9%) and the standstill within the central government, conservatives gained political, ideological, and military power for a possible reversal of the reforms. In 1990, they discussed the possibility of "recollectivisation" of agriculture and also tried to recentralise investment and financial powers from the provinces. However, these efforts failed, but once a solution is reached, “(…) powerful interests locked into emergent institutional arrangements, making it difficult to exit from them” (Nee and Cao, 1999, p.802). It demonstrated how important it has been that reforms resulted in better economic positions for large parts of the population, which would strengthen the position of incumbent politicians, i.e. The Communist Party.

From 1987 to the early 1990s, the dominant reform policy was the “management contract responsibility system”. In 1988, the State Council issued the *"Interim Regulation on the Contract Responsibility System in SOEs*". At the end of 1989, the contract responsibility system was widely adopted as a formal instrument to allocate decision authority and residual control rights. The contract responsibility system drew a clear line between the government and the enterprise. Managers were provided with more incentives than before, and in fact they had become controllers of residual rights. The rapid adoption of the contract responsibility system stabilized the redistributive changes and further consolidated the managers' authority. as well as that of the officials of their supervising ministries or organisations over the management and operations of enterprises (Jefferson, 1998).

Within the management contract responsibility system, enterprises were required to hand over agreed amounts of profits and taxes to the state, in return for which the manager was given extensive autonomy and large responsibility for raising the investment funds from retained profits, bank loans and eventually other sources (Nolan and Wang, 1999). The management contract responsibility system established a strong link between the performance of the firm and both the bonus of managers and revenues of the state. Four forms of management contracts were used by all types of enterprise (Tam, 1999): (a) the contract specified a profit remittance quota and allows the contractor to retain all above-quota profits; (b) the contractor retained profits at a progressive rate; (c) the contractor received a fixed profit quota and a share of above-quota profits; and (d) SOEs also used contracts such as the "two guarantees and one link"—which linked the level of retained profit to the realisation of negotiated output and productivity targets. The contract usually lasted for 3 to 5 years.

The most common form of contract among SOEs was the fixed rate scheme. The average profit retention rates (average share of gross profit retained) of SOEs reached about 33% (World Bank, 1992). But retention rates varied widely because of profit remittances by publicly owned enterprises to their supervisory bodies and a variety of local or ad hoc taxes. According to enterprise surveys by the World Bank in 1992, bonuses in China's firms represented 22% of total cash compensation. Jefferson (1998) showed that a 1% increase in gross profit per worker translated into about a 0,33% increase in the per worker bonus within SOEs.

The contracting agents may include a single director, a management group, or all the personnel of the enterprise (See Table 6.1). Although individual directors dominated SOE contracting during the first round (1986—1988), a broader set of representatives served as contractors during the second round of contracting (1989—1991).

Table 6.1 Designated Contractors in SOEs (% of Sample)

	Director	Group	All Personnel	Other
First Round (n=846)	65,5	17,7	15,6	1,1
Second Round (n=788)	47,6	29,6	21,2	1,5

Source: World Bank (1992)

The basic feature of corporate governance in this period included:

1. Strong managers with a high degree of autonomy emerged in this period. Before the implementation of the 1988 reforms, managers had little autonomy because the enterprise committee was ultimately responsible for managerial decisions. There was also little emphasis on meeting profit targets and no penalties for failing to do so. Under the management contract responsibility system, managers were obliged by law to guarantee delivery of contractual profits, and contracts became more specific. Coupled with the fact that revenues to the central state and party bureaucrats were declining, the legal guarantee intensified bureaucratic monitoring of enterprise profits (Cauley et al., 1999).

2. The monitoring mechanism of the government was two-fold. On the one hand, it introduced the penalty regulations for the manager. While the contract committed the manager to a bonus, the manager must pay a penalty if the target was not met. Contractors were often required to commit their own collateral as a form of performance guarantee. These guarantees, termed “bonding expenses” by Jensen and Meckling (1976), were intended to insure against agents engaging in certain actions, such as asset stripping, that would harm the interests of the supervisory agency or the public (Jefferson, 1998). About 20% of the contractors in SOEs committed some amount of collateral and the average payment was RMB14.258 (World Bank, 1992). On the other hand, it introduced the appointment of the contractor. Under the management contract responsibility system, the enterprise was still under the administrative control. The contractor was selected by the supervisory agency. According to enterprise surveys by the World Bank in 1992, 66% of the designated contractors were directors in enterprises and 92,8% of them were appointed by the supervisory agency. So, the government could still expand and strip the enterprise's operational autonomy at will and the management contract responsibility system did not prevent the government's interference.

