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Corporate governance in China: An institutional logics perspective

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ABSTRACT

There is considerable evidence that the practice of corporate governance within China is different from that within the Anglo-American Business Model (ABM). Dominant Chinese institutions and their inter-institutional relationships undoubtedly influence corporate governance in China. Whilst adopting many ABM corporate governance structures the practices within Chinese publicly listed firms remain somewhat of a mystery. This paper presents the institutional logics perspective (ILP) as a theoretical framework to analyse corporate governance in publicly listed Chinese firms. ILP is then used to analyse the evolution of the dominant institutional logic of corporate control in Chinese firms. The paper shows that an increased emphasis on both the symbols and practices are needed to implement corporate governance as a new institutional logic in China.

Keywords: corporate governance, agency, theories of governance

BACKGROUND

Whilst there had been earlier joint stock companies, the enactment of the UK Joint Stock Companies Act in 1856 proliferated the rise of the dispersed ownership structure we associate with the Anglo-American Business Model (ABM) of modern corporations. The UK Joint Stock Act (1856) emphasised the free market spirit of laissez faire and enabled limited liability ownership giving rise to the separation of ownership and control where no single shareholder has the power to control management (Berle and Means 1932). The potential problems caused by management control were theoretically analysed by Jensen and Meckling (1976) in their work on agency theory. Economists see the ownership/control relationship as a 'game' in which one 'player' (the principal) offers incentives to the other (the agent) to encourage the agent to act in the principal's best interests, instead of in their own self-interest (homo economicus) (Jensen and Meckling 1976, p. 308). The information asymmetries in this relationship, for example, where management have far more operational knowledge about the corporation can give the rise to conditions that effectively result in management control of large publicly listed corporations due to the highly dispersed ownership structure and lack of effective monitoring by the owners. Consequently, governing management control has become a new way of organising our business activities (Cadbury 1992), and competing with the traditional thinking or logic of owner control (Smith 1776). This paper focuses on the corporate governance practices by Chinese companies of which the dominant logic is control. It also aims to explore the benefits and limitations of applying the newly developed institutional logics framework to the area of corporate control in Chinese firms. This paper is organised as follows. The concept of institutional logics and its characteristics are described, followed by a discussion of the evolution of the dominant institutional logic of corporate control in Chinese firms. After this, we conclude by discussing the benefits and limitations in applying institutional logics perspective (ILP) to analysing corporate control in Chinese firms.

LITERATURE

Corporate Governance and the Institutional Logics Perspective

Corporate governance emerged as a new competing logic in corporate control in developed countries since the late 1970s. It is defined as "the system by which companies are directed and controlled" (South African King Report, 1994) and has been the focus of considerable research efforts. Much of these studies primarily focus on the agency problems caused by the separation of ownership and control, and thus on agency costs (Jensen & Meckling 1976) and the major internal and external corporate control mechanisms, such as the remuneration packages of managers (Lee 2002), the role of board, ownership concentration, and market for corporate control in order to better align management interest with the owners'. Recent studies on corporate governance have shifted its focus from these internal and external control mechanisms. Instead, the role and influence of other institutions on corporate governance has emerged, and increasingly considered corporate governance as being influenced by institutions external to the firm. Friedland and Alford (1991) further argues that corporate governance is an institutional logic, or organising principle, used by the society in structuring its social systems and guiding its practices. Building on the seminal work of Friedland and

