Chapter 2
Firms' Governance Structure in the Chinese State Sector

In this chapter, we will analyze how state ownership coordinates the transformation of state-owned enterprises (SOEs) toward a modern governance structure, building up a coordinated firms' governance structure, and coordinates technological modernization.

2.1 SOE Reorganization: Keeping the Large and Letting Go of the Small (*zhuada fangxiao*)

Before the mid-1990s, there were two separate parts in China's state industrial sector: one consisted of small and medium-sized SOEs under the supervision of local governments, the other one consisted of big SOEs under the supervision of the central government. In China's state industrial sector in 1993, although large industrial SOEs accounted for 5% of all enterprises and about two thirds in profits and taxes and in net value of fixed assets, they had a share of 57% in terms of output, while small and medium-sized industrial SOEs together accounted for 95% of all enterprises, about one third in profits and taxes as well as in the net value of fixed assets, and 43% in terms of output (see Table 2.1). In a 1995 survey, the State Assets Management Administration reported that there were about 300,000 SOEs. The top 1,000 SOEs accounted for 40% of total assets, 51% of net assets, and 66% of profits (People's Daily 1995).

Most of the small and medium-sized SOEs were under the supervision of county and city governments, and were located in competitive industries, like machinery, electronics, textiles, and food processing. Most of the large enterprises were supervised by the central government, and were located in the industries that the state views as having strategic value, such as high technology industries, oils, raw materials, petrochemical, telecommunication, banking, railroad transportation, airlines, and electricity. (Cao et al. 1999).

Small firms supervised by local governments had been performing poorly. Reforms of tax, fiscal, monetary, and banking policy in the 1990s hardened the budget constraints of local governments. Local governments and the SOEs under their supervision now had to survive using their own financial resources. At the same

C. Liao, *The Governance Structures of Chinese Firms*, Innovation, Technology, and Knowledge Management 100, DOI 10.1007/978-1-4419-0036-4_2,

Table 2.1 State-owned industrial enterprises by size, 1993

	Number (%)	Output (%)	Employment (%)	Net value of fixed assets (%)	Profits and taxes (%)
Large	4.7	56.7	43.2	62.0	66.7
Medium-sized	12.9	23.6	25.6	18.6	19.4
Small	82.3	19.7	31.1	19.5	13.9

From China Statistical Yearbook (1994, pp. 388–91), except employment figures, which are from the State Statistical Bureau.

time, increased competition, mainly from the nonstate sector, raised pressures on local SOEs. By the mid-1990s, the nonstate sector in China had already become a major force in the economy, and both domestic nonstate firms and foreign firms had become the major source of competition. The SOEs supervised by local governments were in competitive industries, which nonstate firms entered, while the larger SOEs that were supervised by the central government were in the strategic industries, where there was almost no nonstate firm. Thus, the competition from the nonstate sector had a much greater effect on the local SOEs than on those supervised by the central government (Cao et al. 1999). Under harder budget constraints and increasing competitive pressures, the performance of many small SOEs deteriorated quickly. In 1994, about 90% of the loss-making SOEs were small ones, while 82% of all SOEs were small ones (Cao et al., 1999; Zhou and Shen 1997; Garnaut et al. 2005, p. 3; Chiu and Lewis 2006, p. 125). In 1995, 72.5% of local firms were unprofitable, but this was only the case for 24.3% of the big SOEs supervised by central government (Zhao 1999). Small SOEs also generally carried more debt than big SOEs. In a 1994 survey of the state industrial sector, the debt-to-assets ratio was 71.5% for small SOEs, as compared with an average of 65.6% for all SOEs. The debt-to-equity ratio was 2.49, compared with 1.92 for average SOEs (Zhou and Shen 1997). Increasingly poor performance and highly leveraged debt of small SOEs had become increasingly heavy fiscal burdens for the local government budget. These circumstances provided an incentive for local governments to privatize small and medium-sized SOEs, to cut state sector losses and reduce the flow of bank financing to inefficient small SOEs, while relieving the fiscal burdens of local governments (Cao et al. 1999; Yusuf et al. 2006, p. 217).

SOEs, especially the big ones, have been the key for the state to pursue technological modernization and heavy-industry-oriented strategic goals. Most of China's heavy industry and a lot of its technology are in the state industrial sectors. SOEs dominate the heavy industries and the capital-intensive sectors of the economy. They are the major producers in the power, steel, chemicals, and machinery sectors, and in the defense industry. In these heavy-industry, capital-intensive, and high-technology sectors, the share of output by SOEs has remained very high over decades. SOEs are at the core of Chinese industry, providing the key productive inputs of iron, steel, power, telecommunications, etc. on which all other sectors rely (Chiu and Lewis 2006, pp. 9–56). SOEs have employed a large number of workers and assumed many social responsibilities. The share of employment in SOEs was 65.27% in 1997 and was 53.90% in 2001. SOEs remain the most important financial source of government revenues. SOEs contributed 87% of the total government revenue in 1978 and still 71% in 1995 (Lin and Rowe 2006).

