

## The Path Dependence of Chinese Corporate Governance

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**Abstract** Though describing the situation about Chinese corporate governance, according to the theory of the path dependence of corporate governance, this paper analyses the reason about path dependence of Chinese corporate governance. The path dependence of corporate governance originates from two aspects: structure-driven path dependence and rule-driven path governance. The structure-driven path dependence focuses on the initial structure of ownership how to influence the follow structure of ownership. The rule-driven path governance means that the initial structure of ownership influences the follow structure of ownership by the influence of administer company with legal institution.

**Key words** Corporate governance; Path dependence; Structure-driven path dependence; Rule-driven path dependence

### 1 Introduction

In china, the listed company is born of state-owned enterprise of planned economy, the initial structure of ownership were controlled by government. The shareholding reform of state-owned enterprise were demanded to ensure the frame of state-owned enterprise holding.

The state-owned enterprise changes joint stock limited company, No matter which way of issuing shares to be adopted, ratio of state-owned storks are not weakened, so the joint stork limited company issue 30 % - 40% to the public, and long time the state-owned stocks have not been free flow to cause centralized structure of ownership.

We can perceive from table that the position of number-one shareholders could not change if the quantity of number-two to number-five shareholder added. In 2006, even if some company reduced state-owned stocks, the ratio of number-one shareholder descend, they can control company as before, so the structure of shareholder were highly centralized system.

**Table 1 The Shareholding Proportion of Large Shareholder in China**

Proportion of holding stock (%)	year								
	1998	1999	2000	2001	2002	2003	2004	2005	2006
Shareholding proportion of no1 shareholder	45.22	45.51	44.39	44.00	43.41	42.50	41.65	40.32	35.98
Average shareholding proportion of no1-no5 large shareholder	59.24	59.73	58.99	58.57	58.72	58.66	58.83	57.48	52.49
Average shareholding proportion of the sixth large shareholder	0.86	0.87	0.82	0.77	0.80	0.80	0.89	0.92	1.09

From: li Jianbiao; Wang Guangrong; Li Xiaoyi; Sun Juan; Ownership Structure, Information and Benefits of Control in the Experimental Market; Nankai Business Review; 2008.1.66-67

Ownership structure of the state-owned enterprise is centralized through institutional change of many years. It seems forming balance mechanism that general meeting of shareholders, board of directors, board of supervisors and managers exercise power separately. But in fact, the structure of ownership is excessive centralized, the board of director are controlled by large shareholder or insider; In form, the board of supervisors and the board of directors are equal on legal status, the board of supervisors is not restricted by the board of directors seemingly, It can supervise the board of directors and manager. But it is impossible that the board of supervisors supervise the board of directors and manager from their function. Especially under the situation that chairman of the board and general manager hold a concurrent, status of supervisors board are low and function are reduction, company can not form an effective governing structure and countervailing mechanism. Controlling shareholder and insider control begin to appear and increases gradually by absence of balance mechanism.

## 2 Theoretical Analyses: The Path Dependence of Corporate Governance

The concept of path dependence is from the natural sciences at first, in 1975, the American economical historian Paul A. David in his work brought “the path dependence” to economic research category. To 1980s, David and W. Brian Arthur introduced this concept into the analysis of technical change, thus they analysed intension and the action mechanism in depth, Arthur used it to discuss increasing return how to influence the economical system revolution.

In the Arthur research foundation, many economics have widespread research and have obtained some important achievements in research. It becomes one of the important theories in the modern economic.

North developed the theory of path dependence to the institutional economics, describing the past achievements how to influence present and the future with it. North believed that the path dependence is similar to the “inertia” in the physics, once enters the path, no matter “good” and “bad” possibly has the dependence. Along the path, the change of economical and political system may enter the positive cycle and rapid optimization; and may glide through the original path, even “lock-in” some inefficiency condition.

The path dependence of institution has some typical characteristics.

First: non-determinate. the formation of institution relies on the initial condition, it is decided by the exterior accident, in initial many kinds of institution, the people did not define which institution were chosen and did not know which institution is more effective.

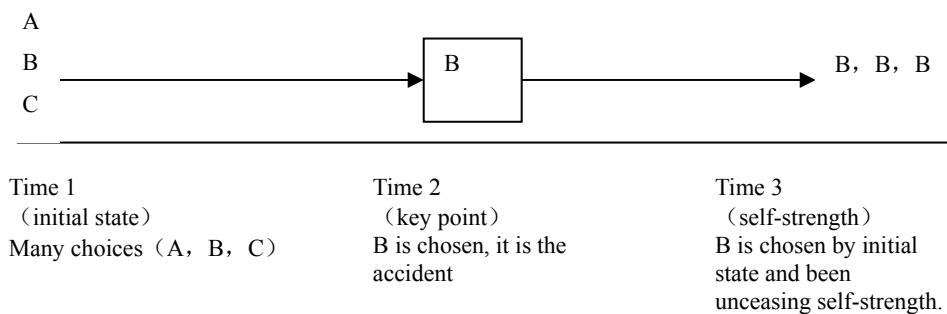
Second: technical is locked. Arthur believed: technical or technical product was known by the potential consumer relying on the market share superiority which occupies first to realize the self-enhancement positive cycle and defeat the match in the competition. On the contrary, technical or technical product that has better quality does not been recognition because developed late, at last sinks into the difficult position. Once a kind of institution take the advantage, it can unceasingly the self-strengthening and the consummation, becomes some national or the local leadership, the initial multi-selective and non-determinate vanishing, causes its development direction “lock-in”