Alford (1991) on institutional logics, several researchers (Lounsbury, 2001; Thornton & Ocasio, 1999, 2008) have further developed it into a theoretical framework, 'the institutional logics perspective' (ILP) as "a meta-theoretical framework for analysing the interrelationship among institutions, individuals, and organisations in social system" (p. 2). The emergence of ILP as a meta-theory combining classical institutional theory (Friedland & Alford 1991; Giddens 1984) and neo-institutional theory (Powell & Dimaggio 1991; Deephouse and Suchman 2008; Whittle, Suhomlinova & Mueller 2011) has offered a new framework to examine corporate governance. Specifically, it offers a framework for analysing the characteristics of an institutional logic, its dimensions (material practice and cultural symbols), and how it emerges and evolves (Thornton, Ocasio, & Lounsbury, 2012). Moreover, little research has been done on how institutional logics influence corporate governance, and specifically control within firms, particularly MNCs from transitional economies. Corporate governance in China has been in the transitional period since 1979 when China implemented its "open-door policy", thus can offer a golden research opportunity for studying the dynamics of institutional logics and its further development (Thornton et al. 2012, p.174).

The institutional logics perspective: concepts and characteristics

Lounsbury (2007) describes the concept of logics as "broader cultural beliefs and rules that structure cognition and guide decision making in a field" (p. 289). Friedland and Alford (1991) defined institutional logics as "a set of material practices and symbolic constructions, which constitutes its organising principles" (p.248). Thornton and Ocasio (1999) view it as ''the socially constructed, historical pattern of material practices, assumptions, values, beliefs, and rules.'' (p.804). Whilst Friedland and Alford's (1991) definition emphasised the latent nature of institutional logics, Thornton and Ocasio's (1999) perspective emphasised the physical and cultural manifestation of institutional logics, which has greatly facilitated the understanding and analyses of institutional logics, and their measurement. The institutional logics perspective views our society as an inter-institutional system of institutional orders, such as Christian religion, the nuclear family, the bureaucratic state, the capitalist market, and democracy (Friedland & Alford, 1991). Each of these institutional orders has its own principles, practices, and symbols which shape the context under which reasoning takes place and rationality is perceived. In other words, institutional logics represents a frame of references that condition the choices of actors (individuals and organisations) for sense-making, the vocabulary they use to motivate action, and their sense of self and identify under different institutional orders. These actors, or "agency" in Scott's (2008) terms, are aware of the differences among institutional orders and incorporate them into their decision-making, thoughts, and beliefs. At the same time, the actors' behaviours and vocabulary can shape and change these various institutional logics. Proposed as a meta-theory, the institutional logics perspective is principally characterised by 1) the duality of agency and structure, 2) institutions as material and symbolic, 3) institutions at multiple-levels of analysis, and 4) institutions as historically contingent (Thornton & Ocasio, 2008; Thornton, et al., 2012). Institutional logics have been applied to the studies in a number of areas and at different levels, such as organisation theory, management, cultural sociology and cognitive psychology. These studies include the shift from the logic of editorial to market in the higher education publishing industry (Thornton & Ocasio, 1999), and practice diffusion from a regulatory logic to a market logic in the mutual fund industry (Lounsbury, 2002). It has also been used to analyse the contemporary phenomena such as occupation prestige ranking (Zhou, 2005), corporate social responsibility (Herremans et al 2009), practice adoption in international financial reporting standard, consumers behaviour at market level, stability and change in the public employment service sector, and corporate ethical decision-making and behaviour in the context of MNCs (Kostova, Roth, & Dacin, 2008; Tan & Wang, 2011). However, few studies have been conducted in transitional economies, nor exploring the logic of corporate control.

Corporate control in China: the evolution of institutional logics, social value and corporate practices

Corporate governance in Chinese firms present a unique situation and have been in transition since 1949 when the Communist Party of China (CPC) took over the power and established the dominant logics of control. Since then, the logics of corporate control in China have undergone three stages of changes from state/bureaucrat control to bureaucrat/manager control, and then to a hybrid of bureaucrats/manager and corporate governance. The following sections examine the change of structure, practice and symbol of corporate control in these three stages.