In 1994, the Chinese government passed the Corporation Law, which provided the legal framework for the SOE reforms. The Chinese government started to adopt a reform approach toward SOEs, which was officially confirmed at the 15th Party Congress in October 1997, and which is characterized with the slogan "Keeping the large and letting go of the small" (*zhuada fangxiao*). This reform strategy was to concentrate state ownership and control on a core of large SOEs in strategic industries, that is, to establish the "strategic core." It was also to withdraw state ownership and control from small and medium-sized SOEs in other "competitive" industries where state intervention is not needed (Lin and Rowe 2006; Chiu and Lewis 2006, pp. 66–82; Holz and Zhu 2002; OECD 2000, p. 52). The state decided to keep about 1,000 large enterprises as state-owned or state-controlled and to privatize small and medium-sized SOEs. The centerpiece of the "keeping the large" reform strategy is the creation of a strategic core of large SOEs, which involves their corporatization into modern enterprises and the formation of large enterprise groups. Based on the Corporation Law, the government began to corporatize large SOEs through the introduction of the "modern enterprise institution," which is dominated by the shareholding system. The government also promoted a number of large SOE or state-controlled-enterprise groups. By implementing the strategy of "letting go of the small," the government allowed the smaller SOEs to be privatized through selling them to insiders or other parties, leasing, auctioning, merging, and bankrupcy (Chiu and Lewis 2006, p. 66; OECD 2000, p. 51; Smyth et al. 2005, p. 16; Lin and Rowe 2006). According to a national survey in 2005, 86% of all SOEs had been through the "Keeping the large and letting go of the small" reform by the end of 2001, and 70% had been corporatized or privatized (Garnaut et al. 2005; Yusuf et al. 2006, p. 16).

2.1.1 "Letting Go of the Small" in the Competitive Industries

Following the official decision, local governments quickly embarked on programs to privatize their small and medium-sized SOEs. Of the variable forms of privatization, three forms were the most popular ones. Firstly, stock cooperatives (*gufen hezuozhi*), in which SOEs were sold to and then their shares owned by the employees; secondly, corporatization (*gongsizhi*) into a limited liability or joint-stock company; thirdly, outright sale (*chushou*) to outsiders – private domestic or foreign investors. Three modalities accounted for more than half of all privatizations: stock cooperatives had been the most prevalent modality. Stock cooperatives, outright sale to private investors, and corporatization accounted for 35, 11, and 8%, respectively. The other forms of privatization included merging SOEs, leasing of assets, contracting out, and bankruptcy. (Holz and Zhu 2002; Cao et al. 199 l Liu 1997). Privatization by these modalities had proceeded quite rapidly: as many as 80% of small SOE had been privatized by the end of 1998 (OECD 2000, pp. 52–7).

2.1.2 "Keeping the Large" in the Strategic Industries

"Decisions on Issues Related to State-Owned Enterprise Reforms and Development" issued by the 15th Party Congress held in September 1997 restated the principle that state ownership would continue playing the major role in the Chinese economy. "Keeping the large" was to create the strategic core of large SOEs, and state ownership would retain the dominant position in large SOEs in the strategic industries. State ownership would remain dominant in pillar industries and backbone enterprises in "high-technology sectors"; nonrenewable natural resource, public utility, and infrastructure services sectors; and the military industrial sector. To secure the state strategic goal of technology modernization, state "backbone" enterprises hold a dominant position in high-technology industries. Especially in high-technology areas, the state adopts a driving function to provide financing and to support both basic and applied research (OECD 2000, pp. 51–2; Holz and Zhu 2002; Chiu and Lewis 2006, p. 74).

The creation of the strategic core of large SOEs involved their conversion into modern enterprises and the formation of large enterprise groups. Establishing a "modern enterprise system" meant a transformation of the large SOEs into commercially viable entities that would remain under state control. The modern enterprise system is characterized by clearly allocated property rights, clear rights and responsibilities, the separation of government and enterprise, and a scientific management (Holz and Zhu 2002). The shareholding system became the dominant setting to restructure the SOEs and to establish the modern enterprise system. It imposed the governance mechanisms of a joint-stock system and enabled the state to retain ownership of the large SOEs. Two complementary modalities were used to establish the shareholding modern enterprise system, that is, corporatization and ownership diversification.