3. Because the manager had little stake in the firm, the management contract responsibility system generated various types of agency problems. First, as management got more autonomy in decision-making, managers could illegally but safely claim more virtual residual than specified in the contract. Hiding profits and stripping assets are the most usual way. It was hard for the state to have judicial and administrative checks on their behaviour because of asymmetrical information. Secondly, the management contract responsibility system had improved the management's incentive to make short-term profits; the long-term incentive problem was not solved. Managers preferred distributing retained profits among employees or to make investments in quick revenue-generating projects, rather than making

investments in long-term productivity-enhancing projects and R&D (Huang, et al., 1998). In many cases, abnormal short-term profits were made at the expense of long-term productivity (Broadman and Xiao, 1997). The problem was so serious that the contract responsibility system was stopped after 1992 and the mechanism of *Modern Corporation* was launched as the key enterprise reform measure.

6.3.3 "Off-path" on the way

By the end of 1993, the economic system as a whole was still under the control of the government. After 14-year's "on-path" reform, the market mechanism was still under construction. It was a slow process and at the same time, government's control in enterprises had become more costly. The "on-path" reform faced more and more problems. On the other hand, after 14 years of reform a great change in the informal institutions was taking place.

6.3.3.1 Informal institutions

Fourteen years of reform has aroused the sense of the "individual" in the people and had encouraged people to put the individual's interest more central. "Making money is glorious" became the most popular slogan in China. With the introduction of markets and consistent incentives, people started to realize that their income level was dependent on their talent, efforts and the performance of the enterprise. Enterprises and individuals were seeking for high efficiency, the income gap was extended and equalitarianism was disappearing.

Individualism and self-consciousness were intensified and competition improved people's sense of independence and initiative. The relationship among people became more dependent on the exchange of wealth. Again *Guanxi* had an important role in the new system, but the emphasis of *Guanxi* was transferred from the bureaucratic hierarchy to the "making of money". Also then *Guanxi* bonded people through the exchange of favours to improve their own interests.

However, informal constraints do not change overnight. Strongly imbedded informal institutions take a much longer time to change (Lichtenstein, 1996). With the thousand years' influence of Confucian paternalism, the Chinese central government was still very powerful, though its influence in the economic system has decreased in recent years. Government continued to keep its power in the economy supported by the values of single-orientedness.

While the sense of individual economic interests was intensified, the values of group collectivism wavered, but did not disappear in the period under consideration. Chinese traditional culture does not encourage individualism so the initial types of private enterprise were "disguised" as collectively owned enterprises and Town and Village-owned enterprises (TVEs) (Chapter 3). An important reason being that the word “private” did not have a positive meaning in Chinese informal context. This situation has not changed until the end of 1990s.

Chinese reform changed some cultural traditions, but not all. The traditional culture still affects the economy to some extent. M&A is probably an appropriate case to investigate the new balance because it concerns the heart of the market economy.

6.3.3.2 Formal institutions

Two waves of “emancipation of the mind."

After 14 years of reform, analysts found that the Chinese reforms were entering into a fundamental dilemma of government control of firms: maintaining the government's control over firms entails high political costs because of arbitrary interference that did not fit a market economy, whereas expanding managerial autonomy induced high agency costs when managers had an information advantage and no obligations to accountability (Qian, 1996). This dilemma directly led to the decline of the financial performance (i.e. profitability) of SOEs. On average, profits and taxes per unit of net capital stock and working capital in state industrial enterprises fell from 24,2% in 1978 to 12,4% in 1990 and further down to 6,5% in 1996 (China Statistical Yearbook, 1997). In 1978, eight million SOEs owned 74,6% of total industry asset and contributed 77,6% of China’s total industrial output. 60% of the labour force in the urban areas worked in SOEs. One out of ten SOEs admitted losses. In the middle of the 1990s, there were constantly more than one-third of SOEs in the red. By 2000, about half of the 9.283 large-sized SOEs were in the red.

During his southern trip in the spring of 1992, Deng Xiaoping, the designer of the Chinese reform, made the point that "both plans and markets are economic means." He also criticized the debate on whether a reform was socialistic or capitalistic, saying: "Do not debate on this issue any more." "Carry out a reform so long as it is beneficial to the increase of social productivity, the country's overall strength, and the peoples' living standards." Following his remarks, the big ideological broke through occurred at the 14th Party Congress in September 1992 when the Party, for the first time, endorsed the "socialist market economy" as China's reform goal. This was known as the second wave of "*emancipation of the mind*".

