

## **Chapter Seven**

### **Conclusions**

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#### **Introduction**

The general objective of this study was to analyse the process of Chinese institutional change in the last three decades paying specific attention to the transition of SOEs and the role of M&A in that process.

Using the insights of institutional economics, we firstly described the process from 1949 onwards in the Chapters 2, 3 and 4. In Chapter 5 we examined listed firms involved in takeover deals empirically. In Chapter 6 we developed a dynamic framework to analyse the interaction between the institutional layers of (in)formal institutions, institutional arrangements and the actors.

In this concluding chapter we first provide an overview of the thesis (Section 7.1). In Section 7.2 we discuss the findings in relation to the research questions formulated in the first chapter. We describe the process of institutional change and present three possible scenarios for future developments in China's institutional framework.

#### **7.1 Overview of the Thesis**

In Chapter 1 the general research question is formulated as one with a focus on understanding the process of institutional change in China. Evolution and path dependency are then relevant concepts, which are central in institutional economics. The two pillars of institutional economics – the new and the original one – are briefly discussed in Chapter 1. Three levels of institutions are systematically examined in this thesis: the informal institutions, the formal institutions and the institutional arrangements with a focus on governance structures in State Owned Enterprises and Mergers and Acquisitions.

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The transition in China is generally considered to be a process of incremental change, a process of path dependence, in which history plays an important role for understanding the present and the future. That is why Chapter 2 gives an overview of the evolution of the planned economic system in the three decades (1949-1979) before the market oriented reform started. Chapter 2 describes the planned economic system in terms of informal institutions, formal institutions and the governance structures. It is argued that China's informal institutions are rooted in Confucianism, with large implications for the role of the state and the position of the individual. The central state controlled the allocation of resources, the distribution of goods and the determination of prices. The whole economic system was organised as a multidivisional firm with the central government acting as the corporate headquarters and state enterprises as its production divisions. It is explained why the centrally planned system was inefficient, what the content of the reforms was and their results. Insights from property rights and agency theory proved to be relevant. Economic and political drivers made the state to take initiatives to fundamentally reform the system.

Since the end of 1970s, China has been on its way to transform the economic system into a market-oriented economy. Following the structure in the previous chapters, Chapter 3 discusses the changes in the different institutional levels. The reforms aroused individualism and self-consciousness, but maintained the primacy of politics. After setting the goal of a "socialist market economy", a series of well-planned radical changes in policy were introduced, such as tax, and financial and social security systems. At the same time, laws and regulations were accepted concerning property rights and corporate governance, including the privatisation of agriculture, the restructuring of state-owned enterprises and the promotion of the non-state sector. It is shown how the past strongly influences the nature of the reforms causing problems especially in the SOEs. It is also shown that government took the lead in the formulation of policy, in informing the people and in adopting new laws. In this stage of the transition, government started experiments the testing of different options. They learn by trial and error, while keeping control over the process.

Chapter 4 pays special attention to Mergers and Acquisitions (M&A) in China, which potentially imply an important change of the property rights. The emergence of Mergers and Acquisitions during the transformation process is explained and a description of the Mergers and Acquisitions activity in the two national stock markets – Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZES) is provided. Since the mid 1980s, experimentation with mergers and acquisitions in China began with small firms. In the 1990s, more and more large enterprises became subject to a change of property rights through M&A. Although the Chinese stock market provided a growing stage for M&A, the absence of a well-functioning legal framework limited the effectiveness of the stock market as a market for corporate control. M&A was typically fitted into the Chinese institutional setting and was an instrument in the policy towards restructuring the SOEs. This made

Chinese M&A is something very specific with a very strong involvement of government. The power structure was not affected by new laws and regulations; the communist party, the bureaucrats and the *Guanxi*- relations were not distorted. However, flexibility and experiments were introduced and stimulated in the non-state sector, whereas at the same time more autonomy was given to the regions and local communities.