2.1.2.1 Corporatization

The Chinese SOEs were integrated as a part of the government departments under the prereform central planning system, and had had strong ties with the government agencies after the early reforms. The major problem of this arrangement was the ambiguous property rights of the SOEs – the assets of SOEs were subject to the control of a range of government departments but ultimately belonged to no one. "Corporatization" promised to clarify the property rights of the SOEs, to make them separate legal entities, and to separate government functions from enterprise operations. "Corporatization" may also transform SOEs into "modern corporate enterprises" with commercial objectives. It introduces governance mechanisms of a shareholding system, which in turn establish accountability of the management to the enterprises' owners (the state), and which also initiate a diversified ownership structure. The enactment of the Company Law in 1994 provided the legal framework for the "corporatization". Through "corporatization" SOEs become either limited liability companies or joint-stock limited companies. By the end of 1999, more than 7,000 medium-sized and large SOEs had been corporatized. The structure of the shareholders' general meeting, the board of directors, and the supervisory board had been implemented to ensure effective corporate governance (OECD 2000, p. 53). State entities remain the largest shareholders in most corporatized big SOEs, with an average stake of 65% in 2005 in the form of nontradable shares. Many big state-controlled shareholding companies have been listed on stock exchanges (Financial Times June 20, 2005; Green 2003).

2.1.2.2 Ownership Diversification

The reform of "ownership diversification" for big SOEs since the early 1990s meant that shareholding among various state entities, such as the central and local governments and the central and local state asset management companies, or other SOEs is encouraged, while nonstate interests in SOEs are allowed. The state directly holds a minimum of 35% of shares of corporatized SOEs. Other entities under state control also hold a similar percentage of shares; however, these shares may not be traded on the stock exchanges. As a result, state ownership has dominated the shareholding companies and only one third of the companies' shares can be actively traded; nonstate interests in SOEs have been limited to a certain degree. In contrast to the wholesale privatization pursued in European transition economies, China's state ownership still remains more important in the overall economy, despite the reform of "ownership diversification" (OECD 2000, pp. 53–4).

The formation of large SOE groups is another important reform approach to create the SOE strategic core. In the early 1990s, authorities began to establish large enterprise groups among the central government controlled SOEs. The formation of large enterprise groups had been directed by the government through top-down processes and was to achieve the scale, scope, diversity of operations, specialization in production, and coordination among SOEs. Following the 15th Party Congress in 1997, the promotion of a number of large SOE groups became the centerpiece in establishing the strategic core of the SOE industries. The government supports the enterprise groups through credit access and technical upgrading and listing. The enterprise groups are either sector-specific or conglomerates, which control companies in several industries. In 1997, the number of these large enterprise groups directly positioned under the central government had grown to 120 (OECD 2000, p. 55), which were known as the "national team." They controlled US $192.7 billion in assets and had total sales of US $112 billion. Table 2.2 shows the general situation of the pilot enterprise group in selected industries in 1999.

Through "Keeping the large and letting go of the small." the number of SOEs fell dramatically, but the state still controls the large and profitable SOEs. In 1997, the 4,800 largest industrial SOEs alone accounted for 70.08% of industrial added value. And the large industrial SOEs were the most profitable (Holz and Zhu 2002). The 500 largest SOEs under central government control held 37% of the state's

Table 2.2 General situation of the pilot enterprise group in selected industries, 1999

Type of industry	Number of groups	Total assets (billion yuan)	Net assets (billion yuan)	Sales income (billion yuan)	Profit and taxes (billion yuan)	Export income (million US dollars)
Metallurgy	8	35.7	19.2	17.8	2.8	228.0
Energy	11	41.3	20.3	14.7	1.7	30.9
Chemical	7	7.7	2.9	3.5	0.5	25.5
Automobile	6	26.3	9.0	21.9	2.4	42.1
Machinery	14	4.4	1.3	2.5	0.3	26.2
Electronics	10	4.3	1.5	4.3	0.4	103.6
Transportation	8	23.4	8.1	10.3	0.6	256.1
Pharmaceutical	5	3.9	1.3	2.4	0.3	31.4
Construction	3	15.5	3.1	10.7	0.5	48.3
Foreign trade	8	11.9	2.3	13.6	0.3	764.7
Average of 120 groups		13.4	5.4	7.8	0.7	117.3

The figures refer to enterprise groups controlled by the central government. From Shen (1999) and OECD (2000, p. 56).

industrial assets, and they accounted for 46% of the taxes and 63% of the profits of the state sector. As Vice Premier Wu Bangguo said in that year, "controlling the [500] largest firms means that we have control of the largest chunk of the state economy" (Zhao 1999). At the beginning of 2000, China's industrial SOEs accounted for 70% of the fixed assets, 69% of the total assets, and 51% of the sales revenues (Broadman, 2001). In 2004, state enterprises still accounted for more than half of the total assets and about half of the total output value. Although the number of state enterprises was now fewer, they had become bigger, and had grown much faster than nonstate enterprises: 2.5 times versus 1.4 times (Garnaut et al. 2005, p. 7). Therefore, although the number of SOEs has decreased and the ownership structure has changed, state enterprises are still the main pillar of the Chinese economy, and state-owned and state-controlled large enterprises still monopolize the state strategic industries. Chinese state enterprises will continue to play a leading role in the national economy in the coming years (Zhao 2005, p. 111).