Third: non-optimal. The institution is “lock-in” because of the initial accident, but it is not the best, a more superior institution is difficult to shake its status that develops afterwards.

Generally, the existence of path dependence is a double-edged sword, on the one hand, the institution being advantage can self-strengthen, to be unceasingly consolidated and to be perfect to become the market leadership; On the other hand, because the path is dependence, even the more superior institution is difficult to break its blockade and monopoly to the market. It also means the economical development can lock in the low efficiency condition. Because of the initial accident, once the institution has been chosen, the inertia strength can cause this institution unceasing self-strengthen.

In fact, the lock-in of path dependence is a tendency process. The choice of initial path has locked the tendency institution change process.

Jame(2000) summarized the principle of path dependence, like Figure 1:



**Figure 1 The Principle of Path Dependence by Jame(2000)**  
 Source: Jame Mahoney, 2000, Path Dependence in Historical Sociology

Bebchuk and Roe utilize the theory of path dependence to resolve the structure of ownership and corporate governance. Bebchuk and Roe discovered that the structure of ownership exist the situation of path dependence. In other words, the structure of ownership depends on its initial pattern. Therefore, a country has the different structure of ownership because of their different environment and some historical event, then even if their economy become extremely similar by other reasons, these differences in ownership also possibly continually exists in long time.

Bebchuk and Roe believed the path dependence of corporate governance originates from two aspects: structure-driven path dependence and rule-driven path dependence. The structure-driven path dependence focuses on the initial structure of ownership how to influence the follow structure of ownership. The rule-driven path governance means that the initial structure of ownership influences the follow structure of ownership by the influence of administer company with legal institution. The institution of company exist the path dependence.

The research of Bebchuk and Roe indicated that the reason of the structure-driven path dependence is efficiency and rent seeking. The emergence of rule-driven path dependence has effective factor and affection of other interest group.

They believed because effective company structure and institution possibly rely on a country's initial structure of ownership, the company structure and institution are path dependence and effective; next, the company structure and institution rely on initial environmental condition of their country, so the structure and institution appear by different way and tend different degree.

### **3 The Reason of Chinese Corporate Governance's Path Dependence Analyses**

#### **3.1 The structure-driven path dependence**

First, the structure-driven path dependence is caused by efficiency question, in some time, the effective structure of company possibly rely on earlier pattern of ownership structure. Because Chinese state asset changed state-owned stocks in shareholding transformation, the proportion of state asset is big. But in order to guarantee the state-owned enterprise holding the status, the state-owned do not been circulated, forming centralized the structure of ownership. If at that time the choice was effective, Chinese has been choosing the centralized structure of ownership at first, in order to adapt the centralized structure of ownership through the addition correlation institution, but the earlier investment of these institutions already precipitated in the centralized the structure of ownership, the change of these structures will lead to initial investment cost waste. The centralized structure of ownership affects choice of the future ownership structure by scale effect and study effect and so on. Chinese structure of ownership relies on earlier structure of ownership.

Second, the suitable structure can maintain continuously because of rent-seeking, if the structure of ownership was not effective already. The transformation of ownership structure needs cooperates mutually that control company. The private benefits of control that the transformation of ownership structure brings can not indemnify loss of controlling shareholder, thus the controlling shareholder can obstruct transformation in every possible way, even if they realize the function of reform.

Under background that the controlling shareholder control, the controlling right of listed companies are controlled by controlling shareholder. In the modern enterprise, the rights of controlling shareholder grow the unusual degree. Therefore, the scatter of controlling right is not realistic choice. In the centralized structure of ownership, ownership dilution and condition each other mean the behavior of controlling shareholder being supervised, the right and private benefits of control of controlling shareholder will have great discount, so, the controlling shareholder will obstruct transformation of ownership structure to preserve the huge economic interest that the controlling right brings.

#### **3.2 The rule-driven path dependence**

##### **3.2.1 Formal institution**

The company system can affect corporate governance. The initial structure will be able to have influence to the future company system. This will further affect the structure of company. The structure of ownership affects the company system, the path dependence of institution are affect by efficiency and rent-seeking of interest group. Even if the extant company system is effective, the initial structure of ownership also can affect relative efficiency of company system that can choose. Because it met need of the initial structure of ownership and eliminated the barrier of system to obtain the development to tend long time. This effective institution last longer, the initial investment cost is lower. If the extant system will be substituted that will cause huge waste of the initial investment cost.

