Is Entrepreneur-Politician Alliance Sustainable During Transition? The Case of Management Buyouts in China

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Abstract

This paper explores the dynamic interactions between entrepreneurs and politicians in transition China through an unconventional lens of management buyouts (MBOs). Specifically we identify two contrasting outcomes of entrepreneur-politician alliances: Privatization buyouts by entrepreneurs and failed MBOs implying the collapse of the original alliance. Drawing on the rent appropriation literature, we treat Chinese MBOs as a bargaining, clarification, and redistribution of organizational rent between entrepreneurs and politicians, and further develop a model of entrepreneur-politician bargaining that identifies the determinants of varying rent bargaining (MBO) outcomes.

Keywords: Entrepreneur, Politician, Management Buyout (MBO), China, Transition

Running Title: Entrepreneur-Politician Alliances and Management Buyouts in China
INTRODUCTION

The rise of entrepreneurship in post-communist economies has attracted considerable attention from students of institutional transition (Filatotchev, Wright, Buck, & Zhukov, 1999; Wright, Hoskisson, Busenitz, & Dial, 2000; Peng 2000, 2001; McMillan & Woodruff, 2002). Despite the stifling environment for entrepreneurs in the pre-transition period and the turbulent transitional environment where market-supporting institutions remain underdeveloped and government predation is rampant, a variety of entrepreneurial activities are clearly visible in both the de novo private sector and reformed enterprises. While studies on the characteristics, strategies, and economic impacts of these indigenous and returning entrepreneurs have made significant progress (Chang & MacMillan, 1991; Puffer, 1994; Tan, 1996; Tsang, 1996; Wright, Liu, Buck, & Filatotchev, 2008; Filatotchev, Liu, Buck, & Wright, 2008), our understanding of the process by which they interact with other major players during transition, such as politicians, state-owned enterprises (SOEs), financial institutions, and foreign firms, remains inadequate. Even less clear is how and to what extent these complex interactions impact entrepreneurs’ attempts to create sustainable competitive advantages in this extremely volatile business environment, be they founders of new start-ups or entrepreneurially-minded managers in reformed industrial firms.

This paper aims to narrow this gap by analyzing the dynamic interactions between entrepreneurs and politicians through an unconventional lens – management buyouts.
(MBOs) in transition China. An MBO typically involves the acquisition of all or part of a firm by a new company in which the existing management takes a substantial proportion of the equity (Wright, 2007a). While conventional entrepreneurship research focused on private start-ups, entrepreneurship is well-known to be present in a wide range of business organizations (Shane & Venkataraman, 2000; Zahra, Ireland, Gutierrez, & Hitt, 2000). Existing research in developed economies suggests that MBOs have the potential to unleash entrepreneurship in restructured firms (Wright, et al., 2000; Zahra, 1995), whereas privatization buyouts by managers and employees in Eastern European transition economies have received a mixed assessment (Djankov & Murrell, 2002; Wright, Buck, & Filatotchev, 2002). It has become a stylized fact that relative to outsider privatization, insider control through voucher schemes and MBOs (especially the former) is less likely to induce effective corporate restructuring, organizational learning, and performance improvement (Estrin & Wright, 1999; Filatotchev, Wright, Uhlenbruck, Tihanyi, & Hoskisson 2003). Indeed, the behavioral patterns of the former SOE managers did not change overnight and they were more skillful at securing subsidies from government officials than at undertaking normal market competition. Thus, the umbilical chord between the state and the firms was not completely severed as originally expected by reformers, with soft budget constraints and government interference in firm-level decision-making dying hard. In sum, we have observed much more managerial entrenchment and organizational inertia than entrepreneurship in these insider-controlled firms (Filatotchev, Wright, & Bleaney, 1999). At the same time, the extent to which 

*de novo* start-ups have occurred in
transition economies has varied depending on the institutional context (Estrin, Meyer, & Bytchkova, 2007). Stimulating entrepreneurship in privatized enterprises is, therefore, an important issue in the successful transition to a market economy.

The case of MBOs in China tells a somewhat different story, owing mainly to a different sequence of economic reforms from that in its Eastern European counterparts. Unlike the shock therapy that attempted simultaneous market liberalization and mass privatization, market competition in China was gradually introduced through price liberalization as early as 1984 (Naughton, 1995), while large-scale privatization was not widely initiated by local governments until the late 1990s (Cao, Qian, & Weingast, 1999; Green & Liu, 2005; Liu, Sun, & Woo, 2006). Two consequences of this unique transition path can be identified: First, since the formal private sector did not blossom due to legal and ideological constraints until the mid 1990s, a large number of entrepreneurs established their businesses with the help of revenue-seeking politicians by registering them as collective enterprises, which in turn were affiliated to corresponding government authorities. These collective hybrids such as township and village enterprises (TVEs) soon achieved a high speed of growth through the unique synergy between entrepreneurs and politicians. Second, unlike their Eastern European peers, many of the SOE managers in China during the reform era, especially those in the less regulated industries and in local government controlled state firms, have to face increasingly intense competition in the product market. A small number of SOE leaders demonstrated their entrepreneurial flair in the volatile competitive
environment by helping their firms to obtain market leadership and impressive profitability.

Alongside the deepening of institutional transition in the 1990s, private ownership of industrial firms was gradually legitimized but the entrepreneurs did not have significant ownership stakes in the businesses they once helped to found and/or grow. As a result, the Chinese MBOs starting in the late 1990s can be seen as a bargaining, clarification and redistribution of firm surplus between the key stakeholders – entrepreneurs and politicians in this case. The result of the bargaining, i.e. the success or failure of an MBO, has profound impacts on the durability of the entrepreneur-politician alliance and the long-term performance of these firms. In view of various successful and failed MBO cases that have attracted a great deal of academic, business and media interests in China, this paper develops a fresh analytical framework and theoretical propositions to characterize entrepreneur-politician bargaining in this emerging market context. In particular, we draw on the rent bargaining/appropriation literature (Coff, 1999; Bowman & Ambrosini, 2000; Alvarez & Barney, 2004) to shed light on the complex MBO process in China.

The next section provides a brief overview of existing studies on the origin and strategic choice of entrepreneurs in transition China, with special reference to their interactions with central and local political forces. Furthermore, two broad patterns of entrepreneur-politician bargaining outcomes are identified: (1) Successful
privatization buyouts by entrepreneurs: Entrepreneurs manage to gain corporate control while politicians exit, but the alliance remains at work in some different forms from government control; (2) The collapse of the original alliance: Entrepreneurs fail to gain control and are dismissed by politicians, who sometimes introduce replacement from outside. On the basis of the stylized outcomes from illustrative actual MBO cases in China, we next develop a theory of politician-entrepreneur bargaining, which offers a set of testable propositions with reference to the determinants of their evolving bargaining powers, the intensity of the rent struggle, and the durability of their alliances. The final section concludes and identifies theoretical contributions, limitations and future research directions, and policy implications.