What has been changed through the reforms is that the previous policy of the state owning 100% of the assets and having 100% control over the enterprises has been superseded by a policy of using state capital to control the core enterprises in key sectors and that the state became a shareholder (Chiu and Lewis 2006, pp. 75–6). Through industrial restructuring, SOEs concentrate in several strategic industries. Referring to the *Fortune* 2004 listing, "The China 100" are mostly transformed SOEs and are mostly found in oil, steel, chemicals, and other state strategic sectors. Around 30–50 giant state corporations and conglomerates have even been nurtured to become "national champions" by 2010 (The Economist 2005).

That the state rids itself of the burden of managing millions of SOEs, and that it rather concentrates on managing fewer large enterprises, can alleviate the problems arising from insufficient information, and improve the efficiency of those remaining

SOEs. Furthermore, the state can pursue its strategic goals by retaining control over the bigger SOEs. So in a real sense, the industrial restructuring and the reforms of SOEs are not for reducing the state's command over the key sectors of the economy, but for seeking to make the control more effective. After all, the state intends to remain in control in the strategic sectors (Lin et al. 1999; Yusuf et al. 2006, p. 217; Chiu and Lewis 2006, p. 75).

The approach to keep sizable and expanding large enterprises under state-ownership control indicates that China's model of development has not reoriented itself to adjust to the orthodox free market model. The state is to retain control over the "commanding heights" of the economy, to direct the path of the overall development, and to fulfill the strategic goal of technological modernization. At the 16th Party Congress, full privatization continued to be ruled out for the SOE reform. The state made clear that it will not relinquish state control of the "commanding heights" of the economy. It furthermore restated that the essence of public ownership lies in the control rights of the enterprises in the reform process of promoting the shareholding system and the diversification of enterprise ownership (Chiu and Lewis 2006, p. 126).

2.2 The Formation of the State Ownership Coordinated Modern Governance Structure of SOEs

2.2.1 The Corporatization of SOEs Results in High Levels of Surplus

2.2.1.1 The Corporatization of SOEs

In 1993, the Chinese government declared the blueprint to establish a socialist market economy, and promulgated the Company Law. The Company Law provided a legal framework for corporatizing SOEs and for establishing a modern enterprise system. It provided rules for the incorporation of SOEs into limited liability companies and limited liability shareholding companies (joint-stock companies). It also provided the rules regarding the governance structure, the transfer of shares, as well as mergers and bankruptcy (Stoyan Tenev et.al. 2002, p. 16). The limited liability company has a restricted number of shareholders (two to 49 shareholders) with a small equity base (0.5 million yuan), in which equity cannot be transferred. The limited liability shareholding company in contrast has 50 or more shareholders and a large equity base (ten million yuan), and is permitted to be listed on the stock markets to raise capital from the public and to transfer equity in the stock markets. The limited liability shareholding company is the formal equivalent of the Western stock corporation (Chiu and Lewis 2006, p. 118). According to the Company Law, a SOE becomes an independent legal entity after has been converted into a company, with the state as owner. The SOE acts in a commercial way, adopting management strategies similar to the strategies of an OECD-based capitalist enterprise (Gabriel 2006, p. 112), and is governed by public laws like a private enterprise.

Therefore, since 1998, the category "SOEs," which had included "pure" SOEs, solely state-invested limited liability companies, and state–state joint operations before, has also included all state-controlled shareholding companies (where shareholding companies comprise limited liability companies and stock companies) (Holz and Zhu 2002, p. 74).

2.2.1.2 A Key Priority of the SOE Reforms: The Corporate Governance Reform

In 1999, the Fourth Plenum of the Chinese Communist Party's 15th Central Council further identified corporate governance as "the core" of the modern enterprise system. The establishment of effective corporate governance mechanisms has become a key priority of the SOE reforms. The corporate governance reform ensures that SOEs adopt key features from the OECD model of corporate governance and function effectively in a market environment (Tam 1999; Smyth et al. 2005, p. 2).

Since the early 1990s, policy-makers in China have increasingly realized that poor SOE performance and weak governance is attributable to the "unclear property rights" and the "lack of separation between the government and the enterprises." Under the old system of the unity of ownership and control by the state, the state imposed noneconomic objectives (e.g., social welfare functions) on SOEs, which made enterprise managers unable to respond efficiently to market forces. Multiple state agencies with conflicting demands supervised the enterprises, and SOEs lacked incentives and sanctions found in private firms. Because of the ambiguity of property rights together with state ownership, there is no clear representative of the state to monitor the performance of managers (Pannier 1996; Estrin 1998; Chiu and Lewis 2006, p. 118; OECD 2000, pp. 64–5). In the new environment of the market economy, the Company Law provided means for separating governmental and business functions. It also provided means for separating the state ownership from the state bureaucratic control, clarifying property rights of SOEs, delineating the roles of the state and the enterprises clearly, and freeing managers from bureaucratic interventions in the modern Chinese corporate entity. A regulation, namely, the "Regulation for Changing the Operational Mechanism of Enterprises Owned by the Whole People," issued in 1992, ceded 14 autonomous management rights to SOE managers, including business autonomy, disposal of assets, pricing of output and labor services, use of retained income, investment decisions, export and import, and refusal of request for compulsory contributions from the government.