The main purpose of Chapter 5 is to reveal features of takeovers in China's transformation and to test the role of takeovers in the restructuring of state-owned enterprises (SOEs). We take listed corporations on two national stock exchanges as the sample of SOEs for the state holds the controlling rights in these companies directly or indirectly. Being Different from those in the West, takeovers targets listed on a Chinese stock exchange are not absorbed by the bidder. Instead, the bidder gains control over the target company through the purchase of a large equity stake in the target's company. In this model, the state continues to play a very important role in the process of takeovers, especially when the state or the state-owned enterprises are the largest shareholder in listed corporations. For example, the price of non-tradable state-owned shares is decided by the negotiation between the state and the bidder, but not by the market. So it is not surprised that M&A in China have the characteristics of a "Mixed Bag".

In order to investigate the characteristics and the effects of takeovers in China, we collected information on 221 takeover cases that took place between 1997 and 2003. Using both accounting data and stock market data, three empirical studies have been executed. The empirical studies revealed some similarities between China's M&A with those in the West.

Firstly we confirmed the hypothesis that the takeover was viewed as a positive information event. The empirical study found that there was positive and highly significant average abnormal return in the stock market around the announcement date and the trading volume appeared to be much higher than that in normal periods. On the other hand the study found a high jump of stock price before the announcement, which means there is a significant leaking of information and the insider trading.

Secondly the hypothesis that takeovers have disciplinary roles was confirmed in two approaches. Targets that were characterised as having poor performances showed a significant improvement in their accounting performance after the deal. In the other approach, we found that the turnover rate of the top management of target firms increased strongly after a takeover and most of newly appointed chairmen of the board or the top managers were outsiders.

Thirdly, evidence was weak but pointed to managerial objectives driving takeovers that reduced bidding firms' profitability and shareholders' wealth. A straightforward regression test indicated that the cash compensation of management increased with the growth of the company. Meanwhile, very limited management share ownership appeared unable to bind managers' behaviour.

Our empirical study of M&A has some limitations. The first is the difficulty to compare our results with the findings in studies of M&A cases in western economies. It is difficult to find a “standard case” in China’s stock market with the same characteristics as one would find in a developed stock market. For example, China’s listed firms are hardly absorbed by others after M&A; also the unavailability of data prevents us from conducting the empirical tests in this thesis with a larger sample and for a longer period. The second limitation concerns the low percentage of listed firms in China. The third limitation is that this thesis excluded M&A cases that were initiated by insiders (such as management buyouts) and foreign investors. All the limitations will become less pressing when the stock market will further develop. Especially larger Chinese enterprises, including the four state-owned banks, will become listed in the coming three years.

Chapter 6 interprets the findings of the previous chapters using the theoretical framework of which the outline is discussed in Chapter 1. In Chapter 6 a more detailed account is given of the developments in NIE and OIE. Special attention was paid to the findings with respect to path dependency, power relations, and “mental maps”. We also tried to conceptualise institutional change in order to contribute to the building of a theoretical framework appropriate to study institutional change in more general terms. In terms of Figure 1.1, we analysed in Chapter 6 the changes in informal institutions, formal institutions and institutional arrangements and tried to show how the Chinese economic system after the reforms largely depended on the structures that existed in the previous stages. What distinguishes the institutional changes in China was its incremental, trial and error character. The government kept the control over the experiments and developments.

Although the distinction between “on path” and “off path” is questionable, for our purpose it turned out to be useful. The Chinese “on path” reforms can be understood from the strong influence of Confucianism giving a central role to government. The formal institutions that government installed clearly have a character of “ceremonial encapsulation” (Bush, 1987, 2003, 2004) keeping the powerful in control. Also the institutional arrangements of governance structures and types of contracts were kept consistent with the (in)formal institutions and power positions for many years. Nevertheless, many small steps can lead to fundamental changes. We consider the steps after 1993 going into a direction, which can be interpreted as a fundamental change towards a socialist market economy with fundamentally different property rights. However, until today this has not led to a fundamental change in the controlling role of government.