ENTREPRENEUR-POLITICIAN ALLIANCE IN TRANSITION CHINA

Contrary to the ‘transition orthodoxy’ which advocates a decisive and clear-cut break with past institutional inefficiencies (Kornai, 1992; Boycko, Shleifer, & Vishny, 1995), the three decades of transition in China are characterized by gradual experimentation making use of a myriad of pre-reform institutional legacies, halfway reform measures and hybrid property-right forms (Nee, 1992; Oi & Walder, 1999; Lau, Qian, & Roland, 2000; Qian, 2000). Among these ‘suboptimal’ practices as viewed from the neoclassical perspective, the emergence of a diverse range of public-private hybrids in China’s rural and urban sectors has attracted substantial scholarly attention. Despite the ‘public’ or ‘collective’ label usually attached to these firms, most are in effect joint
ventures between nascent entrepreneurs and pro-business politicians keen to exploit profit- and rent-seeking opportunities in the increasingly marketized economy. In fact, they were hardly ever integrated into the shrinking central planning system or the central state’s budgetary management during the reform era and behaved qualitatively differently from the large-scale SOEs remaining in the commanding heights of the state sector. In concrete terms, they include not only the well-known TVEs in rural China but also urban collectives, reformed local SOEs, and enterprises sponsored by or affiliated to various state agencies ranging from research institutes to the Chinese military.

The TVEs have been in the academic spotlight for many years owing to their significant contribution to China’s economic growth and the key role they played in rural industrialization. While some dated back to the commune and brigade enterprises in the Maoist era (Byrd & Lin, 1990), most did not flourish until the second half of the 1980s when market liberalization started to gain momentum. Officially speaking, they belonged to all residents of a rural community where they are usually located, but local residents had no direct claim over TVE profits. Rather, community governments on behalf of the residents exercised control rights and made strategic decisions regarding the selection and reward of managers, the disposition of profit and major investment projects (Che & Qian, 1998). In reality, however, most TVEs were under the joint control of local politicians and entrepreneurs (Weitzman & Xu, 1994; Li, 1996). The degree of government control vis-à-vis managerial
autonomy over the key decision-making areas mentioned above was subject to bargaining between the two parties and varied significantly across firms and regions. Previous studies identified two types of TVEs that exhibited subtle but important differences in government-enterprise relations (Oi & Walder, 1999; Whiting, 2001; Chen, 2004). In type-I TVEs, township and village officials contributed financial capital from the community government at the start-up stage and were deeply involved in major decision-making from the outset, though they hired entrepreneurs/managers for operational decisions and awarded more incentive contracts to the latter over time (Byrd & Lin, 1990; Walder, 1995; Chen & Rozelle, 1999; Oi, 1999). The type-II TVEs, in contrast, were initially set up by entrepreneurs, who in turn cooperated with local officials to mask the private nature by designating them as rural collectives (Peng, 2000, 2001; Chen, 2004; Tsui, Bian, & Cheng, 2006; Chen, 2007). This strategic affiliation is dubbed ‘wearing ret hat’ in Chinese. Understandably local officials in this case are much more removed from firm operations while the entrepreneurs enjoy much greater latitude in decision making.

In the urban sector, the development of entrepreneur-politician partnerships is present in a variety of government controlled/sponsored organizations. With respect to existing organizational forms, some small- and medium-sized local SOEs and urban collectives developed in the increasingly deregulated markets (such as those for consumer goods) under the leadership of charismatic managers with an entrepreneurial mindset. Famous examples include TCL\(^2\) and Haier\(^3\), which were
officially defined as a local SOE and an urban collective, respectively. Moreover, such entrepreneurial alliances proliferated across the public sector so that there loomed many unconventional ‘public’ start-ups during the reform era: Technological enterprises/spin-offs, many of whom later become the backbone of the Chinese high-tech sector, were set up by state universities and research institutes in the early 1980s (Francis, 1999; Lu, 2000; White & Xie, 2006). The commercial activities of the Chinese army were not confined to the defense industry but involved the establishment of a host of new manufacturing and services companies (Bickford, 1994; Nolan & Yeung, 2001). Miscellaneous new businesses ranging from trading firms to real estate companies are under the auspices of former or current regulatory agencies to take advantage of the profit- and rent-reeking opportunities (Lin & Zhang, 1999; Duckett, 2001).

That the entrepreneur-politician ventures grew out of the old institutional arrangements implies that there was only a thin and blurred line between the identity of entrepreneurs and that of state sector cadres within these organizations. It is well-known that, during the market transition, many government officials, technocrats, and SOE managers joined the rank of entrepreneurs (Rona-Tas, 1994; Peng, 2001), but a majority had a dual identity by retaining their cadre status/position in the parent state agencies. On the government side, the reasons why the politicians were keen to initiate or assist business ventures have been discussed extensively in the academic literature (Lin, 2001; Whiting 2001; Li & Zhou, 2005; Liu, et al., 2006). In essence, a
set of push-and-pull factors are at work. First, the cadre evaluation system during the reform era exerts heavy pressures on local politicians, who are intent on career advancement to improve the economic growth record of their jurisdiction. The achievement of rapid local economic growth is, in turn, increasingly reliant on the contribution from these hybrid fringe players rather than traditional SOEs. Second, market transition in China has transformed politicians from stereotypical ideology-guided cadres into self-interested, opportunistic agents ready to trade their regulatory power for private gain and self-enrichment. New ventures attached to their administration, relative to the loss-making SOEs, may become a more important base where they derive private benefits, pecuniary or otherwise. Finally, economic transition, however incremental, inevitably causes considerable reform costs such as the respective redundancy of workers and staff in the SOEs and government bodies, and the reduction in central-state-allocated funds. Therefore, the hybrid ventures can be quite useful for the bureaucrats to assimilate the lay-offs and to alleviate budgetary pressure.

Given the impressive performance and growth of these hybrid ventures during transition, theoretical explanations for the competitive advantage of this organizational arrangement revolve around the impacts of the unique institutional environment upon the strategic choice of organizational forms. Since the Chinese government still controls a wide range of financial and regulatory resources, such as access to bank loans, the use of land, and tax breaks and subsidies, it was natural in
the early stage of transition for the entrepreneurs to overcome these disadvantages by adopting a boundary blurring strategy with political agencies (Peng & Heath, 1996; Luo, Tan, & Shenkar, 1998; Tian, 2000; Peng, 2003). Moreover, formal private ownership lacked legitimacy until the late 1990s when the central government officially endorsed it as ‘an important part of the socialist market economy’, so strategic political affiliation helped to defuse ideological hostility, policy discrimination, and predation from the central government and other political institutions (Tan, 1996; Tsang, 1996; Chen, 2007). Consequently, these political capital/resources including institutional legitimacy, access to input factors, preferential treatments, and protection from political harassment, when combined with the market-based competence contributed by the entrepreneurs, formed a unique synergy that made the alliances outperform a large number of SOEs and private firms in the 1980s and the first half of 1990s.

The remarkable achievement of these hybrids notwithstanding, scholars have long predicted the transitional nature of this organizational form (Nee, 1992; Tian, 2000; Hoskisson, Eden, Lau, & Wright, 2000; Peng, 2003; Li, 2005). The growth of market-based institutions and rule-based exchange in the later stage of transition will lead to a decline in the strategic value of government-controlled resources relative to that of market-based capabilities in the more level domestic marketplace, thus reducing the necessity of the entrepreneurs’ political affiliation. While the benefits of this organizational form gradually diminish, the costs loom large of sustaining the
competitive synergies once created by the two parties. Despite politicians having vested interests in the continued success of firms under their control, they normally have a strong tendency to use profitable firms as a social instrument for their own financial and political ends. As Nee (1992, p. 23) put it, ‘the cost to the firm of redistributive claims imposed by local government will surely outweigh the benefits of political support when the institutional foundations of a market economy are more fully in place’ (italics added).

