

Path Dependence and Path Breaking in Chinese State-owned Enterprise

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Abstract—Based on the theory of path dependence, this paper first reviews the reform process of Chinese enterprise and testifies that the evolution of Chinese State-owned Enterprise is path dependent, and then proposes some solutions for breaking up the path dependence in Chinese SOEs.

Keywords—*institutional change; path dependence; path breaking; SOEs*

I. INTRODUCTION

Path dependence means that where we are now is only a result of what has happened in the past. In economics, path dependence means that equilibrium allocations depend on history (Liebowitz and Margolis, 1995). State-owned enterprises (SOEs) are enterprises which are invested and controlled by the state. SOEs exist in various countries due to the comprehensive effect of many factors, such as market failure, regulatory defects, social objectives, etc.

The issue of path dependence in Chinese state-owned enterprises (SOEs) emerges with the reform of economic system in 1979. Before 1979, China was a centrally planned economy. The public authorities controlled all enterprises and whole national economy through rigid mandatory planning. While market was extremely limited and competition was regarded as immorality and illegality. In another word, enterprises were only subordinates of government administration at any levels. In 1979, China determined to enforce reform and open policy. Since then, the transformation from planed economy to market economy has started..

II. PATH DEPENDENCE IN CHINESE ENTERPRISE REFORM

The reform process of Chinese enterprise has gone through four stages (Liu,2007) . At the first stage, from 1979 to 1991, the power of decision-making for operation and management in enterprise was extended, and then, the system of managerial contract responsibility and factory directors (or managers) responsibility were introduced.

The second stage begins from 1992 and ends at 1996. The reform focused on the transformation of enterprise management mechanism and construction of modern corporate system. During this stage, most of SOEs were corporatized and some of them listed on public stock market.

From 1997 to 2002, the enterprise reform was at the third stage: non-nationalization or privatization. SOEs exit strategically from generic industries and corporate ownership dispersed.

Since 2003, Chinese Enterprise Reform gets into a new stage: developing mixed ownership economy and perfecting corporate governance structure.

The SOEs reform is path dependent: First of all, the decision-making power extending in 1979 as a historical matter locked the SOEs reform into the trajectory of property rights reform. Exactly it is not the best choice from present point of view, but it is exclusive under the constraints of old economic, politic and legal systems and limitation of human cognitive capabilities.

Secondly, during the process of power expansion, the rights that authority shifted to enterprises were hold back by and shared with vested interest groups, such as local governments at all levels and administrative departments in charge. To avoid administrative intervention, central authority had to introduce contract responsibility system in SOEs. However, the contract responsibility system was a two-edged sword. It emancipated productive forces of firms on one hand and aroused managers' opportunist and short-term behavior on the other. With the development of cognitive ability, the government was cognizant of that joint-stock system is a better choice, so it began to transform enterprise management mechanism and construct modern enterprise system. The control rights of firm were entitled to corporate boards of directors.

Thirdly, due to the inertia of old institutional structure and the conflicts inside interest groups, the state-owned corporation and state-controlled corporation became two main forms of SOEs during enterprise system reform. The board of directors coincides with the management. The chairperson of the board and general manager in firm were often the same one, while supervisory body is but an empty shell. In addition, the head leaders of an enterprise were actually appointed by its superior, governments at all levels or communist party organization. Thus, large-scale corruption and rent-seeking activities become inevitable. Under this circumstance, the authority had to diversify corporate ownership in order to fundamentally separate government and party organization from enterprises, and meanwhile, reduce the costs directly governed by the authority. Ownership diversification has taken two main

approaches: listing on domestic and overseas stock exchanges in the case of larger SOEs, and selling to insiders, namely, management and employees, in the case of small and medium SOEs (Tenev, Zhang and Brefort, 2002) .

However, ownership reform does not solve the agent problems of large enterprises, and the rights and interests of state as well as other outside investors are often encroached. Loss of assets, falsification of accounts, and fabrication of financial data, with low efficiency, became increasingly serious problems for these enterprises. Hence, corporate governance was placed on official agenda. In 1999, the Fourth Plenary Session of the Chinese Communist Party's 15th Central Committee was held in Beijing and the notion of "corporate governance structure" was first put forward during the meeting. Less than three years later, the Code of Corporate Governance for Listed Companies in China was issued by China Securities Regulatory Commission and State Economic and Trade Commission. The Code set forth, among other things, the basic principles for corporate governance of listed companies in China, the means for the protection of investors' interests and rights, the basic behavior rules and moral standards for directors, supervisors, managers and other senior management members of listed companies. Soon after that, the State-owned Assets Supervision and Administration Commission (SASAC) was established at the level of the State Council and local governments.

Up to date, China adopts simultaneously the ways of incentive and surveillance in SOEs. In the aspect of incentive modes, annual salary system, premium of stock or share option, political honor and status, and the like, are commonly used. As regards the surveillance, dual modes are employed. Concretely, coerced information disclosure and administrative monitoring are external surveillance modes, while checks and balances among boards of directors and supervisors, labor union, and party committee are internal modes.