At the 14th Party Congress in September 1992, the Party for the first time endorsed the "socialist market economy" as China's reform goal. A revolutionary goal was to be accomplished in a gradual way. With the objective of a market system in mind, this landmark document made four major advances in the areas of reform strategy, a rule-based system, building market-supporting institutions, and property rights and ownership. It was the turning point on China's road to markets.

China's reform formally entered the “off-path” reform, which was characterised as discarding the dominating public ownership and the planned economic system.

The 15th Party Congress held in September 1997 made a major breakthrough on ownership issues: Both state ownership and private ownership were important components of the economy. This was known as the third wave of "*emancipation of the mind*". In 1999, the 9th National People's Congress initiated to incorporate private ownership and the rule of law into the Chinese Constitution. An amendment of Article 11 of the Constitution placed private businesses on an equal footing with the public sector by changing the original clause "the private economy is a supplement to public ownership" to "the non-public sector, including individual and private businesses, is an important component of the socialist market economy" (China Daily, March 16th 1999).

Law system

The law system is path dependent because its efficiency in a given country depends largely on the rules and structures that the country had in earlier times. The laws and regulations that an economy has at any given point in time depend on, and reflect, the ownership and governance structures that the economy had initially. This provides another channel for the formal institutions to affect corporate governance. The initial structures affect future corporate rules, which in turn affect future decisions on corporate structures (Bebchuk and Roe, 1999).

After the 1990s a basic legal framework underpinning the corporate form has been established, including *Company Law, Contract Law, Accounting Law and Securities Law*. It is not surprising that the legal framework is biased to the state-owned economy because legal rules are the product of political processes, in which vested interests play a large role.

The *General Civic Law of the People’s Republic of China*, which came into effect on January 1987, stated that SOEs and collective-owned enterprises satisfying certain capital, organizational and approval requirements were to be turned in legal persons. It was not until July 1st 1994 that the *Company Law* provided the legal underpinnings for the concept of a modern enterprise system. The new legislation provided, for the first time, a firm legal foundation for the establishment and operation of companies. It provided rules for the incorporation of all enterprises of different ownership types into limited liability and limited liability shareholding companies and specified governance structures, rules regarding the transfer and sales of shares, and procedures for mergers and bankruptcy.

General principles of corporate law may often be the same across countries (Hansmann and Kraakman, 2000), but the implementation might be radically differently. The corporate rules system “in action” is more important than “in the books”. Bebchuk and Roe (1999, p.24) stated:

> *"What counts are all elements of a corporate legal system that bear on corporate decisions and the distribution of value: not just general principles, but also all the particular rules implementing them; not just substantive rules, but also procedural rules, judicial practices, institutional and procedural infrastructure, and enforcement capabilities".*

Interest group politics might be influenced by the existing distribution of wealth and power. They might influence the choice of legal rules and maintain inefficient rules.

> *"The dynamics of interest group politics depend on the existing pattern of corporate ownership. This introduces another source for the path dependence of legal rules. …Each interest group plays a role in the economic system and seeks to push for rules that favour it. Interest groups differ in their ability to exert pressure on legal rules that favour them or against rules that disfavour them. The more resources and power a group has, the more influence the group will tend to have in the political process. In particular, the existing corporate ownership structures will affect the resources (and hence political influence) that various players will have and thus the rules that will be chosen" (Bebchuk and Roe, 1999, p.29).*

For example, China's *Company Law* explicates a set of requirements for an initial public offer (IPO). However, it also allows issuers who are divested from SOEs or large and medium SOEs, to be exempted from these requirements so they can use pro-forma profit records. This provides incentives to establish SOEs for the specific purpose of listing, which are known as "packaging for listing." The packaged shell companies often do not have a meaningful track record, and their business models are at times ad hoc. Thus the companies that are listed on China's stock exchanges are mostly SOEs. They have strong links with the government, especially local governments, and their boundaries with their parent groups are relatively new and often artificial.

Many studies show that the purpose of the government promoting the development of the stock market is to raise funds for state-owned enterprises (Zhang, C., 2002). For the non-state-owned companies, the most feasible way to be listed is to acquire the controlling right in a listed company and get the listing qualification. That is why the acquiring firms are willing to pay substantial premiums for their acquisitions as shown in our empirical study.