DIFFERING EVOLUTIONARY PATHS OF ENTREPRENEUR-POLITICIAN ALLIANCES

The subsequent evolution of ownership and control in China since the late 1990s largely confirms this theoretical prediction, in that a majority of collective hybrids have been privatized as of the early 2000s (Liu et al., 2006, Table 2 &3; Kung & Lin, 2007, Figure 1). Insider privatization through MBOs is found to be a major avenue of ownership transformation in small and medium SOEs and collective hybrids, though it has been explicitly forbidden by the central government for the reform of large-scale SOEs (Li & Rozelle, 2003; Garnaut, Song, Tenev, & Yao, 2005). The smooth transition from an entrepreneur-politician joint venture to a privatized firm is always associated with the emergence of a new form of entrepreneur-politician symbiosis, not through the traditional ownership affiliation, but characterized by pervasively collusive and patron-client ties (Wank, 1999; Chen, 2004; Liu et al., 2006, pp. 2024-2025). Not all the firms (or the entrepreneurs) are that lucky, though. Anecdotes abound in the Chinese business media of high-profile failures of MBOs in
what were once successful entrepreneur-politician alliances. It is somewhat puzzling to find that the original entrepreneurs failed to secure any sizable ownership stakes and some of them were even removed by the government from their managerial positions through forced retirement or charges of economic crimes. The firms in question either remained as state-owned or were sold to outside groups. The possibility of organizational upheaval during MBO was vividly described by a Chinese commentator when discussing the case of ‘Red Hat’ firms:

‘It is said that those who wear a Red Hat have a time bomb on their head. The first type of firms have safely removed the bomb, the second type has not removed the bomb yet, while the third type blew up when removing the bomb’ (cited by Chen (2007), p. 74).

To further illustrate the stylized patterns noted above, we sketch two cases regarding successful and failed MBOs. The first case – Midea (Meidi) – was a TVE that has successfully transformed itself into a privatized business group concentrating on household appliance. Like many TVEs, the history of the firm can be traced to the pre-reform era: it was once a collective workshop/plant founded by HE Xiangjian – then a cadre in the local community – and 22 local residents in 1968. Under HE’s leadership, the 23 people contributed a sum of RMB 5,000 and formed the ‘plastics production team’ in Beijiao township, Shunde County in Guangdong. During the 1970s, the firm was further involved in metal processing and the production of truck
components. A notable episode during this stage is that the firm began losing money immediately after HE was promoted to a higher position in Beijiao township government in 1977. Thus the township government had to send him back to turn around the business at the end of year 1979. From then on, HE has never been away from the firm.

It was in the 1980s when the firm started to adopt the current name (Midea) and to produce electric fans and air conditioners, which later became its core business segment. Although the township government did not make any financial contribution to the firm at its founding stage, its support proved critical during Midea’s takeoff, ranging from political legitimacy, to access to bank loans and tax breaks, and to the award of export licenses. In 1993, Midea became the first TVE listed on the domestic stock market, and the township government acted as the dominant shareholder owning 44.26% of the listed firm’s stakes. Such clarification of the once ambiguous property rights was not the end of the story, though. It is said that behind-the-scenes negotiations between government officials and company senior managers started as late as 1998 about prospective MBO plans. Specifically, HE and his associates registered two companies in 1998 and 1999. The official owner of the first company is all managers and employees and the other one is owned by eight senior managers including himself and his son. The two companies, in turn, purchased the shares held by the township government at a price below the prevailing net asset per share.\(^5\)

Moreover, the two companies (the management) paid only 10% of the total value
when concluding the deal in 2000, while the remaining 90% was paid by installment and financed by bank loans; and more interestingly, the loans were guaranteed by the seller – the township government. The firm continued to grow and prosper after the MBO and now is one of the largest home appliance makers in China.

While a large number of TVEs achieved smooth privatization buyouts, there is no shortage of failed MBO cases in the TVE sector. Even located in the same Shunde County, a once famous TVE – Kelon – has a drastically different fate from Midea. The predecessor of Kelon is the Guangdong Shunde Pearl River Refrigerator Factory, which was founded in 1984 through collaboration between entrepreneurs and the Rongqi township government. At that time, WANG Guoduan ran a small factory producing cheap transistor radios for a Hong Kong firm. Both Wang and the township government were keen to explore new business opportunities at the advent of economic liberalization and PAN Ning, a vice-head of the township government, was henceforth assigned as general manager to work with WANG. Despite them having neither experience nor technical capability in refrigerator production at that time, Rongqi township provided seed capital of RMB 90,000 (roughly $30,000 at the prevailing exchange rate) and helped to secure a bank loan of RMB 400,000 ($130,000) for the construction of the plant. Another essential support from the local government was related to the fact that it actively lobbied on behalf of Kelon for a production license from the central government in the mid 1980s.
The subsequent takeoff of Kelon in the white goods sector was dramatic. By 1991, Kelon had already become the top refrigerator maker in China, producing 480,000 fridges and enjoying 10.3% market share. Furthermore, Kelon was a pioneer in corporatization experiments. As early as 1992, the firm was transformed into a shareholding company, in which Rongqi township government held 80% of shares and managers and employees were offered the remaining 20% stakes. Thus the newly formed Kelon Electrical Holdings Co. Ltd was an envy of peers in the domestic sector then, in that it combined committed government support with a high-powered incentive scheme for employees. In 1996, Kelon became the first Chinese TVE allowed by the central government to float on Hong Kong Stock Exchange.

During the 1990s, Kelon captured the largest market share in the domestic refrigerator sector and had already become one of the largest air conditioner makers in China. Even at the start of year 2000, the company predicted 11.7% growth in sales and RMB 0.7 billion ($87.5 million) net income. Nevertheless, the year-end result was rather surprising: Kelon fell into the red for the first time in history, reporting a huge net loss of RMB 0.83 billion ($103.75 million) with a 30.9% sales decline. A further financial hemorrhage of more than RMB 1.4 billion ($175 million) net losses followed in 2001, which left Kelon on the verge of bankruptcy. Such a dramatic change of fortune, it can be shown, had to do with two key factors in the firm’s internal governance: Failure in incentive alignment of the management and government expropriation of firm assets.
First, the township government persistently refrained from granting more ownership stakes to company managers so that even the two corporate founders – PAN and WANG – held negligible shares in the listed firm. When managerial talents and efforts could not be rewarded via formal incentive contracts such as share ownership and stock options, the management chose to capture their private benefits through self-dealing activities, which can partly be seen from the soaring operating expenses in the second half of the 1990s. Another dimension of the failure is related to a series of turbulent managerial turnover triggered by the forced retirement of PAN and WANG in 1999 and 2000. PAN disagreed with the government on the lack of ownership incentive plans for managers and repeatedly prevented the government from extracting firm resources at its own will. For example, during his tenure he repeatedly refused to take over other unrelated loss-making firms owned by the local government: hence the purge by the township government. Second, the township government engaged in intensive asset stripping in the late 1990s. Specifically, it diverted a total of RMB 1.26 billion ($150 million) from the listed Kelon Electrical Holdings Co. Ltd through a string of secretive related-party transactions from 1998 to 2001. In the end, Kelon was hastily sold by the township government to an outsider in late 2001.