Stage I: Dominant state control (1949-1979)

Soon after the Community Party of China (CPC) took over the power in 1949, most business entities in China were confiscated and thus owned by the governments at different levels. Since taking ownership the governments have been extensively and directly involved in their operations. Strictly speaking, all Chinese commercial entities became corporatized as they were owned by numerous shareholders: the Chinese public. Politically, the state-control logic over national business activities is an important control instrument of the socialist ideology. Socially, most Chinese people, including contemporary political and business leaders, have grown up and been educated with this political ideology. As a result, the logic of state-control over neo-liberal economic activities at the national level has been established and deeply institutionalised both as material practices and cultural symbols in terms of economic structure and coordination systems at the society level. The governmental agencies were structured accordingly around this state-control logic for implementing these practices, and so were the development of regulatory, legal, and administrative systems across the government and organisation levels. More specifically, the government agencies conducted many micro-economic activities besides exercising macro-economic activities. These included business planning, pricing, allocation of production, and distribution. Probably the most important intervention used by the governments was the appointment of the Party secretary and senior managers to the companies. To wit, business organisations were treated as cost centres or working unit (the *danwei*). The underlying institutional logic was that the state is responsible for the society's employment, production, welfare, and allocation of goods and services. Around this dominant institutional logic, economic structure, national business systems (such as banking, administrative system, accounting, and tax), and processes were established and organised. This deeply-institutionalised logic of state-control, coupled with the appointment of senior managers to the business organisation, has resulted in the logic of bureaucrats/managers control at the organisational level with bureaucrats dominant as proxies of state ownership and command most activities, either commercial or non-commercial (e.g., employees' housing, social securities, and union) within the organisation. At the organisational level, Chinese firms were organised as production plants with the plant head responsible not only for all functional operations, but also, for other non-commercial duties. Managers were appointed by the government; production inputs and outputs were planned by the government; employment unions were set up primarily for looking after the employees' welfare; and Chinese firms were also responsible for providing free accommodation for their employees. In summary, a business enterprise was set up and operated like a mini-government. Thus, the bureaucrats/manager control logic prevailed in Chinese firms before 1979. This is a very different focus than the creation of shareholder value via the ABM (Lazonick & O'Sullivan 2000).

Stage II: A hybrid of bureaucrats- and manager-control (1979-1992)

The open-door and economic reform policy implemented since 1979 has gradually delegated responsibilities from bureaucrats or government agencies to SOE managers, such as introducing performance incentive, price liberalization, profit retention, contracting responsibilities to managers (Tenev & Zhang, 2002). This has gradually reduced the degree of government intervention in the operations of business organisations. However, no fundamental changes were made in the ownership of SOEs, although China started its experiments on the ownership reform in 1984 with 11 SOEs becoming shareholding enterprises. The most important change in corporate governance practices was reflected by the reduction of the logic of government control and intervention and the subsequent strengthening of management control in SOEs. Consequently, there was a gradual, and quantitative, but not qualitative, shift in corporate control to a more balanced bureaucrat/manager control as there was no fundamental change in the nature of corporate control in China during this period.

Stage III: the installation of corporate governance as a competing logic with bureaucrats/manager control (1993 – present)

The last two decades have witnessed substantial changes in corporate control in China, particularly in its structure, ownership and symbols. From a symbolic perspective, the logic of corporate governance emerged as a new institutional logic for corporate control in China in 1993 when the Third Plenary Session of the 14th Party Congress issued the Decision on Issues Concerning the Establishment of a