The first related regulation on M&A, "*Interim Provisions on the Management of the Issuing and Trading of Stocks*", issued on April 22nd 1993, stipulated that no individual was allowed to hold more than 0,5% of the common shares issued by a listed company directly or indirectly. In fact, this article deprived the right of private companies to merge or acquire a state-owned enterprise. But at same time, it also limited the fraction of the managerial ownership losing an effective tool to constrain the agency problem. The constraint on private shareholding has been kept in effect until the announcement of *Securities Law* in 1999. Our empirical study found that Chinese top managers hold a small percentage of common shares in their companies; the average percentage in our sample is 0,03% with a range from 0 to 0,08% (Chapter 5). Small ownership is unable to bond managers' behaviour and may lead to serious agency problems. We showed that managerial objectives might drive mergers: the merger brings no benefit to the bidding company, but the managers' cash compensation of increases with the growth of the company.

6.3.3.3 Corporate governance and M&A

From 1992 onwards China initiated a reform, which aimed to separate the government from enterprises through a corporatisation scheme. It called for the first time for the establishment of modern corporations, placing the emphasis on the reorganisation of large and medium-size SOEs into legal entities through corporatisation, and on the clarification of property rights (Tam, 1999). Now most SOEs have been converted into shareholding companies. The corporate governance structure of a typical company is showed in Figure 6.4, which is a mix of the Anglo-American Model and the Continental Europe Model. However, the present situation strongly reflects the typical Chinese path of development resulting in a strong position of dominating state shareholders and a role of M&A, which is typically aimed at the restructuring of SOEs. In theory the laws and regulations make it possible in China to establish an effective system of corporate governance, which is similar to for instance the German system; practice shows that the typical Chinese characteristics influence the picture in such a way that the present system of corporate governance is a far cry from that model.

In theory shareholders are at the top of the corporate governance structure in China. According to China's *Company Law*, shareholders meet at least once a year at either the annual conference or special shareholder conferences. At the annual conferences, shareholders[27]:

(1) Vote on the company's operating strategy, investment plan, and other important issues such as changes in registered capital, debt issuance, mergers, dissolution and liquidation of the company, and amendments of the company's articles of association;
(2) Elect members of the board and the supervisory committee, and determine the members' compensations;

[27] *Company Law* of China, Provision 103-104. A special shareholder conference may be called when (1) the number of board members attending the annual conference of shareholders is less than what the law requires; (2) the company has a loss exceeding one third of its owners' equity; (3) requested by owners with more than 10% of the company's outstanding shares; (4) requested by the board of directors; and (5) requested by the supervisory committee.

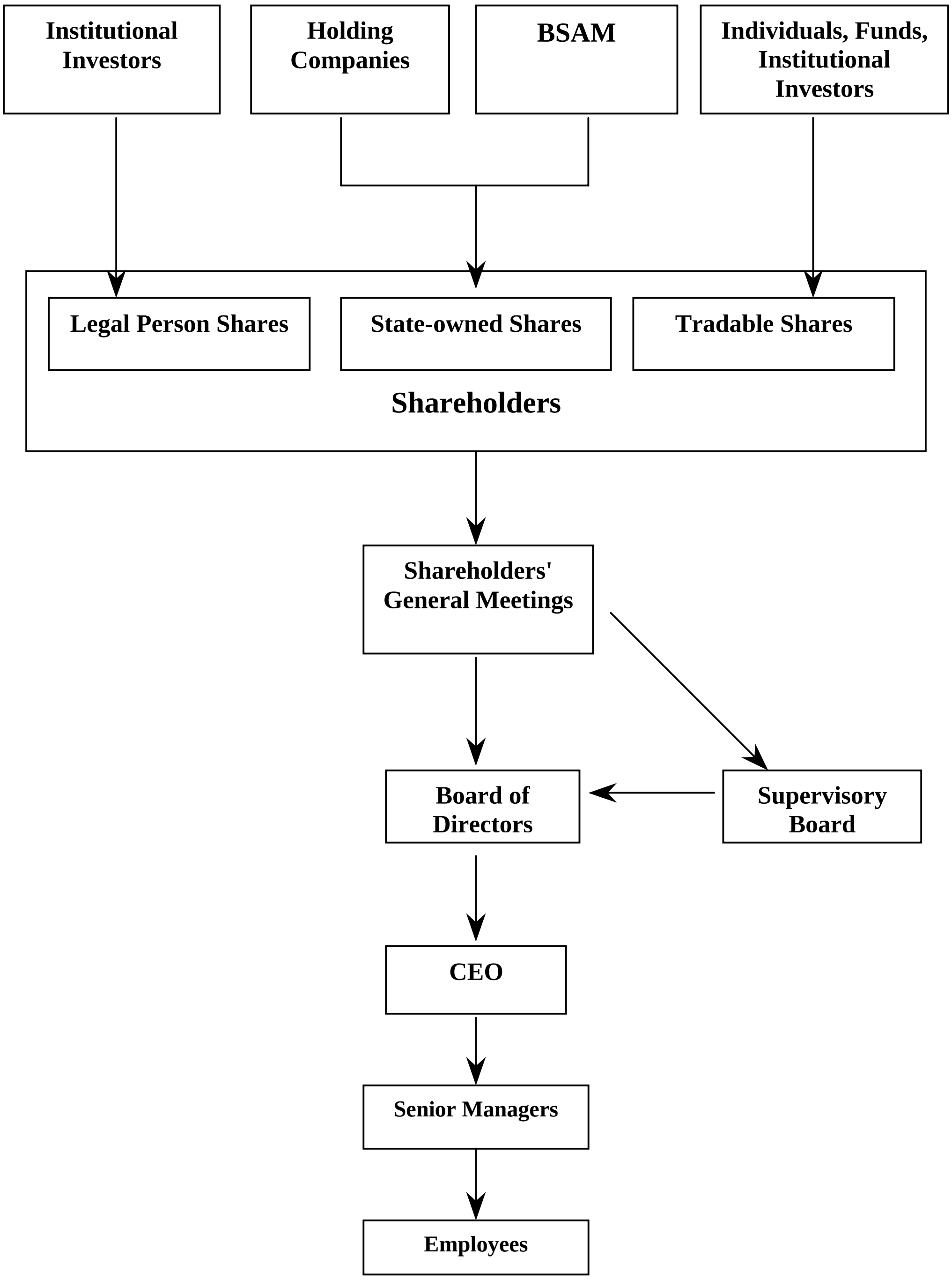
(3) Review and approve the annual reports by the board and the supervisory committee, dividend policy, and the budget for the next year.