Given the divergent paths of evolution with seemingly similar initial conditions and organizational structures, existing literature has only succeeded in telling the first half
of the story, and few, if any, in-depth, micro-level studies have yet explored how entrepreneurs/managers managed or failed to decouple the firms from the supervisory/sponsoring government agencies (or defuse the ‘time bomb’) through the MBO process. How do entrepreneurs play the delicate and sometimes dangerous game with politicians equipped with the powerful fist of state apparatus to accomplish their MBOs? What internal and external factors determine the varying outcomes of bargaining between the two parties over firm surplus? Answers to these questions are of critical importance to understand the dynamics of entrepreneur-politician interactions during institutional transition and their bearings on the retention or destruction of competitive advantages of indigenous start-ups in emerging economies.

ENTREPRENEUR-POLITICIAN BARGAINING AND ORGANIZATIONAL EVOLUTION: TOWARD A THEORY OF RENT APPROPRIATION DURING INSTITUTIONAL TRANSITION

The foregoing observation of the contrasting evolutionary paths in these entrepreneur-politician alliances motivates us to develop an emergent theory of rent appropriation/bargaining by entrepreneurs and politicians in the context of institutional transition. Following the introduction of a two-stage model of organizational rents as an overarching framework, we derive research propositions regarding the stability of the rent-generating alliance, the determinants of bargaining power, and the intensity of bargaining.

The Dynamics of Organizational Rents
Organizational rents, according to the resource-based view (RBV) of the firm, are above-normal economic returns stemming from a unique bundle of resources and capabilities embedded in an organization (Amit & Schoemaker, 1993, p. 36). The rent-generating strategic resources, in turn, must be valuable, scarce, imperfectly imitable, and difficult to substitute (Barney, 1986; 1991) to bestow sustained competitive advantage. Recent studies, however, have noted that the traditional RBV literature only provided the first half of the story of organizational performance, in that it is largely silent on how the rents generated within a firm or across interfirm networks are appropriated by its stakeholder groups before being observable in conventional performance measures (Coff, 1999; Bowman & Ambrosini, 2000; Alvarez & Barney, 2004; Barney, Wright & Ketchen, 2001). According to Coff (1999, p.120), ‘… performance is an outcome of a two-stage game. Rent generation is the first stage, and rent appropriation is the second stage’. Therefore the sustainability of organizational rents also depends on whether the organization can retain a significant portion of these rents while preventing them from being dissipated among its stakeholder groups (Kay, 1993, pp. 181-191).

As illustrated in Figure 1, the formation of organizational rents involves two stages. In the rent generation (RG) stage, rents arise from a nexus of explicit and implicit contracts within the firm or across organizational boundaries, both of which involve a
wide range of stakeholders such as investors, managers, employees, suppliers, customers, financial intermediaries, and strategic partners (Hill & Jones, 1992; Zingales, 1998, 2000; Dyer & Singh, 1998; Gulati, Nohria, & Zaheer, 2000). In the eyes of the RBV, it is in the nexus of stakeholder contracting that the potential organizational rents are generated. Hence the term ‘nexus rent’ coined by Coff (1999). In the context of the entrepreneur-politician partnerships in transition China, the rents of this particular organizational form stemmed largely from the unique alliance between human and political capital under this unique institutional environment. Therefore, ‘alliance rent’ in this context can be a parsimonious term to characterize the rent-generating nexus between the two key stakeholders.

Once the nexus rents have been generated, they are up for grabs by stakeholder groups in the rent appropriation (RA) stage before being visible in conventional accounting terms. In reality, it is quite common to observe that a significant proportion of nexus rents fail to be retained within the firm but flow to certain stakeholder groups. The managerial agency problem identified in the financial economics literature (e.g., Jensen & Meckling, 1976; Shleifer & Vishny, 1997) can be reinterpreted as the grab of rents by management through a variety of channels such as excessive executive compensation, on-the-job consumption, and ‘empire-building’ activities. Value appropriation by external stakeholders like suppliers, distributors and business partners is well documented in the academic literature (Klein, Crawford, & Alchian, 1978; Deligonul, Kim, Roath, & Cavusgil, 2006; Alvarez & Barney, 2001).
Similarly, the scope for rent capture by managers and financiers in MBOs in the West has also been recognized (e.g. Lowenstein, 1985; Jones & Hunt, 1991), although this has been the subject of some debate (Bruner & Paine, 1988). In this paper, different outcomes regarding management buyouts also represent different results of rent appropriation by management and politicians. Successful privatization buyouts imply a transfer of rents from government agencies to managers/entrepreneurs, whereas failed ones indicate the opposite.

A key implication of the above decomposition of organizational rents is that, apart from rent generation, rent appropriation by stakeholder groups plays an important role in the sustainability of a firm’s competitive advantage. Moreover, the China case leads us to recognize that the consequences of stakeholder bargaining over nexus rents may well go beyond the unobservability of ‘an appropriated advantage’ (Coff, 1999, p. 127). Here we extend Coff’s study of stakeholder bargaining over nexus rents by explicitly considering RA and RG in a *dynamic* set-up. Specifically, the functioning of a business firm as a nexus of stakeholder contracts can be seen as a *continuous* sequence of RG and RA activities.

As the preceding cases indicate, an initial unjustified distribution of appropriated rents, however defined or perceived by key stakeholder groups, may significantly impair the incentives of the disadvantaged/dissatisfied group(s) in contributing to the RG stage in the next round of the game, thus resulting in a gradual erosion of the nexus rents.
Meanwhile, they also may encourage dissatisfied stakeholder group(s) to devote more time, energy, and resources to enhancing their bargaining powers in the hope of changing the current rent distribution in the later rounds of RA. This, in turn, gives rise to more intense bargaining and more rents being appropriated away from the firm. If an agreement can be reached among key stakeholders after the renegotiation about rent distribution, organizational infighting may come to a halt, with the bulk of organizational rents preserved. Under some circumstances, however, our empirical examination suggests that a downward spiral might occur, which results in a steady decline of organizational rents or even a break-up of the original rent-generating nexus/alliance. Thus, we are less optimistic than Coff (1999, p. 128) about the long-term stability of the rent-generating nexus, when taking into account the potentially significant negative effects of stakeholder RA on a firm’s subsequent RG and RA activities. Inspired by two-decade-odd organizational evolution of the hybrid firms in China, this conceptualization of dynamic rent bargaining leads to the following baseline propositions in ceteris paribus terms:

**Proposition 1:** The stability of the original stakeholder alliance is positively correlated with the amounts of nexus rents generated in subsequent stages, and negatively correlated with the amounts of rents appropriated by the stakeholders in subsequent stages.

**Proposition 2:** The higher the degree of dissatisfaction by key stakeholder
groups about the current distribution of appropriated rents, the more intense the struggle in the subsequent rent appropriation stages, and the larger amounts of rents appropriated away from the firm.

**Proposition 3:** The higher the degree of dissatisfaction by key stakeholder groups about the current distribution of appropriated rents, the less incentive they have to engage in subsequent rent generation, and the smaller amounts of nexus rents generated within the firm.

