Available online at www.sciencedirect.com
ScienceDirect
ELSEVIER
Research in International Business and Finance 21 (2007) 447–468
RESEARCH IN INTERNATIONAL BUSINESS AND FINANCE
www.elsevier.com/locate/ribaf

Transaction cost, corporate governance and division of labor—A general equilibrium analysis of professional managers and its implication to China's practice

Ke Li *

Graduate School of Business, Nihon University, Japan

Received 23 December 2006; accepted 26 December 2006
Available online 13 January 2007

Abstract

This paper develops a Walrasian general equilibrium model based on transaction cost and specialization to investigate the emergence and evolution of the role of management services in a competitive market with the general concern of corporate governance. It explains the reason why along the commercialization and modernization of human society, there is substantial increment of professional managers available for business world, and also becoming more affordable for more business companies. With the improvement of transaction efficiency, the market demand of professional managers are more preferred and profitable, which will also bring about new business structures and new economic institutional systems to improve the well-being to the overall members of society. Thereby, hiring professional managers in a competitive market can promote aggregate productivity by enlarging the scope for trading off network effects of the division of labor on aggregate productivity against transaction costs. To business practitioners, this model suggests hiring professional managers a key element of business viability during that a major transition took place in human society. China's recent practices in ownership transformation and corporate governance have also been examined, which further proves our argument that performance and effectiveness of interaction and interrelation between ownership and corporate governance are endogenously determined by different market conditions. It is impossible to achieve success ownership transformation and establish effective corporate governance without upgraded changes and consecutive adjustment and improvement of market conditions to facilitate the solid function of market mechanism.

Keywords: Corporate Governance; Professional managers; Management services; Specialization; Transaction cost; Division of labor; Fixed learning cost

* Tel.: +81 3 52759444.
E-mail address: KLi@gsb.nihon-u.ac.jp.

0275-5319/$ – see front matter © 2007 Elsevier B.V. All rights reserved.
doi:10.1016/j.ribaf.2006.12.007

1. Introduction

China has achieved remarkable economic growth rate since 1978, which is attributable primarily to various sound economic reforms, such as special economic zones, provision of government incentive packages that promote exports, opening up the economy to foreign investors for joint ventures and investment, and the restructuring of numerous unprofitable State-Owned Enterprises (SOEs). Moreover, Chinese-style gradualism has been regarded as a counter-example of the transitions undergone through the shock therapy by most Eastern European economies and in the former Soviet Union (Boone et al., 1998). Among them, over the last two decades China has experienced three distinct stages of enterprise reform: the first stage commenced in 1980 in Sichuan province, which focused on restructuring the incentive system for SOEs, granted greater autonomy to managers, and developed of product markets outside of the planned economic system (Hay et al., 1994); the second stage of reform focused on the simultaneous development of product and factor markets as well as property-rights reform; and the third stage of enterprise reform, which is still ongoing, is to corporatize SOEs, to create diversified ownership structures in the industrial sector,[1] and to improve the efficiency and performance of SOEs through an effective and solid system of corporate governance (Lin, 2001). In many ways, the gradual transformation of corporate governance of SOEs is the organic channel taken to reform in China, compared with the shock therapy approach. Although the gradual approach to reform brings more favorable results than in those cases that opted for the accelerated approach, there still are contradictory or controversy among these comparison (Boone et al., 1998). Particularly, since Chinese government still maintains ownership of majority of shares in SOEs, it cannot effectively monitor all of the firms. Hereby, with the consideration of ailing performance of SOEs, the Chinese authorities nowadays have to concretely promote the emergence of more effective system of corporate governance, and grasp this area henceforth as a priority for Chinese economy. In spite of the scope of such reforms, there are still remaining questions on their ability to improve Chinese corporate governance: firstly, how the administrative-type reforms in the state assets management system can contribute to improving the system of corporate governance in these firms; secondly, the interrelation between the internal control mechanisms and those that are external to firms, i.e. whether privatizations and the measures introducing the traditional instruments of corporate governance will be enough, while some basic mechanisms of external control are still absent or largely deficient; thirdly, whether a profound transformation of the control structures acting on firms is compatible with China's current political and economic life of the country. Nevertheless, besides the ownership transformation, corporate governance and related issues of SOEs have reached the consensus of being regarded as the crucial bridge of China further economic reform (Huchet and Richet, 2002).

The primary meaning of corporate governance is about the control of the resources in firms, and is concerned with the institutions that influence how business corporations allocate resources and returns. In current literature and in common practice, corporate governance is to indicate that decision-takers of the corporate (professional managers) must be accountable to corporate owners for their actions. A system of corporate governance determines who makes investment decisions in corporations, what types of investments are made, and how returns from investments are distributed (Lazonick and O'Sullivan, 1995). The control should be organized in such a way that investors,

[1] By the late 1990s in China, wholly controlled SOEs counted for 44 percent of total industrial sales, collective-owned firms counted for 26 percent of sales, mixed state and private owned firms provided 24 percent of sales, and wholly private-owned firms supplied 6 percent of sales (Liu and Garino, 2001).