Practice in China is the existence of type of shares that are typical for the path of development and differ strongly from the US or Germany. As explained in Chapter 4 all shares are classified as domestic (A-shares) and foreign (B-, H-, N-shares). A-shares are divided into four subcategories: the state shares, the legal person shares, the tradable shares and the employee shares. Only the tradable shares and B-shares are traded in the two open markets.

The state shares are shares held by the central and local government or holding companies (solely-government-owned enterprises). The ultimate owner of state shares is the state council of China. The Bureau of State-owned Asset Management (BSAM) or a government investment company acts as the agent of the state. For listed companies in which the state owns equity, local offices of the BSAM or officials of local finance bureaus exercise ownership rights on behalf of the state. The BSAM collects dividends and submits them to the Ministry of Finance, while the local finance bureau can use them as revenue of its own. State shares are not allowed to be traded in the open market, but they could be transferred to legal and natural persons within and outside China. Besides the agreement between traders, the transfer of state-owned shares must satisfy the requirements of relevant state law, administration regulations and industrial sector policies, such as the *Regulations on state-owned shares in the stockholding company and the regulation from Bureau of State Property Management, No.32 (1997)*. For example, the *Regulation from Bureau of State Property Management*, *No.32* (*1997*), announces that the transfer price for state-owned shares must be higher than its net equity per share. That is why the premium is found in our sample cases no matter how poor the target is (Chapter 5).

The legal person shares are shares owned by institutions, including domestic and foreign institutions. In China, the legal person is defined as a non-individual legal entity or institution. In official documents, domestic institutions include stock companies, non-bank financial institutions and SOEs that have at least one non-state owner. Securities firms, trust and investment companies, finance companies and mutual funds are major non-bank financial institutions. According to the *Commercial Banking Law of China*, which came into effect in 1994, China's banks are not allowed to underwrite, hold and trade shares of firms. State-owned legal person shares are held by institutions in which the state is the majority owner but has less than 100% shareholding. So shares directly and indirectly owned by the state include the state shares and the state-owned legal person shares. Like the state shares, the legal person shares are not tradable in the open market, but they can be traded between institutions upon approval from the government.

Figure 6.6 Corporate Governance Structure in China



The tradable A-shares are held and traded by individuals and domestic institutions. In order to have enough shareholders, *Company Law* (Article 152) requires that the number of shareholders, who hold shares of a par value totalling at least RMB 1.000, is not less than one thousand. So for the company whose total share capital is not less than RMB 50.000.000 shares issued to the public must account for over 25% of total outstanding shares; for the company whose total share capital exceeds RMB 400.000.000 shares issued to the public must account for over 15% of total outstanding shares. The employee shares are offered to employees when the company makes its IPO. They could be traded after a period of 6 to 12 months. The issuance of employee shares stopped in 1998, because most employees were not willing to hold their company's shares and sold them after 6 months.