**The Determinants of Stakeholder Bargaining Power**

To the extent that *ex post* stakeholder bargaining and the existence of power differentials between stakeholder groups are the norm in modern business organizations (Klein, 1982; Hill & Jones, 1992), we cannot understand the distribution of the appropriated rents without examining the determinants of stakeholder bargaining powers. Coff (1999, p. 125) outlined four generic determinants of bargaining powers possessed by management, employees, and shareholders in a corporate context – capability of unified action, access to/control over information, replacement costs if stakeholder exits, and stakeholder exit costs. While these general factors go a long way towards helping understand the determinants of power, without combining details of a particular business context, it remains very difficult to predict an *exact* pattern of rent distribution (bargaining outcome) among the three groups. Stakeholder bargaining in business organizations in emerging and transition
economies, a largely uncharted area, offers a unique opportunity to advance our understanding of this interesting issue. Below we examine the factors that may affect the evolving bargaining powers of entrepreneurs and politicians in their alliances in transition China, the results of which are summarized in Table 1.

First, a large part of managerial bargaining power stems from the information asymmetry between politicians and the management, as the latter has much more detailed information about the internal operation and the true value of the firm. In some cases, only the management has an accurate idea of how many (nexus/alliance) rents are actually created in the first place and are subject to subsequent bargaining! If government officials do not participate in day-to-day operations, as is especially the case in many ‘Red Hat’ firms, entrepreneurs/managers will be in an advantageous position to distort the information available to the former through the manipulation of accounting numbers. Specifically, they may make the firm’s performance look worse than it actually is to motivate the politicians to undertake privatization. If the buyout price is based on the book value of total assets rather than on a contingent basis with a claw-back mechanism, as the Midea case suggests, they are very likely to obtain a discount by artificially lowering the book value upon expectation of an MBO. In sum, we have the following proposition in ceteris paribus terms:
Proposition 4: The higher the degree of information asymmetry between entrepreneurs and politicians in firm operations, the larger the rent bargaining power of the entrepreneurs relative to that of the politicians.

Second, the cost of a potential break-up, which incorporates both replacement cost and exit cost discussed by Coff (1999), can be high for both parties, thus resulting in a bilateral dependency. But the cost is generally higher to entrepreneurs/managers than politicians in supervising agencies. Since many cadre-entrepreneurs retained their Party cadre status in the parent government agencies and are the agents of ‘public’ enterprises in an official sense, they are susceptible to political retaliation if the bargaining breaks up ungracefully, which ranges from forced retirement to arrests for economic crimes. Even absent political retaliation, the threat of exit by entrepreneurs is not very credible because of the firm-specific investments they have made since the firm was founded. Partly owing to this asset specificity and partly to the underdeveloped managerial labor market in China, they have very limited outside options to recover the full value of their human capital. For politicians, the cost can be high if the original rent-generating alliance collapses, but the situation is far less devastating to them since there is still a possibility of building up new rent-generating alliances with outside investors/entrepreneurs. Therefore, we can derive the following proposition in ceteris paribus terms:

Proposition 5a: There is a negative correlation between the cost of potential
break-up to a stakeholder and the power of the stakeholder in bilateral bargaining.

*Proposition 5b: The cost of potential break-up to entrepreneurs is higher than that to politicians in their alliances during institutional transition.*

Third, a stakeholder’s contribution to earlier stages of rent generation can be an important factor determining its power in subsequent rent bargaining. Although Bowman and Ambrosini (2000, pp. 9-10) asserted that there was no correlation between the value contributed by a resource supplier and the amount of value that he/she captures, our comparative case study of Midea and Kelon strongly suggest the otherwise. The essential contribution of political resources in the early stage of firm development equip politicians with strong bargaining powers in subsequent rent appropriation, in spite of the gradually declining value of the resources at their disposal in later stages of transition. In particular, if government agencies contributed financial capital at the start-up stage, it is very challenging for entrepreneurs to change the *de jure* status of ownership; whereas, our study also shows that the absence of direct financial input from government makes it easier for the entrepreneurs to change the *status quo* of rent distribution. On the basis of our observation, we have the subsequent proposition in *ceteris paribus* terms:

*Proposition 6: The larger the contribution to previous rent creation by the*
politicians/entrepreneurs, the larger the bargaining power they have in succeeding stages of rent appropriation.

Fourth, the discussion of power differentials between entrepreneurs and politicians cannot be isolated from the impacts of other stakeholders on bilateral bargaining. Key among these stakeholder is the central government since it is its agencies that set the regulatory framework regarding MBOs. Generally speaking, the central state does not want to make a clear distinction between these hybrids and traditional public enterprises. While turning a blind eye to insider privatization in TVEs and small local SOEs, it is extremely cautious about, if not outright against, the use of MBOs in large and medium reformed SOEs and collectives in the urban sector. Interestingly, however, there was no well-defined MBO regulation at the central level in the late 1990s and early 2000s. The Ministry of Finance once in 2003 called for a suspension of MBOs before the legal regulation is put in place, but it was largely ignored at the local level. The first comprehensive government regulation – *Provisional Regulations on the Management Buyout of State-Owned Enterprises* – was issued by the State Asset Supervision and Administration Commission and the Ministry of Finance as late as April, 2005. Consequently, the bargaining power of the grass-roots politicians is enhanced by this ‘institutional void’ (Khanna & Palepu, 1997). For entrepreneurs, especially those in large and medium hybrid firms, to accomplish an MBO, they need almost invariably to secure local politicians’ dedicated support as a political shelter from central intervention. Otherwise, grass-roots politicians have every excuse to
crack down on *unilateral* buyout attempts on the grounds of enforcing central government policy.

Relatedly, financial intermediaries have a major impact on the financing of an MBO (Wright et al., 2007). A key difference between a privatization buyout in China and a leveraged buyout (LBO) in the West lies in the ease with which the management can raise sufficient funds to finance their buyout (Wright, 2007b). Conventional channels such as commercial banks are controlled by the Chinese state and their credit decisions, despite the growing independence of the banking sector in recent years, can easily be influenced by local politicians. Even without political manipulation, management may still experience difficulty in providing collateral to obtain bank funds, while a political helping hand could easily solve the financing problem, as shown in the Midea case above. Therefore, the bargaining power of grass-roots politicians is also related to the extent to which they can affect bank lending decisions, which in turn serve to relieve or harden entrepreneurs/managers’ financing constraints. The future bargaining position of management in these hybrid firms remains to be seen, but it depends on whether political intervention in the banking system is quickly diminishing, and on whether they can find and effectively utilize new financial partners such as private equity firms and foreign investors to bypass domestic constraints.