Socialist Market Economic Structure. Subsequently, China formally introduced the concept of corporation through *importing* (Roche, 2006, p.36) as a crucial part of the China's effort to create a 'modern enterprise system' and diversify its state ownership. This started a new wave of enterprise reform in China focusing on the corporatization and ownership diversification of SOEs. These market-oriented reforms have seen many large and medium SOEs corporatized themselves and most small SOEs have been bought out by their managers, employees, or new investors, often dominated by insider directors. As a result, many larger SOEs, or part of, have also been listed in domestic or international stock exchanges. Structurally, Chinese Company Law was promulgated in November 1993 introducing firstly, the concept of a board of directors, and stipulating the establishment of a board in large corporations, and secondly, emphasising the role of auditing. China established two stock exchanges in 1990 and 1991, and China Securities Regulatory Commission (CSRC) in October 1992. Institutional investors, both international and domestic, have gradually been encouraged to invest in the Chinese stock exchanges. The stock exchanges have promoted an ABM corporate governance logic, and this may influence Chinese firms via Powell and Dimaggio's (1991) coercive and mimetic isomorphism. In Chinese stock exchanges the listing requirements and codes on corporate governance have been influenced by international trends, and combine to influence firms to respond in similar ways to develop appropriate corporate governance structures, practices and symbols from firms. Figure 1 outlines the key actors and structure of corporate governance in China.

<u>Insert Figure 1 about here</u>

Although the Chinese government has imported the ABM logic of corporate governance, restructured its administrative systems and structure, and promulgated corporate laws, and gradually delegated many responsibilities to business organisations, the shift of corporate control logic from bureaucrat/manager controls to corporate governance has proven challenging for several reasons. Culturally, the concept of corporate governance has been implemented via structures, but not internalised in its value and meaning among the Chinese key actors, such as government agencies, business executives, board directors, institutional investors, and more importantly the general public. The implementation of corporate governance can have a negative impact on the power and interest

Chinese bureaucrats and managers enjoyed with the logic of bureaucrat/manager control. Structurally, the Chinese government has installed key institutions and established relevant organisations for implementing corporate governance. Nevertheless, the devil is in its details, or practicing in the case of corporate control.

In practice, Chinese governments are still the owners of, or control, a significant proportion of the organisations' shares, particularly large Chinese organisations, and are still heavily involved in business activities at the organisational level, particularly in SOEs. This includes appointing senior managers to SOEs, coordinating inter-firm activities, and financing. At the organisational level, a unique model of corporate governance has been adopted in China. This model is control-based and characterised by 1) the controlling shareholders (often the state) employ all feasible governance mechanisms to tightly control the listed firms, and 2) a management friendly board. (Liu, 2006). More specifically, "concentrated ownership structure, management-friendly boards, inadequate financial disclosure and inactive take-over markets have been the standard governance practice commonly observed among the Chinese listed firms" (p. 418). The existence of a single concentrated shareholder is probably the most distinctive characteristic of corporate governance in China. Liu (2006) conducted a survey on the listed companies in China and found that the largest shareholder in China on average held 44.8 per cent of shares while the sum of the percentage of share-holding held by the second to the tenth largest shareholders had an average of 16.93 per cent only. Moreover, a majority (55.6%) of the companies were controlled by the government and their shares are not tradable. Thus, there is no market for take-over. More than two-third (78.9 per cent) of the publicly listed firms in China have a parent company that can complicate the listed company's operation and also reduce its transparency (Bebchuk 2000). An overwhelming majority of these parent companies are SOEs where the senior managers are often appointed by the CPC from government bureaucrats, producing a dominant bureaucrat/manager control logic in these enterprises. This ownership concentration, coupled with the existence of parent companies, has resulted in the selection of most senior managers in the listed companies from their parent company. Regarding board composition, Chen, Fan and Wong (2004) reported that almost 50 per cent of the directors are appointed by state-controlling owners, and another 30 per cent are affiliated with various layers of governmental agencies. There are few professionals (lawyers, accountants, finance experts) on Chinese boards and almost no representation by minority shareholders. More than one-third (34.6%) of the CEOs are also the chairmen of the board of directors, which contravenes most corporate governance code thinking that advocates the separation of these roles. Additionally, top managers typically own little of their companies' shares (0.1 per cent only). Therefore, it can be expected that most board of directors would be characterised as insider, and the agency cost is very high in the listed Chinese companies as managers have very little shares in the company. The weak corporate governance practice has been pointed out as the major cause of recent corporate scandals and poor corporate performance. These include corruption, stock market manipulation, tax cheating, fraudulent dealing, all manners of plundering of state assets, and the lack protection of minor shareholders' rights (Tam, 2002). Consequently, this has generated a perception among Chinese business executives, politicians and public about corporate governance in China as a weak corporate control mechanism. Following the definition of institutional logics (Thornton, et al., 2012) as historical patterns of cultural symbols and material practices and the approach used by Thornton (2004) in treating the institutional orders and its categories as X-axis and Y-axis respectively, the institutional logics of a bureaucrat/manager and corporate governance and its characteristics in China are outlined in Table 1.