As explained, B-shares are available exclusively to foreign investors and some authorised domestic securities firms. In 2001 the government allowed domestic investors who had foreign currency, to buy B-shares. The B-share market is separated from the A-share market, with SSE (Shanghai Stock Exchange) B-shares denominated in US dollar and SZSE (Shenzhen Stock Exchange) in Hong Kong dollar. H-Shares are issued and traded at the Hong Kong Stock Exchange. N-shares are listed on the NYSE.

Chinese listed companies have a mixed share structure with state, legal persons and individual investors as the three dominant groups of shareholders. Table 6.2 reports the share structure of China's listed companies from 1992 to 2003. The state shares are the largest part in the stock structure, which part declined between 1992 and 1997, but from then on gradually increased again until a level even higher than in 1992.

Table 6.2 The Share Structure (1992 - 2003) (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number of firms	53	183	291	323	530	745	851	949	1088	1160	1224	1287
Fractions of State shares	41,4	49,1	43,1	38,7	35,4	31,5	34,6	36,1	38,9	46,2	47,2	47,4
Fractions of legal person shares	26,5	20,7	22,5	24,6	27,1	30,6	28,3	26,6	23,7	18,3	18,1	16,9
Fractions of tradable shares	29,8	27,8	33,1	35,6	35,2	34,5	34	34,9	35,7	34,8	34,7	35,7
Others	1,2	2,9	1,2	1,1	2,2	3,2	3,2	2,3	1,5	0,8	0	0

Source: Calculated from the statistic of China Securities Regulatory Commission (CSRC) (cited January 20th 2004), Stock and Future Yearbook (2002), p.132.

In the period we studied, we found that the ownership of stock in listed companies is concentrated (Table 6.3). Especially the largest shareholder usually holds an average of over 40% shares and dominates the company. Other nine largest shareholders just hold around 20% shares on an average. We also found about 60% of the largest shareholders to be either the government or its representatives. In theory, all the shares entitle shareholders to have the same dividends and voting rights. In practice, the largest shareholder has a strong influence on firms because of the high concentration of stocks. For example, the company may have different dividend policies for different shareholders, for example to pay the large shareholder cash dividends, but to offer other shareholders stock dividends. This policy is prohibited as off 1998. Moreover, tradable A-shareholders are in a disadvantageous position due to the lack of proxy voting procedures.

Table 6.3 The Concentration of Stocks (%)

	1997	1998	1999	2000
The largest Shareholder	44,73	45,16	45,44	44,82
Top 5 Shareholders	58,69	59,16	59,87	59,22
Top 10 Shareholders	61,75	62,19	62,85	61,85

Source: Yu, D (2002)

The board of directors is the decision-making body of the listed companies. Shareholders should control the board in order to protect their interests in the firm. According to China’s *Company Law*, the number of the board directors ranges from 5 to 19. It is responsible for:

(1) Calling and hosting the annual or special shareholder conferences, and reporting to shareholders.
(2) Executing resolutions passed by shareholders.
(3) Making up the company's operating and investment plans, dividend policies, and debt and equity financing plans.
(4) Making proposals to merge, separation, and dissolution of the company.
(5) Determining the company's internal organizational set-up, rules and regulations.
(6) Appointing or replacing top managers; approving nominations of vice general managers and CFO by the general manager; setting their compensations.

The supervisory committee plays a fairly passive role in corporate governance. It carries out the following duties (*Company Law*, Provision 126).

(1) Overseeing financial operations of the company.
(2) Watching board members and managers for violations of the company's bylaw.
(3) Correcting decisions by board members and managers if they hurt the interest of shareholders.

(4) Calling special shareholder meetings.
(5) Supervising board meetings.

In theory this looks like the systems we know from established market economies. In practice it turns out that the composition of the board and the supervisory committee largely depends upon the founders' administrative affiliation and their ownership before going public. As explained, most of China’s stock companies are either created by transforming SOEs, or launched by a group of legal persons. A large number of the members in the board and supervisory committee are from the holding companies and the government or its representatives. They can be party’s leaders, managers or trade union cadres. Other members are from social institutions, which have little relationship with listed companies, such as professors, lawyers or other experts (they are non-owners). Few members are individual shareholders. Xu and Wang (1999) studied about 154 China’s listed companies and found that 90% of the members of the boards and supervisory committees were from the state, holding companies or other legal person institutions; 60% were the representatives of the largest shareholders; 10% were the non-owners and there were almost no individual shareholders in the boards and supervisory committees.