Another stakeholder group that cannot be ignored in the analysis of power
differentials between the management and the politicians is the employees. In the Chinese context, management tries to enhance the legitimacy of their MBOs and secure employee support by incorporating them as new owners of the firm in real or symbolic terms. Specifically, the management creates a new collective entity – an employee shareholding association – as the proposed new controlling shareholder of the buyout target, or establishes a new holding company with significant employee ownership (like the case of Midea) to acquire the target firm. Similar to the Eastern European transition (Filatotchev, et al., 1999), employees in China are generally concerned about the prospect of outsider privatization which may involve massive restructuring activities; they are more supportive of incumbent management as long as their welfare benefits are not adversely affected by the MBO. Summing up the impacts of other stakeholders discussed above, we have the following proposition:

*Proposition 7a: The central government and the state-controlled financial sector can significantly enhance the bargaining power of the grass-roots politicians.*

*Proposition 7b: The emerging private and foreign financial intermediaries and the employees can significantly enhance the bargaining power of the entrepreneurs.*

In addition to the above, MBOs in China also highlight the importance of the wider institutional environment in affecting the bargaining powers of the two parties. It has
been well recognized that economic actions are embedded in a wide array of regulatory, normative, and cognitive institutional factors (Scott, 2001). Among them legitimacy is a core concern of institutional theorists. They argue that to obtain legitimacy, economic actors and organizations are under heavy isomorphic pressures to comply with prevailing institutional logics (DiMaggio & Powell, 1983). We apply insights from the institutional theory to examine the impact of the wider institutional environments on the power of economic agents during rent bargaining. From the perspective of management, the current institutional environment in China seems a mixed blessing. On the one hand, ‘privatization’ is no longer a political taboo but a legitimate policy option for SOE restructuring, so that entrepreneurs/managers cannot be punished by the act of MBO itself. On the other hand, current MBO practices in China, characterized by the absence of open, competitive bidding, the lack of third-party monitoring on asset evaluation, and the clandestine nature of the whole MBO process, are reminiscent of the notorious *nomenklatura* buyouts in the 1990s Eastern Europe with serious social justice and ethical problems (Filatotchev, Starkey, & Wright, 1994). Indeed, MBOs have been treated by some populist media as synonymous with the dissipation of state assets through insider self-enrichment, nothing more than another episode of widespread corruption and social injustice in transition China.\(^{13}\) This public unpopularity of MBOs, whether justified or not, translates into a reduction of managerial bargaining power: They may be less tough when negotiating an MBO deal with their political partners because they have to rely on them to help overcome the external hostility. Thus, the final proposition regarding
the power balance between entrepreneurs and their political partners can be expressed as below:

Proposition 8: The prevailing institutional environment, especially the legitimacy of varying forms of rent distribution, has a significant impact upon the power balance between stakeholder groups – entrepreneurs and politicians – in a firm.

The Intensity of Rent Struggle in RA Stages

Given that a specific distribution of the appropriated rents at a specific time arises from the balance of bargaining powers among the stakeholder groups, which in turn is determined by the firm-specific and institutional factors detailed above, it has considerable impact on the intensity of rent bargaining in subsequent RG stages especially when some key stakeholder(s) is (are) dissatisfied with this distribution (recall Proposition 2). In this subsection we explore other crucial factors that may determine the intensity of rent bargaining and ultimately the stability of the RG alliance over time.

One of the key features of the Chinese entrepreneur-politician alliances concerns the generally substantial ambiguity in their initial property right arrangements. For instance, there were always no explicit contracts between the two parties specifying the disposal and distribution of firm profits. This is striking in comparison with the
theory of the firm with incomplete contracts (Coase, 1937; Grossman & Hart, 1986; Hart & Moore, 1988). It treats a firm as a nexus of incomplete contracts in the sense that economic actors can never spell out all future contingencies in their contracts *ex ante*. So ownership and control of a firm can be understood as residual rights. Ownership is essentially the claim over residual income defined as the difference between total revenues realized *ex post* and the fixed payments specified in the contracts *ex ante*, while control is effectively an exercise of residual rights – those that are not explicitly specified in existing contracts. Furthermore, claims over residual income and residual control rights should be allocated to the party most vulnerable to potential ‘hold-up’ by other stakeholders and who has the largest incentives to maximize the nexus rent.

Chinese experience, nevertheless, indicates that initial contracts cannot only be incomplete, but also are explicitly ambiguous in the hybrid firms, where residual income and control rights are unspecified and subject to intensive bargaining and renegotiation. Interestingly, this observation resonates with recent developments in entrepreneurship theory that argue that it may not be easy to identify the optimal assignment of residual rights in entrepreneurial firms, because of a much higher degree of uncertainty surrounding the entrepreneurs than in established firms. Therefore, entrepreneurial firms can be regarded as ‘institutional place holders’ where property rights are gradually identified and clarified over time (Alvarez & Barney, 2005; Alvarez, 2007). What is more, the costs of renegotiating the previously
commonly held residual rights can be high and the stability of the entrepreneurial firms cannot be taken for granted. Alvarez and Barney (2005) noted that ‘…many entrepreneurial firms have a difficulty transitioning from small to large or from an emerging to a more established firm’ (p. 790), and they may even ‘carry within them the seeds of their own destruction’ (p. 789). Given the sheer amount and the unique nature of the political and business uncertainty in the early stage of transition China, it is reasonable to expect a more ambiguous property right arrangement among the entrepreneurial hybrids and more intense ex post rent struggles than their developed economy counterparts. Consequently, we have the following proposition:

**Proposition 9:** All else being equal, the higher the degree of ambiguity in the initial property rights arrangements of entrepreneurial firms, the more intense the struggle in the subsequent rent appropriation stages.

Another factor highly relevant to the intensity of rent bargaining is the evolving cognitive clash we identified between entrepreneurs and politicians. As their alliances grow, both parties have developed, to varying degrees, a ‘proprietary attitude’ to the alliance rents they have generated. With respect to entrepreneurs, they may perceive themselves as the real founders/main contributors of the ventures and regard the existing rent distribution as ‘unjustified’ during economic liberalization and transition. Some may play down the politicians’ contribution by treating the affiliation to government bodies as little more than a political expediency, whereas others
appreciate the initial and continuing network value of the political partners in ‘their’ firms. For instance, PAN Ning at Kelon did not seem to value the contribution from his political partners in the late 1990s, as he once contrasted his experience in Hong Kong to that in the Mainland: “When I am in Hong Kong, I can concentrate on business and there is no special need of making friends with government officials. But here I have no choice but to deal with the local politics.” In contrast, our informants told us that HE Xiangjian at Midea has a more ‘realistic’ understanding of the role played by the local government even in the late stage of transition. On the part of politicians, some, especially those who have contributed financial capital at the beginning, tend to adopt a legalistic view of firm ownership by regarding the entrepreneurs as little more than the agents of normal public enterprises, whereas others are aware of the essential contribution of the entrepreneurs/managers and remain open-minded about future change of ownership forms as long as their private benefits can be retained. Consequently, a potential clash of their perceptions about the magnitude of their respective contribution to the generation of alliance rents could result in serious discontent about the extant rent distribution and thus fiercer bargaining in the subsequent RA stages.

In addition, entrepreneurs and politicians may have different estimates of the costs of potential break-up to their partners and themselves during institutional reform: Some entrepreneurs might believe that they are integral to the firms so that their political partners cannot do without them, a scenario which proves to be incorrect afterwards.
If the beliefs of the two parties about the break-up costs and therefore their bargaining powers diverge over time, there tends to be a higher level of ex post rent bargaining since each may believe they have the ability to change the status quo in their own favor. Alternatively, if their estimated break-up costs and consequently their perceived power balance agree with each other, the intensity of subsequent rent struggle will reduce since they are not convinced that they have the capability to change the status quo, at least for the time being. To sum up, cognitive factors with respect to rent contribution and break-up costs do have profound impacts on the intensity of rent struggle, and we have the next proposition:

Proposition 10: All else being equal, the intensity of rent struggle between stakeholders in subsequent rent appropriation stages is positively correlated with the degree of their cognitive clash over the importance of their respective contribution to rent generation and over the estimated costs of potential break-up.