The effective institution relies on the initial structure of ownership to some extent, the company system forms and develops on basis of adaptation the initial structure of ownership, the company system that adapts the initial structure of ownership forms the structure of corporate governance. In 1993, the company law was published directing resource the need of shareholding transformation of state-owned enterprise. The basic task and the basic spirit draw up the law way and the organization shape, promoting establishment of modern enterprise system. For example, the stipulation that the state-owned enterprise rebuilt stock-limited company in the company law, the rule about solely state-owned company

and revised the company law in 1999, these reflected influence of initial structure to company system. Hereafter, the related law and regulations with the company law were published one after another that formed complemented and concerted effect, consolidated the company law movement. In the company law, the function of general meeting of shareholders and the board of directors overlaps mutually, the authority to supervision of board of supervisors lacks guarantee in the procedure and so on, these has seriously restricted to restrain controlling shareholder's right.

The choice of company system is the process which the correlation benefit community games, the result of game is decided by the strength of every group. The strength of every group relies on the choice of initial structure of ownership. Under the centralized structure of ownership, the controlling shareholders grasp the company resources and the controlling rights. They control resources more, the authority is stronger. The controlling shareholders have opportunity to transform this kind of right into the political power of society, thus influence the choice of company system.

Once the company system are established relying on the initial structure of ownership, it can affect later the structure of company. The extant company system causes legalization of the controlling rights. This kind of legitimate right can strengthen the company system. After the controlling shareholder has controlled the listed company through the reasonable and legitimate way, because the controlling shareholder control absolutely, the smaller shareholder is very difficult to inflict significant influence to company's decision, cause the smaller shareholder to lack the way of participative company governs. Because the right of controlling may bring the huge benefit, the controlling shareholder does not give up the controlling status.

### 3.2.2 Non-formal institution

The mode of corporate governance is result of rational choice under certain social system environment. One kind of mode is not only decided by economical strength but also drove by custom, ethics morals, cultural tradition, concept of value and so on. Chinese structure of corporate governance has its own original state and the constraint condition. First, Chinese structure of corporate governance was transformed under the planned economy, its development was influenced by objective environment of institution and the mode of traditional plan; Next, Chinese corporate governance transplants western correlation theories to a great extent. But we knew, although formal institution is easy to be transplanted, non-formal institution is not easy to be transplanted by historical accumulate and ideology rigidity, therefore the vicissitude of non-formal institution is slow and lagging. The transplant institution is better, if it cannot be compatible with the other institutions, it brings repulsion between institutions.

The validity of corporate governance rely on the support of non-formal institution, the cultural tradition and the concept of value occupying dominant position is a foundation which the efficiency of institution can display fully. For example, the decentralized equity ownership structure in American is influenced by ideology of liberalism long term, the American dislike monopoly power.

China is influenced by theory of Confucianist education, but the beginning of the Confucianists is "the family". People speak and act only according to the status, this kind of culture inevitably incarnate in the enterprise culture. The important characteristic of culture emphasizes harmonious and avoids conflicting, Chinese culture favors mutually dependence, but the Western culture emphasizes independence, this is the reason that internal structure of governance is effective in western country but it is transplanted to china losing its effective.

In the enterprise, the privilege consciousness of Chinese culture strongly reflect paternalism, the people is imbued with the awe and the anticipation to the authority, cause the authority of institution losing. For example, the board of directors is an organization of surveillance and executive, but in China, the board of directors has become the privileged stratum actually. Under the concentrate equity ownership structure, the right of chairman basically reflects the will of the controlling shareholder, our system arrangement has also carried on this kind of culture tradition, usually cause the mechanism of internal controlling losing effectiveness. In china culture, the people have vassal psychology generally, directly causing the smaller shareholder lacking initiative of participative corporate governance.

In china the people lay too much stress on relationship, but contempt for law, it has affected people's ideology seriously, once meeting the question, the people think firstly how to resolve depending on relationship, but not regulation; the western culture attach importance to individual, emphasizing individual and creation consciousness, this decide they carry on the self-restraint through the law but not the morals. The people obtain freedom under the legal restraint, forming the mechanism which keeps balance mutually in the corporate governance.

We can transplant the Western advanced theory, but we can not transplant their ideology, thinking model, the traditional culture and so on. In china, the ideology, the traditional culture, the thinking

model which followed down several millenniums hinder formation of “the right keep balance”, causing the low efficiency of Chinese corporation governance.

#### **4 Conclusion**

The scale and direction of the institution change are not random, but restricted strictly by the initial condition, having intense path dependence. The institution change exist increasing return and self-strengthened mechanism liking technology evolution. This kind of mechanism strength the path which was chose originally, promoting self-strengthening. The choice in the past decides present possible choice. In china, the structure of corporate governance has obvious characteristic of path dependence because it was influenced by the structure of ownership. The mechanisms of corporate governance that keep balance need the support of external strength.

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