Insert Table 1 about here

The logics of state-control and corporate governance have been competing in China since 1993, and created 'institutional complexity' (Greenwood, Díaz, Li, & Lorente, 2010) for both business executives and bureaucrats. It not only creates inter-institutional contradictions across the level of the state and organisations, but also intra-institutional contradictions at each of both levels as corporate governance as a new institutional logic of corporate control demands some fundamental changes in practices, structure, systems, and value at both levels.

CONCLUSIONS

This paper draws on the key principles and characteristics of ILP to examine corporate governance in China and explore the benefits and limitations in implementing corporate governance as a new institutional logic. Several benefits can be gained through using the ILP in analysing corporate governance in China. Firstly, the ILP has included important factors from several disciplines (such as material practice from economics, symbol from cultural sociology, and agency from cognitive psychology), and thus offers a comprehensive, systematic, theory oriented framework for analysing the introduction and development of a new institutional logic. Therefore, it can provide new insights, such as the interdependence of structure, practice and symbol, and the cross-level institutional interaction in the case of corporate governance. It also offers potential to develop new theories, particularly meso- and micro-ones in the area of corporate governance. Secondly, the implementation of corporate governance in China has been so far unbalanced from the institutional logics perspective, with substantial structural changes, but less emphasis on practice. As Tenev and Zhang (2002) concluded in their studies of corporate governance in China, "ownership diversification and corporatization have had only a limited impact on corporate behaviour". The corporate governance in Chinese corporation can be described as a control-based model where (Liu, 2006) with major control exercised by the major controlling shareholder, often the Chinese government. In the future, a more balanced approach emphasising symbols and practices is needed to implement corporate governance as a new institutional logic in China. Figure 2 outlines the current approach and indicates the potential direction in implementing corporate governance in the future.

Insert Figure 2 about here

Thirdly, the analyses above also demonstrate the importance of internalisation of a new institutional logic in the society. Although structural changes have been made by Chinese government to support the introduction of corporate governance, its impact on the symbolic value seems very limited. There are also several limitations in applying the ILP to analysing corporate governance. Although the ILP provides a framework for conducting institutional analyses, the current developmental stage seems to be quite broad, with many gaps to fill, particularly at the meso- and micro-levels. In the case of analysing corporate governance, for example, agency theory and transaction cost theory are still powerful in explaining cause-effects and behaviours of key stakeholders, such as shareholders, managers, and directors. These micro-level theories are supplementary to the ILP. Another limitation in applying the ILP to corporate governance analysis is the comprehensive nature of the ILP as an analytical framework could make the analysis more complicated, and thus at the cost of parsimony of a theory. The third limitation of the ILP is that it is difficult to identify the key factors that can determine the introduction and evolution of a new institution. The historical contingency of institutions, one of the four principles of the ILP makes this task more difficult. Finally, it is also challenging to consider the local context into the analysis, and thus difficult for conducting international comparative analyses. One of the benefits of the ILP is that it emphasizes the importance of context in conducting institutional analysis.