However, it cannot be assumed that clarifying property rights of SOEs without implementing a corporate governance mechanism was enough for corporatized SOE to be managed effectively and to improve their performance. In a modern corporation where there is a separation between the ownership and the managerial control of assets, there is an agency problem, that is, managers and employees as the agents of shareholders may have interests that diverge from those of the principals. Without certain checks and balances on managerial behavior, there can be no guarantee that the managers are managing the enterprise's resources in the owner's interests. Corporate governance is concerned with the design of checks and balances to control management behavior, and to ensure that the managers are monitored, motivated, and disciplined to act to the best advantage of the owners (Chiu and Lewis 2006, p. 134). Western economists would not argue that managers should be given complete autonomy to improve corporate performance. Rather, managers should be given room to implement their management strategies, while being monitored, up to the point of poor performance, when they may be dismissed.

Chinese policy-makers had held the view that the key to SOE performance is to clarify the property rights, to extend the autonomy of managers, and even to hand over some important rights attaching ownership to managers. The lesson learned from the contract responsibility system was that simply handing over control to managers was not enough to improve the performance of SOEs. Management autonomy cannot be independent of the corporate governance mechanisms to keep the managers in check (Chiu and Lewis 2006, p. 127). Because China is different from OECD countries and other transition countries, the transformation of SOEs in China meant forcing those SOEs remaining under state ownership to act more like private commercial firms. This was carried out through corporatization and the creation of corporate governance to provide the necessary incentives and disciplines. The government is withdrawing from the management of enterprises, while exercising its functions as owner and shareholder through separate entities created for these purposes (OECD 2000, p. 64). If supported by the proper corporate governance, the corporatization of SOEs can be tackled without depleting state assets and undermining the state as owner. In fact, property rights in corporatized SOEs must operate within and can only be effectively protected through a proper corporate governance (Chiu and Lewis, 2006, p. 127).

There are two major objectives in the establishment of the effective corporate governance mechanism. The first is to establish mechanisms to exercise the state's ownership rights in corporatized SOEs that are separate from the government's regulatory functions. The second is to establish corporate governance mechanisms, which shall provide incentives and accountability for managers to act in the interest of their owners (OECD 2000, pp. 63–5).

2.2.1.3 Separating the State Shareholder Function from the Regulatory Function

In May 2003, China established the State-Owned Assets Supervision and Administration Commission (SASAC) to push forward the reforms and restructuring of the SOEs. SASAC acts as a shareholder of state assets to overcome the fragmentation of the state ownership arrangement. See Fig. 2.1.

The state owns assets of enterprises on behalf of the people of China, and the State Council represents the state as the owner of SOE assets. State Council representation is reserved for large SOEs and state-owned holding enterprises. For all other SOEs, the state is represented by governments of provinces, autonomous regions, municipalities, and cities. SASAC is now authorized by the State Council

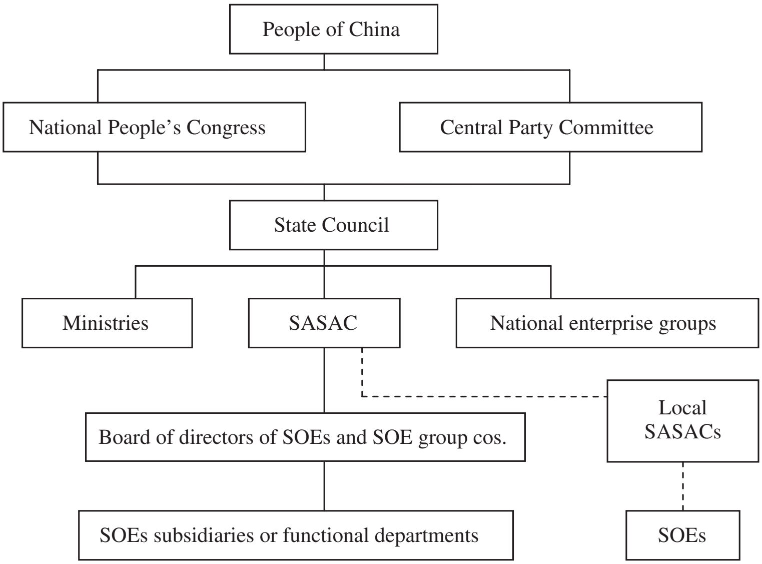

Fig. 2.1 The SASAC model. (From Chiu and Lewis, 2006, p. 121, Fig. 4.2c)