Finally, our cases suggest that such exogenous factors as the presence of opportunities for further firm growth may also affect the intensity of rent struggle between the key stakeholders. For example, if a firm is located in an industry with good growth prospects, stakeholders may at least defer the infighting even if some are not entirely happy with the current rent distribution. Rather, they expect themselves to be better off by quickly enlarging the pie, even if the current proportions of the slices remain
constant. This is precisely the case that can be illustrated by the MBO at TCL (see note 2). When LI Dongsheng and the Huizhou municipal government negotiated the MBO plan in 1997, the TV sector in general and TCL in particular were enjoying fast sales growth due to the strong demand from both the urban and rural areas. Therefore, the parties reached the following agreement fairly easily: The existing stock of firm assets remained state-owned; but from year 1997 onwards, the management could be rewarded by share ownership if there was a net increase in the firm’s net asset (equity). Concretely, if the annual growth in return on equity (ROE) ranged from 10% to 25%, the management could obtain 15% of the annual equity increase; if the ROE growth rate lied between 25% and 40%, the management could share 30% of the equity growth; and if the ROE grew more than 40%, the management were able to share 45% of the equity increase. Since TCL’s average annual ROE growth rate was above 50% during the entire 1990s, the municipal government’s stakes were gradually diluted since then. However, if the industry in which the firm lies no longer offers great opportunities for further growth, the declining prospect of future rent generation may act as a catalyst for more intense struggle over the rents that were previously generated. This exogenous impact can be summarized in the subsequent proposition:

**Proposition 11:** All else being equal, the intensity of rent struggle between stakeholders in rent appropriation stages is negatively correlated with the prospect for further growth of the firm in question.
Summary

Combining the theoretical propositions derived above, we propose a dynamic model of rent appropriation that can predict the durability of a rent-generating alliance in general and that of the entrepreneur-politician alliance in particular. This is illustrated in Figure 2. We begin by positing that the long-term stability of an entrepreneur-politician alliance depends on a dynamic balance between the amount of rents created by the two parties in the RG stages and those taken away by them in the RA stages (Proposition 1). These two types of rents are in turn determined by two important intervening variables respectively – the initial distribution of appropriated rents and the intensity of subsequent rent struggle. Rent distributions are associated with different intensities of ensuring rent struggle and ultimately the total amounts of appropriated rents (Proposition 2). Meanwhile, differing rent distributions affect the willingness, especially among entrepreneurs/managers, to invest in future rent generation and hence the total amounts of rents that will be created by the alliance (Proposition 3). A given distribution of the appropriated rents in an alliance is a result of a power balance between entrepreneurs/managers and politicians, which is determined by a wide range of firm-specific and systemic factors (Propositions 4-8). The intensity of rent struggle, on the other hand, is also affected by the degree of ambiguity of initial property rights arrangements (Proposition 9), the extent of cognitive clash between the two parties over preceding contribution to RG and break-up costs (Proposition 10), and the prospect an alliance has for further growth (Proposition 11). All in all, these variables interact during the course of transition to
determine the trajectories of entrepreneur-politician alliance in China – successful and failed MBOs.

<Insert Figure 2 about here>

DISCUSSION AND CONCLUSION

Reflecting upon the dynamics of entrepreneur-politician alliances in transition China, this paper blends indigenous context and a variety of management theories, including but not limited to rent appropriation literature, stakeholder theory, agency theory, and institutional theory, to develop a holistic model of entrepreneur-politician bargaining with respect to the evolving bargaining powers of the two parties, the intensity of the struggle over organizational rent, and the sustainability of the alliances. This in turn throws light on the complex determinants of varying MBO outcomes in China. To the extent that emerging markets have become ‘fertile grounds not only for testing existing theories but also for developing newer ones’ (Wright, Filatotchev, Hoskisson, & Peng, 2005, p. 27), the paper represents our modest attempt to take advantage of the opportunity. Specifically, our analysis helps extend understanding of the determinants of rent generation and the distribution of rent capture that has hitherto tended to focus on developed Western economies (Coff, 1999).

The emerging propositions developed in this paper can act as a basis for further detailed case studies and large-scale surveys of Chinese firms, so that the validity of
the theory can be empirically tested. The challenges of conducting empirical work involving private firms in transition and emerging economies are well-recognized (Estrin & Wright, 1999; Hoskisson et al., 2000). Nevertheless, the extensive debate about MBOs in China has meant that it is feasible to identify substantial numbers of transactions particularly involving listed corporations, while identifying MBOs of TVEs poses significant challenges.

Our emerging propositions have taken a general view of entrepreneurs and politicians. We know from previous research on private equity and management buyouts that the managers involved can be quite heterogeneous. For example, some managers may be more entrepreneurial than others and place more emphasis on seeking gains from exploiting growth opportunities rather than cost reductions and efficiency improvements (Wright et al., 2000). Further, buyouts can involve different types of transaction, most notably in terms of whether they are driven by incumbent or external managers or a hybrid combination of both (Wright 2007a); there may be a need to augment the management team for the MBO to be viable. With respect to politicians, these may also be heterogeneous in terms of their local or national level and their seniority. Further theoretical and empirical research may usefully consider exploring the implications of this heterogeneity for the stability of entrepreneur-partner alliances, and the successful completion of MBOs.

Our analysis has drawn attention to the heterogeneity of entrepreneurial activities in
the Chinese context. In the challenging transition conditions, there is a need to understand the processes involved in entrepreneurial activities through start-ups and entrepreneurial activities that occur through MBOs. Further research might examine differences in opportunity recognition, differences in the composition of entrepreneurial teams and differences in growth trajectories. How does the life-cycle trajectory of these firms evolve? Do the buyout entrepreneurs remain owners of the firms over the longer term or is this new ownership coalition diluted over time or changed completely if the firm is subsequently sold to outsiders? Such analysis would provide an interesting contrast to the conventional Western debate regarding the longevity of the buyout form (Jensen, 1989; Rappaport, 1990; Kaplan, 1991; Wright, Robbie, Thompson, & Starkey, 1994; Wright, Thompson, Robbie, & Wong, 1995).

A further research agenda concerns what happens to those cases where an MBO is attempted but is not consummated. For example, analysis is warranted of the career trajectories of the entrepreneurs. Do the entrepreneurs remain in the business or do they leave (forcibly or voluntarily)? If they leave, do they go off to start new businesses or to work in larger corporations?

On a more general conceptual methodological note, our research echoes the call for an organic combination of exploration and exploitation in conducting Chinese management research (Tsui, Schoonhoven, Meyer, Lau, & Milkovich, 2004; Tsui, 2006). First, we *contextualize* the rent generation and appropriation literature by
focusing on a unique type of organization in a transition economy. Second and perhaps more important, we generalize the contextually rich phenomena by building a theory of entrepreneur-politician bargaining, which could be potentially applied to analyze other types of stakeholder bargaining in other emerging markets. Hence, further research might compare our analysis in respect of China with other markets that have taken a different route in emerging from central planning (e.g. Central and Eastern European countries), and with those that are emerging from other political and economic regimes where the interactions with politicians may be different, such as democratic, former military regimes, and regimes where formerly particular parts of the community were excluded from power (e.g. India, Brazil, South Africa, etc.).

On the policy front, the efficiency and legitimacy of ongoing privatization buyouts in Chinese industrial sectors have been a very controversial and even emotional issue in both academic and policy communities. This paper certainly offers fresh perspectives that seek to go beyond the emotional level to achieve a more analytical understanding of MBOs in China that can lead to policy development.