All of above institutional assignments are the result of foreign corporate governance experience integrated with Chinese characteristics. Take directorship for example, China borrows dual boards system from Germany on one hand: coexistence of directors board and supervisory board, and influenced by Japan's Commercial Law on the other: supervisory board is in small size and subordinate to director board. Simultaneously, it introduce independent directorship from the United States. While in practical operation, the boards of directors are sometimes controlled by the Communist Party of China (CPC) and its branch.

The arrangements stated as above may be low efficient: On one hand, multiple supervisions enhance monitoring costs because these supervising measures can be substituted for one another; on the other hand, SOEs evolve along original trajectory, not changing to anticipated, more efficient path, because of path-shaping and path-dependence induced by political, institutional and structural legacies.

III. HOW TO BREAK PATH DEPENDENCE IN THE REFORM OF CHINESE SOES?

Except small historical matters, institutional structures and vested interest groups, there are many other causes which cause path dependence, including initial conditions, cognitive capabilities, witching costs, etc..

As a mathematical prescription of the state of a dynamical system at some specified time, initial conditions are often considered as boundary conditions. The structure and system of SOEs encounter various institutional environments based on historical backgrounds before they get into shape. These "initial conditions" determine the framework of CG and its evolutionary trajectory.

The information in real life is incomplete. Moreover, the costs and techniques to procure and dispose information are indispensable. Simultaneously, human society is complicated and diversified, while human rationality is bounded (Simon, 1957) and thus human cognitive capabilities are limited (Williamson, 1993). The limitation of cognitive capabilities makes the optimum arrangements hard to be found. Even though it has been found, the evolving path will be locked in due to great sunk costs.

The formation and development of firm institution needs large continual irreversible investments from firm and society. When firm switches from one institution to another, switching costs will occur. The first kind of switching costs is sunk costs, which have been incurred previously and cannot be reversed. They are relating to institution-specific investments. The second is setup costs, which associated with establishing a new fir institution, such as design costs, learning and training costs, and adaptive costs. The third is frictional costs, including implicit and explicit costs associated with institutional transformation, such as compensation for breach of contracts, loss of efficiency, psychological and physiological discomfort, social destabilization and risk, etc. The switching costs may obstruct the creation of new firm institution, so that the society can only invests in and follow precious institution.

However, different from natural biologic evolution, the evolution of SOEs can be controlled and influenced by human beings. In other words, the path dependence in SOEs' reform can be broken. Next we will discuss the approaches for path breaking in SOEs reform mainly according these causes.

To begin with, it is required to find what the best firm system is. The cognition and understanding for firm is quite different among different people, due to the complexity of firm and limitation of cognitive capabilities. Someone ignore the institution specialty, paying more blind worships to the theoretical models and advanced experiences; someone overlook the complicated institutional environments, considering the firm as it stands; others though proposed some meaningful approaches and measures, while lack of long-term effects. It is not easy to find long-term effective enterprise system for China. Academic scholars from the fields of economics, politics, business, law and the like, should discuss it with practitioners, such as officers from government authorities and top management from business enterprises.

Secondly, it is required to develop participants' cognitive capabilities. Cognition in a sense is a process of psychological anticipation. While psychological anticipation is constrained with the quality and cost of information. Incomplete and asymmetric information plus high information costs may bring about unsuccessful or even wrong anticipation. To deal with this problem, the key is to strengthen the information disclosure and ensure it accurate, timely, and valid. In my view, not only listed corporations should disclose information, unlisted companies especially SOEs should do so. The information can be disclosed on not only various traditional media, but also corporate own website. Not only financial information should be disclosed, non-financial information should be too. Besides, the technological level of information processing should be enhanced in order to promote the dissemination of information and knowledge.

Thirdly, it needs to improve the external institutional environments. SOE as an institutional assignment is, to a great extent, influenced by the institutional environments it stands. Some of existing institutional legacies in the field of polity, economy, law, culture, etc., may be incompatible with a new institutional arrangement. If institutional environments remain unchanged, the new institutional assignment may be assimilated.

Fourthly, Chinese authorities should manage to split up the vested interest groups which hinder enterprise progress. Olson (1965), according to the type of collective benefits that group members received, classifies groups as "inclusive" and "exclusive". Either inclusive group or exclusive group is not a monolithic block. Interest conflicts may exist among its members due to the disputes of costs-bearing and benefits-sharing. The authorities should make use of these conflicts to disintegrate them and then change the system and mechanism.

Last but not least, when old inefficient path is not changeable, a new "path" should be found and built up as quickly as possible so as not to be assimilated by the old one.

IV. CONCLUDING REMARKS

Since Asian financial crisis(late 1990s), series corporate corruption scandals (early 2000s), and the global financial crisis(late 2000s), the arguments for corporate system has reappeared. Chinese SOEs used to be regarded as irrational and inefficient arrangements. But in our point of view, Chinese SOEs will exist for a long time because of path dependence. Chinese SOEs can change into modern corporate system and improve management performance only if the path dependence has been broken. This paper, based on the theory of path dependence, analyzes the phenomenon of path dependence in Chinese SOEs reform and proposes some approaches with regard to path breaking.

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