to perform the responsibilities of the "investor" of state-owned assets on behalf of the central government, taking over this role from other state bodies, and being a special ministerial level institution directly under the State Council. SASAC acts as an investor of SOEs, enjoying owner's equity rights, and assuming legal liabilities under the Corporate Law without intervening directly in the enterprise's day to day operations. As an investor, SASAC enjoys ownership rights that are separated from the management of the SOEs. SASAC directly supervises and manages 196 large enterprises which are directly subordinate to the Central Party Commission. State-owned assets supervision and management organizations at provincial and city (region) levels were also established, acting as the investors of lower-level SOEs. SASAC is in charge of guiding and supervising regional-level state-owned assets management (Chiu and Lewis 2006, p. 122). We can see the functions of SASAC in Box 2.1.

SASAC has the power to appoint and remove the top executives of SOEs under the supervision of the central government, to monitor their performance, to structure the incentive systems for the management of those SOEs, and to supervise the management of regional-level SOEs. The establishment of SASAC and regional-level state-owned assets supervision and management organizations was meant to solve the problem of multiple controllers of state-owned assets. As shown in the following points, it achieves this objective in three ways. First, the interest of the various state bodies within the enterprises is reduced to a common denominator – equity. Second, the new shareholders have only a single way – shareholder voting – to voice their interests. Majority voting rules eliminate conflicting goals. Third, the new shareholders now have a common interest in raising the profitability of their enterprises (Clarke, 2003; Chiu and Lewis 2006, p. 110).

BOX 2.1 Main Responsibilities of State-Owned Assets Supervision and Administration Commission (SASAC) of the State Council

1. As authorized by the State Council and in accordance with the Corporate Law of the People's Republic of China and related administrative regulations, SASAC acts as the state-owned assets investor to guide and push the reforms and restructuring of the state-owned enterprises. Supervise the maintenance and appreciation of state assets value for those state-invested enterprises, to reinforce the management of the state-owned assets, to promote the establishment of the modern enterprise system of the SOEs and improve enterprise corporate governance, and to drive the strategic adjustment of the state-owned economic structure and layout.
2. Dispatch the supervisory board to some large enterprises on behalf of the state and be in charge of daily management of the supervisory board.
3. Appoint, remove and evaluate the executives of the enterprises through legal procedures and grant rewards and punishments according to their performance. Build corporate leadership selection mechanisms according to the requirements of the socialist market economic system and the modern enterprise system and streamline the motivation and restraint system for the corporate management.
4. Supervise and manage the maintenance and appreciation of state assets via statistics and audit, establish and improve the state-owned assets, maintenance and appreciation target system of state-owned assets and work out assessment standards. Safeguard the interest and rights of the owners of the state-owned assets.
5. Draft laws, administrative regulations, and related rules on the management of the state-owned assets. Direct and supervise the work of local state-owned assets management according to the law.
6. Undertake other issues assigned by the State Council.

From SASAC Web site, accessed 29 March 2005

At the provincial and municipal levels, state asset management committees, which act as investors in SOEs and are responsible for preserving and increasing the value of state assets, oversee a number of state holding companies, or, say, state asset management companies that manage the assets of SOEs entrusted to their responsibility. In the case of large SOE groups, their core firms are authorized to carry out the functions of state holding companies for their member firms. Thus, state holding companies are responsible for the exercise of the state's ownership rights, and also are accountable to the state asset management committees (OECD 2000, p. 65).

2.2.1.4 Introducing Corporate Governance Mechanisms

Introducing corporate governance mechanisms into corporatized SOEs was meant to strengthen incentives and monitoring mechanisms in these shareholding companies. According to the Company Law, corporate governance for joint-stock limited companies includes the shareholder's general meeting, the board of directors, and the supervisory board (see Box 2.2). Corporate governance is to ensure and strengthen the accountability of the management to the board and the shareholders, the supervision of the board of directors and the senior management by the supervisory board, and the accountability of the directors toward the shareholders (OECD 2000, p. 66).

Box 2.2 System of corporate governance under China's Company Law

Under the Company Law (1993), two types of companies are established, i.e. limited liability company (LLC) and joint stock limited company (JSC). The Company Law prescribes a system of corporate governance through an organisational structure comprising three main bodies: the shareholders' general meeting; the board of directors; and the board of supervisors.

The shareholders' general meeting is the highest authority within the company. It has the following rights and responsibilities: to decide on the company strategy and on operational business and investment plans; to appoint and dismiss members of the board of directors and representatives of shareholders as members of the supervisory boards; to examine and approve reports by the board of directors and by the supervisory board; to examine and approve the company's proposed annual financial budget and final accounts, the profit distribution plan and the plan for recovery of losses; and to pass resolutions on the increase or decrease of registered capital, the issuing of bonds, and on merger, division, dissolution and liquidation. Shareholders' meetings are held once a year. Shareholders are entitled to one vote for each share held.