China is a clear case of so-called “insider control”. Xu and Wang (1999) found that 50% of the members in the board of directors were managers and 77% of the members in the supervisory committee were employees in the firm. He (1998) studied 406 Chinese listed companies and revealed that 67% of the members in the board were insiders. Li (2000) investigated 91 new listed companies from 1998 to 1999 and recorded that 49,5% of the members in the board of directors were employees in the firms.

In China's listed companies, most top managers (like the CEO and the CFO) are members of the board of the directors. For example, 72,61% of the general managers are member of the board of directors. In 16,91% of the listed companies, the chairmen of the board of directors and the general managers are the same person. Meanwhile, the fraction of top managers' share is only 0,02% of the total shares. In 20% of the companies, top managers do not have any shares of their own company (Yu, 2002).

In theory, China’s *Company Law and Securities Law* provide for a complete and effective system of corporate governance structure. In practice the path China is developing demonstrates specificities that can be characterized by the following features:

1. Powerful Large Shareholders. According to China’s *Company Law*, monitoring mechanism in China’s firms comprises three main constituent bodies: the shareholders’ general meeting; the board of directors and the board of supervisors. In practise, the monitoring by the single large shareholder (the state or holding companies) is very weak. Because of the concentrated shareholding and voting system, the large shareholder controls the shareholders’ general meeting. The board chairman, most members in

the board of directors and the general manager are usually appointed by the controlling shareholder (Lin C., 2000). The other board members are appointed in proportion to the other major shareholders. The ratio of non-executive directors is very low.

Modelled after the German two-tier system, the supervisory board is established in China's corporate governance system. The supervisory board consists of shareholders' and employees' representatives, but the ratio is not fixed in China's *Company Law*. In fact, these employees cannot carry out effectively the supervising role, because they want to avoid confrontation with their superiors in the company. There is hardly any evidence of supervisory boards performing effective oversight functions over the executive board and senior management.

2. Inadequate Protection for Minority Shareholders. The near-absolute control exercised by a controlling shareholder represents the feature of an insider system. The company is run largely in the interest of insiders to the potential detriment of outsiders and other stakeholders (Lin C., 2000). In many Chinese listed companies, the decision structure lacks the transparency. The large shareholder often abuses its power to infringe upon both the interests of the company and other shareholders. For example, it is common practice that the holding company controls a large amount of capital of the listed company for a long term.

   Minority shareholders and other stakeholders are regarded as outsiders of the company. From the management's point of view, they are just speculators who expect to free ride on the company's performance. Minority shareholder's status and interest are not equally respected and safeguarded. They have little chance to "interfere" in the company's "internal affair" (Lin C., 2000). The protection of the interests of minority shareholders should come from external institutions. The China Securities Regulatory Commission (CSRC) is empowered to inspect and supervise listed companies. CSRC is the most powerful institution to enforce transparency and to protect shareholders' interests. It emphasizes the formulation of rules and regulations concerning the securities market and regulating the offering, trading, registration, custody and clearing of securities (*Securities Law*, Article 167). External auditing agencies perform audits of the firm annually according to the "Independent Auditing Standards for Certified Public Accountants". But as explained, the control costs are high because management have an information advantage and a close relation with bureaucrats and politicians.

3. Weak Managerial Incentives. The relationship between managerial compensation and performance of the firm is blurry in China. The first reason is that cash compensations for managers are not transparent,

> especially when the company's performance is poor. The second reason is that the salary in cash is just a small proportion of the management's total income. Senior management gets a significant part of their income in the form of non-monetary and fringe benefits. It is suggested that stocks and stock options can be used to constrain managerial behaviour. We found senior management to hold shares of their own firms in 80,1% SSE-listed companies, but as stated earlier, the average ratio is just 0,02% of the total shares and the highest is 0,53%. Stock options are tested in several companies but it was not successful. The underdevelopment of China's stock market is an important factor that hinders stocks and stock options to give appropriate incentives for management to maximise the value of the firm.

Our study makes it clear that initial structures might persist because players enjoying rents have both the incentive and power to impede changes in these structures. Due to rent seeking, structures in place might be maintained even if they are no longer efficient from a societal point of view. Changing an ownership structure often requires the cooperation of the parties in control and for that reason it can be wise policy to make changes in such a way that the powerful continue to benefit.

