

# The Change of Corporate Governance in Transitional China By SD Modeling

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## Abstract:

The economies around the world are facing profound transformation. It is no exception for China. All the enterprises in China are going through a radical transformation from a centralized socialist economy to a socialist market economy. The transformation is such a process during which the marketing forces increase and the government regulations decrease. For enterprises, the most important and difficult work in this reform has been to establish a new corporate governance system compatible with a socialist market economy.

To answer for this situation, most large and medium-sized enterprises in China have transformed to stock companies, and established corporation governance structure composed of three committees as the shareholders' general meetings, the board of directors and the supervisory board. The old leading system in enterprise, including Party community, employee representative committee and labor union, which have dominated the enterprises for a long time in planned economy, seems to be substituted.

The change of relative position between old system and new one indicates the change trend of international economy environment. How to deal with the relation of old system and new one, however, is still an important problem unsolved in China. In the enterprises, which have transformed to stock companies, the problem appears such kinds of characteristics as following. First one is that, the new system is nominal and the old one works as before. Second, both old and new system are reputed and vacant, and their respective responsibilities are in state of chaos, which makes both systems weak. Of course this is a temporary phenomenon. If the state continues, the enterprise will disappear ultimately. The third one is blindly pursuing new system as an international criterion, with traditional advantages of old one cased away.

The change of institutional and cultural context is a hard and slow process, especially in China, which makes the status of corporate governance in transformation more complex and multileveled. This paper aims to find a reasonable solution, and make suggestions about further development.

Ownership institution, as the most essential institution in the stock company, determines radically the characteristics of corporate governance. On the other hand, the participant degree of party members and employees (for short, P&E), indicates that the degree of traditional culture followed, regardless they have formal organization or not. So ownership and P&E can be taken as dimensions in discussing

the relation of new governance system and old one.

The mechanisms of corporate governance include manager's encouragement, manager's change, and manager's supervision, upon which ownership concentration and the participant degree of P&E have influence.

Too high or too low concentration doesn't benefit the effect of governance mechanisms.

*Ownership concentration and manager encouragement.* High ownership concentration or big stockholders is helpful to manager encouragement in certain degree and reduce the agent cost, especially at the case of the biggest stockholder holding the dominant stock. When the chairman of the board or CEO is the direct representative of the dominant stockholder or himself, the interest of manager will be consistent with the stockholder's (Jensen and Meckling, 1976), and the manager will make some decisions, which benefits the interest of stockholders. When the stockholding is very dispersed, however, the interest of manager is not so consistent with the stockholders', managers tend to make some decisions which harm the interest of stockholders.

*Ownership concentration and manager displacement.* The manager market or the pressure of being displaced is the important factor to drive the manager work hard (Fama, 1980). When the biggest stockholder dominate stock, the agent he sent will be easy to succeed in fight for the agent power with others. So high ownership concentration makes against the manager's displacement. When the stock is high dispersed, however, the manager or chairman as the decision-maker plays a key role in corporate governance structure. With sufficient information about company operation, they can easily affect the small stockholders who have no chance to participate in corporate operation. The drive-free motivation discourages them from pulling down the current manager or chairman. So the dispersed stock leads to the less likelihood of manager displaced.

When the concentrative degree is neither high nor low, and the company has several big dominant stockholders, the manager may be displaced quickly when ill performance. The big stockholders with much stock have both motivate and capability to find out the problems when the manager operating, or the cause of ill-performance, and pay high attention to manager's displacement.

*Ownership concentration and manager supervision.* When the company owns a dominant stockholder and the manager is not the stockholder himself but his agent, the dominant stockholder have motivate to supervise the agent. Such supervision is general effective. But when other stockholders are all small, and the manager is the dominant stockholder himself, the supervision from small stockholders to the manager is uncertain. In a general way, small stockholders can't challenge directly the dominant stockholder. When the stock is dispersed, however, the supervision to the manager becomes a serious problem. Supervising the manager needs cost, dispersed stockholders have the motivate to drive free and unwilling to do that. When the company has several big stockholders and the manager is the agent of one of big stockholders, other big stockholders have motivate to supervise him with much stock.

In conclusion, ownership institution has great impact on corporate governance mechanisms and corporate performance, and such ownership structure with certain degree of concentration and several big stockholders is superior to the other two.

Optimize ownership structure will be one of important ways to improve corporate governance.

For all the necessities for new governance system to take on main role of corporate governance in business, we can't ignore the peculiar context of history and culture in China. China was always regarded as a typification of ethical societies in history. Now the ethical nature has changed greatly, but something essential still are kept. According to Veblen's institutional theory, institutional change is a process of comprehending culture, adapting to culture and learning culture. The remainder of ethical culture impedes the development of the law and regulation, and the transformation to market economy of which the precondition is rationalism. To ensure the success of the transition, the context of institution and culture should be changed first.

As the theory of path-dependence suggests, the national culture and ideology changes slowly. The culture status will limit corporation governance structure to show its advantages till some time later. Furthermore, the necessary institutional conditions for new system, including the laws of finance and industrial regulation, need to be improved. Contrastively, the traditional culture still works.

As a community in the saddle, the party is still competent for party work through cultivating, educating and supervising the managers since most of them are party members. It can limit effectively power abused and moral crisis.

In social democracy socialism countries like China, the people play the role as the masters of the country all along. With the relative importance of human capital to physical capital increases, employees can also play an important role to supervise manager's behavior and strategic decisions. The party and employee (to sum up, P&E), can still play a role in encouraging and supervising the managers and the chairmen in current culture environment, and the higher degree for P&E to participates in corporate governance, the better the governance effect can be got.

Therefore, a joint governance of new governance system and old one by certain degree, choosing a certain degree of ownership concentration in new governance system and high participant degree of P&E, will greatly benefit governance performance for Chinese companies.

We got data from Questionnaire survey and annals from 226 publicly listed corporations in China, and find out the correlativity between ownership concentration and corporate performance, the correlativity between participant degree of P&E and corporate performance by SPSS.

Then, system Dynamics modeling is applied, and policy analysis is made about how to change the corporate governance structure in transitional China.

Different from other countries, a rational structure of corporate governance in China, in view of its special history and cultural context, should be a modified one of the new system, in which P&E should participate with certain degree.

The paper is organized as follows. Section I analyzes theoretically the impact of ownership on corporate governance, then the correlativity between ownership and corporate performance statistically. Section II discusses the influence of P&E on corporate governance, and the correlativity between participant degree of P&E and corporate performance. Section III applies system dynamics modeling to make policy

analysis. The residual part in this article is a brief conclusion.

**Keywords:** corporate governance, change, transformation, ownership concentration, participant degree of party & employee, system dynamics modeling