The board of directors comprises between five to nineteen members, with members elected by the shareholders' meeting. The board of directors is accountable to the shareholders' meeting and empowered with the following rights and responsibilities: to convene the shareholders' meeting and report work to the meeting; to carry out the resolutions and decisions adopted by the shareholders' meeting; to draft proposed operational business and investment plans; to formulate plans for profit distribution, recovery of losses, merger, division or dissolution of the company; to decide on the company's internal organisation and management structure; to appoint, dismiss, and determine the remuneration of the company's general manager, the deputy manager (upon recommendation of the general manager), and the chief financial officer. The meeting of the board of directors is held at least twice a year.

The general manager attends the meeting of the board of directors as a non-voting member.

The supervisory board comprises a minimum of three members, including representatives of the shareholders and at least one representative of the company's employees. The employees' representative(s) is (are) to be democratically elected by the employees. The tenure of a supervisory board member is three years, which is renewable upon re-election and re-appointment by the shareholders' meeting. Members of the board of directors, managers and the chief financial officer are not allowed to serve as members of the supervisory board. The supervisory board is empowered with the following rights and responsibilities: to oversee and examine the financial affairs of the company; to supervise acts of directors and managers; and to request remedies from directors or managers for their acts which have harmed the interests of the company. Supervisors attend the meeting of the board of directors as non-voting members.

From OECD (2000, p. 68)

Shareholders' General Meeting

The shareholders' general meeting is the highest authority within a company in China. It appoints and dismisses members of the board of directors and members of the supervisory board.

Board of Directors

Board members are elected by shareholders to look after their interests. The board hires and fires managers, and sets the remuneration package for senior executives. The board of directors should keep effective control over the company and monitor the executive management. The directors account for their stewardship to the shareholders at the annual general meeting. The shareholders appoint auditors to provide an independent check on the financial statements based on "Western-style" accounting standards promulgated in 1992 by the Chinese government, which have become increasingly internationally compatible (Cadbury 1992; Chiu and Lewis 2006, p. 147; Smyth et al. 2005, p. 4).

Supervisory Board

Like Germanic countries, China also applies a two-tier board system in its corporate governance, with representatives of employees being appointed to the supervisory board. The supervisory board is designed to oversee and constrain management. It also allows codetermination between shareholders, managers, and employees. To understand the function of the supervisory board, we may compare the two-tier board system in Germanic countries with the one-tier board system in Anglo-Saxon countries.

In Germanic countries (Germany, Austria, Switzerland, the Netherlands), shareholders (and others) are encouraged to use their "voice" to influence the management through the supervisory board, which exists in addition to the executive management board. Table 2.3 compares the governance functions of the two-tier board and that of the one-tier board. The functions undertaken by the senior management in Anglo-Saxon countries devolve to the executive board in the Germanic countries, while the functions undertaken by the board of directors in the one-tier system devolve to the supervisory board in the two-tier system (Nietsch 2005).

Table 2.3 Board functions in one-tier and two-tier board systems

Shareholders' annual general meeting	
Determines fundamental issues, such as: • Selecting the outside auditing firm • Selecting the board of directors (single-tier) or the supervisory board of directors (two-tier)	
Single-tier board of directors	Two-tier supervisory board
• Selects, evaluates and compensates members of senior management (single-tier) or executive board (two-tier) • Guides corporate strategy • Overseas corporate performance • Approves certain important decisions of senior management or executive board body	
Senior management	Executive board
Under the direction of the board of direction (single-tier) or supervisory board (two-tier): • Executes corporate strategy • Manages the operations of the company	

From OECD (1998)

What is different between the two-tier board in China and that in Germanic countries is that in China the shareholders' general meeting appoints the board of directors and the supervisory board, while in Germanic countries the shareholders' general meeting appoints the supervisory board, and the executive board is selected by the supervisory board. Thus, the board of directors is directly accountable to the shareholders' meeting in China, rather than to the supervisory board as is prevalent in Germany (Lin, 2000; OECD 2000).

Compensation System

The compensation system reform in Chinese corporate governance has been introduced gradually since the 1990s. The managerial labor market aligns the interests of managers and shareholders through the contractual arrangements, which link management remuneration to the profitability of the firm or the share price value. Performance-enhanced bonuses and stock options are types of management remuneration generally used for these purposes in corporate governance (Prowse, 1994;

Chiu and Lewis, 2006, p. 152). These reflect the major changes in the compensation system compared with the past, and how market forces determine the compensation structure in corporate governance in large listed Chinese companies (China Youth Daily 2003; Zhao 2005, p. 116).

External Control

Corporate control functions in liberal market economies, like those of the USA and the UK. Changes in share prices will trigger takeover threats. This mechanism amounts to corporate control from markets to discipline management. Falling share prices signal the need for managers to improve the performance of firms. Otherwise a hostile takeover might happen to replace the managers. Corporate control provides mechanisms to keep managers under the control of shareholders.