Our theoretical studies on China’s institutional change had clear limitations in several ways. Firstly it is difficult to analyse in detail the process of changes in the informal institutions. Changes in values and norms can be shown in a broad survey research over a relatively long period of time. Such a systemic research does not exist in China yet. Secondly, in analysing the findings in the previous chapters we followed in Chapter 6 the layers of Figure 6.2 and tried to catch the process of interactions between the different layers of institutions. As expected this turned out

to be a complicated endeavour: we lost rigorousness in order to gain relevancy. Thirdly our research does not provide an analysis of the learning process. China's reform is gradual and experimental and involves a virtual spiral of "trial – error – withdrawal – learning – re-trial". To really understand the learning process in depth case studies are required in specific firms, sectors or regions.

## 7.2 Research Conclusions

In order to understand the process of Chinese institutional change in the last three decades, the thesis focuses on the transition of SOEs and the role of M&A in that process. The central question of this research was presented in Chapter 1:

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

The specific objectives of this study are fourfold, namely: (1) how did the Chinese economic system work in the pre-reform period? (2) how to characterise the process of change? (3) how to characterise the present stage of the transformation towards a market economy? (4) how will the processes of institutional change since 1979 influence the future changes in the Chinese system?

### 7.2.1 The CPE in the pre-reform period.

China's informal institutions are rooted in Confucianism. This culture fosters social hierarchical relationships, family-ism, collectivism and equalitarianism. The CPE after 1949 with a central role of government and a neglect of the interests of the individual was compatible with the Chinese informal institutions. In the pre-reform period, almost all enterprises were state-owned and as "agents" attached to a central or local "principal". The government appointed managers and financed firms' projects; managers had little autonomy over investments. We discussed how the CPE system turned the Chinese economy into one big multi-divisional enterprise. Thirty years of planning left deep traces in society, especially with respect to the values, norms and mental maps of the politicians, bureaucrats, and managers.

### 7.2.2 The nature of the transition process

China's transformation towards a market economy can be characterised as incremental and "on path". Many small steps did not change the logic of the system until 1993; the logic of the collective property rights continued to be aligned with central planning. The analysis showed that government has been in the driver seat to initiate institutional changes. That role was consistent with the values and norms of Confucianism. Inefficiencies were the drivers for politicians to make small changes into the direction of more market. Ideology and power structures did not change until the mid 1990s; the process was experimental and gradual. During the first fifteen years of the reforms a "grand strategy" for the transition to a socialist market economy was missing.

The step towards a "fundamental", revolutionary change in this study is operationalised with the concept of "off path development": when the logic, or nature of the system is changed we consider the development "off path". We identified the property right structure as a crucial indicator of the logic of the CPE and found out that the reforms until 1993 did not really change the property right structure in the economy. SOEs continued to dominate the economy and the reforms were allowing managers more autonomy within the state owned property right structure. After 1993 we saw the problems of central planning increasing and both the informal and formal institutions in interaction started to change the logic of the system. The "off path" development brought other property rights structures into the Chinese system; first more collective types of property and gradually also (foreign) private property was made possible. A series of market supporting institutions were gradually established to replace the "rule of the government" by the "rule of law", such as the law system, tax and fiscal system, the monetary and financial system, and the social security system. At the same time non-state owned enterprises expanded their scale.

Rather than mass privatisation of existing SOEs, as was the case in many East European countries, most of the first private enterprises in China were initiated by entrepreneurs and not the result of the privatisation of SOEs. It is not until 1993 that a large number of first small- and medium-sized SOEs were privatised.

Corporate governance began to change in 1979 and arouse intensive attention in the late 1990s. The "household responsibility system" had been successfully introduced into China's agriculture. In this system, households became residual claimants and obtained control rights over production. In the industrial sector, SOEs experienced the "profit responsibility system", "the tax substituting for profit remission" and the "managerial contract responsibility system" and "corporatisation". In the governance structure, government kept its controlling rights in most enterprises while there is a lack of effective motivating and monitoring of management. The failure of SOEs, especially large-sized SOEs, still is one of the most serious problems in the transformation. It urged the government

to fundamentally change the property rights, which would imply a major step towards the social market economy.

### **7.2.3 The present stage of the transition process**

In the informal institutions Confucianism still plays an important role: people still respect and accept the authority of the government. In the Chinese setting the word “public” is felt to be more positive than “private”. On the other hand, individualism and “making money” are well accepted nowadays. The “mixed bag” seems to be very mixed in the years after 2000.

