Chinese managers used to state control have a hard time acting as capitalists

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China has undergone a series of reforms to make the economy more market oriented, with a major step being the 1999 Securities Law that established rules for stock markets and listed firms. Along with the market reforms, the state also engaged in firm reform, where key element were allowing easier founding and growth of firms with no state ownership, releasing state ownership into private hands, and making it known that state ownership did not mean that pursuit of market goals could be avoided. In short, the goal was a market economy and firms with market goals.

So how well did it work? In our recent paper, we looked at how firms acquired each other. This is a very important decision in firms with market goals, especially in an economy undergoing restructuring, because acquisitions are opportunities for economic growth and profitability that go along with significant risks if plans fail. Before the market reforms, acquisitions would mainly be directed by the state and used to reorganize industries and prop up weak firms.

Who prevented market-oriented acquisitions?

We examined how firms with different ownership and board membership acted, and found that the state policy of a more market oriented economy had a surprising enemy: the state. Firms with greater state ownership made fewer market-oriented acquisitions. Firms with more directors having state experience made fewer market-oriented acquisitions. The key to understanding these findings is that acquisitions promise rewards but also risk, and will always be controversial decisions that require some level of agreement in the board. Directors with state experience are torn between the policy favouring market orientation and the experience following state instructions, and will be more critical to acquisition proposals as a result. They may believe that they are serving the market goal of high returns with low risks, but actually they are just cooling down the acquisition pace.

From this perspective it is not surprising who are the strongest supporters of the state policy of a more market oriented economy: market actors. Firms with more large-cap private owners (as opposed to small investors) made

more market-oriented acquisitions, and firms with directors owning stock made more market-oriented acquisitions. Unlike the state actors, who are torn between old allegiance and new policy, market actors have no barriers against driving forward acquisitions that they find promising.

The role of state ownership in slowing down market orientation also had stock market consequences. Investors seemed sensitive to the potential for firms with state ownership to acquire less, and perhaps also acquire firms for the wrong reason. As a result, market-oriented acquisitions resulted in lost stock value when firms had significant state ownership, a finding not seen for any other kind of ownership. The state not only acted less often with market orientation, it received a stock market penalty when it did act.

Complications of boards

From our findings we can immediately see one reason why market transitions – in China and elsewhere – often seem less smooth than one would want and expect. Firms have habits too, in large part because decision makers act on their experience. The new policy didn't change their experience. As a result, there will be a period of time in which firm decision making influenced both by old habits and by new goals. This time period can be shortened by replacing key decision makers such as members of the board, but at the cost of losing experience.

A less obvious implication is that it can be harder for firms to do turnarounds, and ventures to pivot, than we often imagine. A new strategy is just an intention until it is implemented, and the implementation involves many decisions by many teams. The teams will have many members who have experience from before the new strategy. Just as in the case of Chinese firms making acquisitions, decision makers may think they are just giving options a careful scrutiny for the benefit of the firm – but actually they are acting as brakes on the new strategy implementation.

The key lesson from our investigation is broader than market reform, and broader than China. Firms make strategies looking outward to opportunities and threats, and forward to risks and rewards. Strategies would be much easier to implement if firms didn't also have decision makers who assessed choices looking backward to the past and their experience.

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Notes:

- *This post is based on the authors' paper Institutional Logics and Power Sources: Merger and Acquisition Decisions, in Academy of Management Journal, March 2016*
- *The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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