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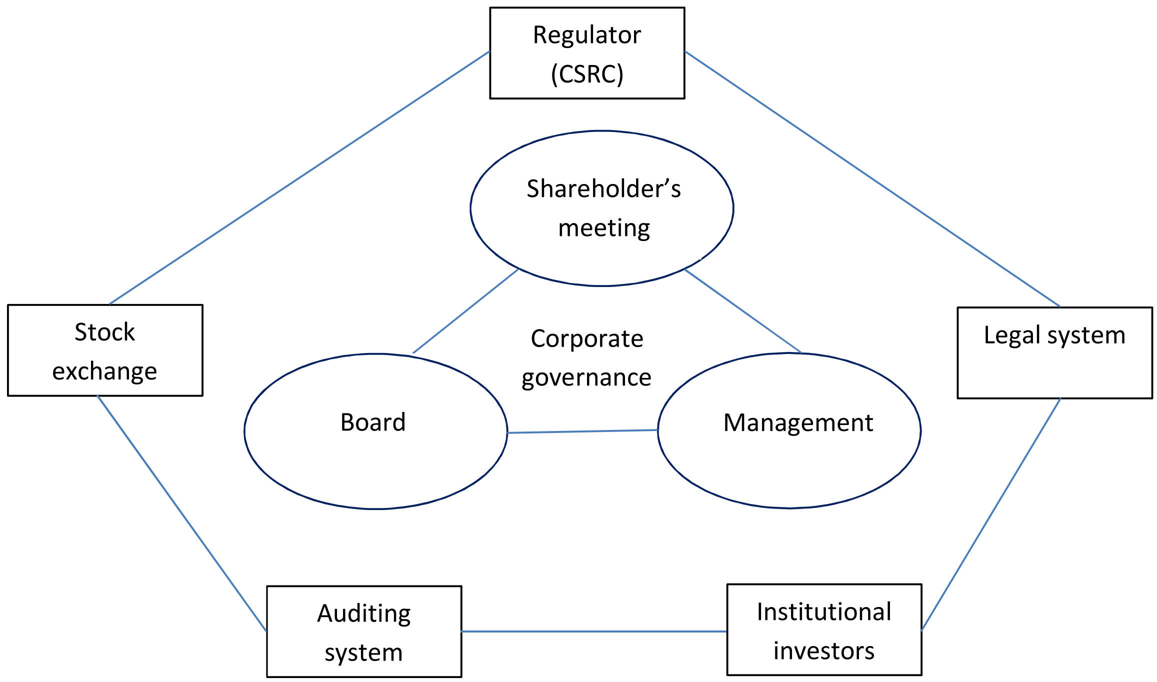
Figure 1: Institutional players related to corporate governance in China



(Source: (Kang, Shi, & Brown, 2008))

Table 1. Institutional logics of bureaucrat/manager control and corporate governance

Organising principles/categories	Bureaucrat/manager control	Corporate governance
Cultural symbols (meaning and ideation)		
The role of State	State plans the inputs and outputs, allocates resources to organisations and appoints senior managers. Administrative, central planning	Managers are appointed by 1). the CPC, 2) parent company, or 3) the board
The role of corporation	Cost centres; Multiple objective A political institution, an administrative body, an economic producer; no economic incentive, no clearly defined boundaries	Conducting national economic activities in SEOEs and its controlled listed companies; Shareholder value - Wealth maximization for shareholders, particularly the major shareholder.
Source of legitimacy and authority	Providing employment and welfare to the society, bureaucrats	Market position of firm; top management
Material practices and structure		
Informal control mechanism	Industry networks	Organisation culture
Employment	Life-time (permanent) employment	Mix of life-time employment and contract
The role of managers	Proxy of the state; Responsible for all activities; Head of the plant, technocrats	Proxy of the state or corporate professional managers
Structure	Primarily conglomerate ('small government') and functional; Inter-firm coordination by industry-specific ministry/bureau at national level/provincial or city levels.	Corporations as independent economic entities; industry-specific ministry replaced by industry association. CPC links less formal.
System	Business systems coordinated by State	Business system coordinated by the corporation
Monitoring	By state agent without effective ultimate principal	By board

Figure 2: The approach adopted by Chinese Governance in implementing corporate governance