To some extent, similar issues have also arisen in the case of management buyouts in the West in general and in the context of privatization buyouts in the UK and in some of the transition economies of Central and Easter Europe. Important influences on the development of policy towards buyouts have been consideration of the trade-offs between issues of rent capture and evidence on the improved efficiencies and
legitimate entrepreneurial activities that otherwise would not have been the generated (Wright et al., 2002; 2007). Rather than banning buyouts of this kind, policy evolved to incorporate mechanisms to enable the state and other stakeholders to capture some of these rents. For example, governmental auditing bodies recommended that mechanisms such as retained equity stakes by the state, performance-contingent pricing, clawback mechanisms relating to real estate disposals, requirements for wider employee share ownership, etc. became standard features of privatization buyouts in the UK (National Audit Office/CMBOR, 1991), with subsequent parliamentary scrutiny of the outturns.

For central government policy makers in China who care about sustaining the competitiveness of the indigenous businesses, they need to be aware of the complex dynamics of the alliances and to design ground rules regulating the delicate bargaining process. Policymakers concerned both with stimulating economic development in emerging markets as well as with regulating potential abuses need to understand where and how rents are generated and avoid squeezing out the former in their attempts to deal with the latter. It is also crystal clear that foreign firms competing or cooperating with Chinese businesses need to keep a close eye on the ongoing development of entrepreneur-politician interactions.

NOTES
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1. In fact, the existence of hybrid organizational forms and the path-dependence nature of institutional change also can be realized from the Eastern Europe transition experiences (Stark, 1996).

2. Founded by Huizhou municipal government in Guangdong province and a group of enterprising individuals in 1981, it now has become the world’s biggest color TV maker by acquiring Thomson’s TV division in 2004 (Khanna, Oberholzer-Gee, & Lane, 2006).

3. Currently the third largest white goods manufacture in the world, Haier originates from a failing urban collective plant established as early as 1955, which is under the control of Qingdao municipal government since then. The turnaround happened after 1984, when Zhang Ruimen, then vice head of the household appliance division of Qingdao government, was appointed as director of the nearly bankrupt firm (Palepu, Khanna, & Vargas, 2006).

4. The following information on Midea is largely based on interviews that we conducted at the company in April 2006.
5. Valuation of assets in transition economies is a well-known problem (e.g., Valentiny, Buck, & Wright, 1992).

6. The following description of Kelon draws on Huang and Lane (2001) and Liu and Sun (2006).

7. Stakeholder groups appropriate rents in the sense that their actual reward is higher than the normal return of their services, which is determined by the outside factor markets.

8. Coff (1999, p. 128) correctly predicted that ‘if internal stakeholders became dissatisfied with the distribution of rent, they might quit and dissipate the rent-generating capabilities’. However, he regarded this scenario as ‘unlikely if all stakeholders earn at least normal returns’.

9. For an exception, see Buck, Filatotchev, & Wright (1998)’s stakeholder analysis of Russian privatized firms.

10. See Wright, Filatotchev, Buck, & Robbie (1994) and National Audit Office/CMBOR (1991) for discussion of this issue in the contexts of Central and Eastern Europe and UK, respectively.

11. In privatization buyouts in the U.K., this approach was also increasingly adopted, especially where trade unions were strong and employee monitoring was an issue (Thompson, Wright, & Robbie, 1990). Similarly, Hungarian privatization buyouts which were generally dominated by management frequently involved an employee ownership element (Karsai & Wright, 1994).

12. The association is not controlled by trade unions and the management treats
themselves as normal employees to contribute funds to the association. In practice, it is very common for the association to be captured by the management and used as a mere vehicle for MBO.

13. This has resonance with the widespread media and trade union criticism of private equity backed buyouts that erupted in the US and Europe in 2007.

14. Since Kelon is listed on Hong Kong Stock Exchange, Pan took business trips to Hong Kong quite frequently.

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Figure 1. The Formation of Organizational Rents

Organizational Rents = Nexus Rents -- Appropriated Rents

Rent Generation (RG) Stage

Rent Appropriation (RA) Stage
Table 1. The Determinants of Evolving Bargaining Powers of Entrepreneurs/Managers and Politicians in Chinese Hybrid Ventures

<table>
<thead>
<tr>
<th>Determinants of Bargaining Power</th>
<th>Entrepreneurs/Managers</th>
<th>Politicians</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control of Information</td>
<td>Control of detailed information about firm operation and the true value of firm assets</td>
<td>Limited access to information about the internal operation of the firm and the true value of firm assets, given the underdeveloped capital market</td>
</tr>
<tr>
<td>Costs of Potential Break-up</td>
<td>Can be very high because: 1) They may face political retaliation if they fail to secure new political support 2) They have made a huge amount of firm-specific investment since the venture was founded, thus having limited suitable outside options</td>
<td>Could be fairly high since: 1) It may not be easy to find suitable and reliable outside replacements 2) They may suffer a big loss in government financial revenues and their own private benefits, due to the evaporation of alliance rents</td>
</tr>
<tr>
<td>Contribution to RG</td>
<td>Large and essential on account of their entrepreneurial and managerial skills</td>
<td>Significant in early stage of transition but may be declining alongside the deepening of institutional reform</td>
</tr>
<tr>
<td>Impacts of Other Stakeholders</td>
<td>The central government: It treats these hybrid firms as traditional public enterprises and is generally against MBOs. The regulation and attitude of the center serve to raise local politicians’ bargaining power because without their cooperation and support, it is virtually impossible for entrepreneurs/managers to accomplish buyouts.</td>
<td>Financial Intermediaries: Most banks are state-owned and under heavy influence by local politicians. This can add to their bargaining power by constraining the financing of MBOs if they wish. Increasingly, however, managers can approach domestic/foreign venture capital and private equity to facilitate their MBO financing.</td>
</tr>
<tr>
<td></td>
<td>Employees: Entrepreneurs/managers can increase their own bargaining power and the legitimacy of their buyouts by enlisting employees’ support – including them as a part of the new owners.</td>
<td></td>
</tr>
<tr>
<td>Institutional Environment</td>
<td>It is generally not in favour of entrepreneurs/managers, since MBOs, at least in their current form, lack legitimacy. They have always been portrayed as managerial self-dealing and embezzlement of state assets by media and public opinion, partly owing to the lacklustre reputation of their counterparts in Eastern Europe and Former Soviet Union.</td>
<td></td>
</tr>
</tbody>
</table>
Figure 2. A Dynamic Model of Rent Appropriation

- **Ambiguity of Initial Property Rights Arrangements**
- **Prospect of Further Firm Growth**
- **Intensity of Struggle in the RA Stages**
  - 1. Long-run Stability of RG Alliance
  - 2. Total Rents Appropriated
  - 3. Rents Subsequently Generated
  - 4. Control of Information
  - 5. Break-up Cost
  - 6. Contribution to Previous RG
  - 7. Other Key Stakeholders
  - 8. Institutional Environment
  - 9. Cognitive Clash
  - 10. Stakeholder Power Balance and the Distribution of the Appropriated Rent

- **Other Key Stakeholders**
  - 11. Cognitive Clash

- **Institutional Environment**

- **Cognitive Clash**

- **Break-up Cost**

- **Contribution to Previous RG**

- **Control of Information**

- **Other Key Stakeholders**

- **Institutional Environment**