Also M&A fits in the specific path of China’s development. Mergers with SOEs began with small and medium sized SOEs, especially those with poor financial performance. But the core of the SOE sector – the large and profitable state-owned enterprises, was not involved. As explained in previous chapter, M&A was experimented by local government in a few provinces such as Shandong, Guangdong, and Sichuan as early as 1992. Later, the central government endorsed it under the policy of “grasping the large and releasing the small.” Our empirical studies found that takeovers in China were directed at poorly performing companies and that the turnover rate of top management of target firms increased dramatically after a takeover. This is similar to the M&A we see elsewhere.

A closer look reveals that in fact, Mergers and Acquisitions are one of the most important methods of “non-nationalization”. As explained, M&A usually does not decompose the enterprise but allows for restructuring by others, thus facilitating SOEs to accomplish their governance transformation. From the beginning of the reform, the Chinese government insisted to follow a more gradual, experimental approach and to avoid major economic disruptions. Maintaining political and social stability concerns the power of the ruling group and to prevent riots of large parts of the deprived population. Reforms should not harm the powerful too much, because government needs their cooperation. Stability is in the interests of the large public and when government is able to show that the reforms also bring material wealth to them, the role of the Communist Party is legitimised. The government needs to buy political support from the members of the ruling group who should be compensated if reforms make them potential losers.

The lack of a social insurance system outside the enterprises is also an important reason why M&A were welcomed as an instrument in the reforms. It was well recognized that SOEs in communist countries are an institution not just for generating profits, but also for serving many other purposes, including the provision of social welfare, such as housing, health care, pension funds, etc. Without a social insurance system, which is independent of the enterprises, laid-off workers would riot, which directly threatens the position of the ruling group.

The typical Chinese method of M&A is related to the type of shares: the acquiring firm has to negotiate with the large shareholder for the acquisition of the controlling right. Also the transaction price is not totally decided by the market. According to the *Regulation of the Bureau of State-owned Assets Management, No.32 (1997)*, the transfer price must be higher than its net equity per share, no matter how poor the company is. For example, Shanghai Yongjiu Company (600818), a listed company at the Shanghai Stock Exchange, launched the acquisition announcement on July 20th 2001. It announced that the controlling shareholder, Shanghai Industry Group, had decided to transfer its state-owned shares (about 54,07% of outstanding shares) to a private company, Zhonglu Group. The price was RMB 0.0692 per share, which was lower than the net equity per share. After the transaction a private company would control Shanghai Yongjiu Company. But the acquisition did not come true until October 8th 2002 when Shanghai Yongjiu Company announced that the acquisition had been approved by the authority, but the price was raised to RMB 0.2372 per share, 300% higher than the previous one and the same as the net equity per share. So the acquiring company, Zhonglu Group, had to pay about RMB 24.13 million more.

The above case is not incidental. Rules that enable controllers to extract large private benefits from the control are common practice in publicly traded companies. In a country in which ownership is largely concentrated, controlling shareholders of existing companies are powerful interest actors with substantial resources.

6.4 Concluding Remarks

In contrast to the “Big Bang” in East European countries, China’s gradual reform has produced an impressive economic result during the past 25 years. Standard economic tools do not seem appropriate to analyse such an extremely complicated issue. Institutional economics supplies concepts and tools that seem more useful to analyse processes of transition in countries like China. Williamson (1998) provides a helpful four-layer-framework: informal institutions, formal institutions, institutional arrangements and markets (Figure 1.1). The higher levels constrain the lower ones: the informal institutions constrain the formal ones, which set the boundaries for institutional arrangements to be established like M&A.

NIE focuses on the property rights (Level 2) and the institutional arrangements (Level 3). It denies the feed backs from the lower levels to the higher ones and isolates individuals from institutional structures. NIE tries to explain institutional arrangements given the (in)formal institutions. The core of our theoretical framework is the OIE, which is useful to create a dynamic framework (Figure 6.3) to study the processes of institutional change in China. Especially the theory of path dependency seems adequate.

What makes institutional changes in China differ from those in East European countries is the more incremental, path-dependent nature of the changes. The approach is gradual with government in control of the experiments. In the analysis in this chapter of the interactions between the institutional layers and the actors we have tried to show that path dependency and how value structures, legal structures and power structures reinforce each other. We have the strong impression that the designed incremental process of change allowed all parties involved to learn from the experiments. The resulting institutional structure clearly is a mixed bag, in which powerful actors have privileges and are in control of the changes. Beside those developments also “non-state” economic actors were offered more and more opportunities to create new institutional arrangements creating a “bag that is even more mixed”.

Although the process of transition clearly is of an incremental nature, many small steps can cumulatively result in fundamental “off path” developments. In our opinion such a process started in 1993, but until today the central role of government has not really changed.