Also in the formal institutions the present state clearly shows fundamental changes. State ownership is downgraded to a "pillar of the economy" and private ownership was elevated to an "important component of the socialist market economy". Privatisation also of the large SOEs is nowadays an accepted policy, including foreign firms taking over Chinese ones even in key sectors like energy and water the doors are opened. With respect to M&A it has been shown that these institutional arrangements fitted well in the path described above: first an instrument in the hands of the central planners and nowadays moving into the direction of a market for corporate control. But China is far from a situation comparable to developed capital markets. As discussed in Chapter 5 government controls developments, and powerful insiders determine the conditions of the deals. As our empirical studies show also here the “bag is very mixed” and clearly in a state of transition.

### **7.2.4 The future of China's institutional framework**

In the literature about the dynamics of economic systems the issue of convergent or divergent systems is prominent (Whitley, 1999). Broadly speaking economists are inclined to see systems evolving into the direction of one optimal end state, whereas sociologists, political scientists and historians see more reasons for divergence. In Chapter 6 we discussed the work of Aoki and North in which multiple equilibria and path dependency are central. In our study we also found strong reasons for divergent systems and that the future of China's economic system will be one of a more or less unique constellation of institutions. To provide more solid arguments for this position we are in need of more in depth knowledge of the interactions between the different institutional layers.

Many researchers in institutional economics conclude that for understanding the dynamics of a system the interaction between (in)formal institutions, institutional arrangements and the mental maps of the individuals is the key to understanding the causalities. Also our study demonstrates the need of such an analysis. At the same time it is generally recognised that we know very little about the interactions, that the conceptual frameworks are limited, that we know little about trial and error, about learning, and about trust emerging and disappearing. Our study has shown

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the importance of the interrelations between culture, politics and economics for understanding the institutional changes in China with respect to specific institutions like the SOEs and M&A. It has become clear that general theories provide useful insights into general causalities, which always need enrichment with institutional specificities of time and place. Moreover, in taking the specificities on board many of the generalities became more meaningful because of the deeper insights into the conditions under which specific institutional changes take place. It seems also to be true that cases like the one of China provide insights to construct theoretical models at more abstract level; what are the general conditions under which a development like the Chinese one could take place? What are the differences with other economies in transition? A comparative analysis would provide us with more useful information. That is not only the case when comparing different countries, but is also the case when comparing different regions and industries within China. In depth comparisons will provide the necessary material to become more explicit about the conditions under which certain developments take place.

### *Future scenarios*

As indicated above, developments in China's institutional framework are characterized by (1) experiments that can quickly be reversed (trial and error), and (2) a focus on keeping control of the process. The restructuring of the SOEs is a good example: China's authorities clearly recognize the importance of property rights for the companies' future outlook. We distinguish three possible future scenarios.

#### *Scenario 1 Staying on track*

In this scenario the current pattern of trial and error continues, delivering a gradual process of successful institutional change. This is our central scenario, with high probability (60%).

#### *Scenario 2 Losing control*

The Chinese authorities run the risk of losing control. Should one or more of the economic risks described in Chapter 1 materialize, e.g. a widespread banking crisis, the government will have a hard task dealing with the consequences. In such circumstances, China will be unable to follow its preferred pattern of trial and error and is forced to take draconian measures. While such a scenario is unlikely (15%), it is by no means hypothetical. The banking system, for example, is virtually bankrupt and highly dependent on high and stable economic growth. When the Chinese people become wealthier, they may seek to gain more influence in political issues, which could very well undermine the current control.

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### *Scenario 3 Accelerating change*

Should everything go very well, the authorities could decide to accelerate the process of institutional change and grant more power to holders of private property rights. They may judge further privatization is in the interest of the Chinese economy as a whole and allow truly private companies to operate in China and purchase both healthy and ailing Chinese companies. Given their positive experience with the process of gradual change, the authorities are unlikely to change their ways at this stage. Hence the likelihood of this scenario is relatively low (10%).