It is difficult for hostile takeovers of Chinese listed companies to happen because of their existing ownership structure. Even though there are some merger and acquisition cases each year, the number in China is insignificant, and the level of industry concentration is low compared with that in the USA. Of 46 industries, only eight had a concentration greater than 40%, with most having a concentration of less than 20% (HSBC 2001; Stoyan et al. 2002, pp. 115–6).

For external governance in corporatized SOEs, the government as the representative of principal shareholders plays an important role. It is reflected by the fact that the authority appoints operators and managers and exercises external supervision and constraint over the operational activities of managers; e.g., to appoint the chief financial supervisor and carry out auditing. A survey conducted in 2000 by the Chinese Entrepreneurs' Survey System showed that government appointment has always been the principal form for choosing and controlling managers and operators of corporatized SOEs, accounting for about 76–80%. Corresponding to such a pattern of external governance exercised by the government, mergers, acquisitions, takeovers, and other components of the market mechanisms play a much less disciplinary role. Studies have demonstrated with substantial evidence that the corporatized SOEs with absolute controlling shares held by the state show less market corporate control, including mergers and acquisitions. Even when control authority is transferred, the transfer is mainly via the contractual transfer and allocation of state shares, not through purchasing on the secondary market (Chen and Huang 2001).

2.2.1.5 The General Process of Corporatization in China

The general process of corporatization in China proceeds as follows:

- Asset assessment and verification.
- Identification of owners.
- Choice of company form of a limited liability company or a joint-stock company.
- Establishment of the board of directors and the supervisory board.

- Appointment of CEO, deputy CEO, and other senior managers.
- The company begins its business.

In the SOE restructuring, large SOEs are corporatized into limited liability shareholding companies, with a selected few listed on China's two stock exchanges: Shanghai Stock Exchange and Shenzhen Stock Exchange. Until 1999, Chinese companies were selected to be listed according to a system of quota allocation administered by the China Securities Regulatory Commission. The firms which met certain qualifications could apply for listing. Listing was then authorized by a committee to appraise a firm's financial strength, quality, and prospects (Chiu and Lewis 2006, p. 166). After 1999, the Chinese government eliminated the quota system for initial public offerings. Which companies will access the market was from then on based on market principles. The China Securities Regulatory Commission requires the committee assessing initial public offerings to pay attention to corporate governance issues, that is, whether the company's shareholders' meetings, board of directors, and supervisory board have been discharging their duties and exercising their rights independently (Tenev et al. 2002, p. 111). At the beginning of 2005, 1,377 enterprises were listed on the two markets, almost all of them were large state controlled shareholding companies (China Securities Regulatory Commission Web site, cited by Chiu and Lewis 2006, p. 111). Their market capitalization is about 40% of GDP (Standard & Poor's 2004). The China Securities Regulatory Commission has made efforts to strengthen corporate governance practices among these listed companies (Garnaut et al. 2005, p. 6), and they have on the whole adopted more modern corporate governance arrangements than other enterprises in China (Chiu and Lewis, 2006, p. 165).

2.2.1.6 Classifying Shares of Listed Companies: State Shares Cannot Be Freely Traded

Chinese company shares are classified as A shares, B shares, H shares, and N shares. A shares are designated for domestic investors; B, H, and N shares are designated for overseas investors. A shares are further classified into state shares, legal person shares, and tradable shares. Each type of share accounts for about one third of all shares. State shares are owned by the state, i.e., the central and local governments, which are represented by state asset management companies. State shares can also be held by the parent of the listed company, mostly an SOE. The state is the controlling shareholder and state shares are not tradable. Legal person shares are held by domestic institutions such as industrial enterprises, security companies, nonbank financial institutions, transportation and power companies, and technology and research institutes. Almost all of the legal person shareholders are SOEs. Legal person shares are not generally tradable but can be transferred to other legal persons. Thus, in the majority of cases, the state is the direct or indirect (through industrial SOEs) controlling shareholder of listed companies. State and legal person shares can only be transferred to domestic institutions if approval is given by the China Securities Regulatory Commission (Tenev et al. 2002, p. 76). The Chinese government ensured that it would not lose control over the listed SOEs by requiring that a proportion of the state's shares could not be sold (Yao 2004). About 30% of all shares are tradable and are owned by domestic individuals and institutions. Thus, listed companies in China have a mixed ownership structure. The state, legal persons, and domestic individual investors constitute the largest groups of stockholders. In 2004, the state held 47% of shares, legal persons held 11% of shares, and domestic investors held 28% of shares. Less than one third of the shares of listed companies (i.e., those held by individuals) were freely tradable (Chiu and Lewis 2006, p. 111; Tenev et al. 2002, pp. 76–7).

2.2.1.7 Effective Corporate Governance Generates More Surpluses To Be Invested in Rapid Technological Modernization

After realizing the increasingly adverse impact of the weak governance and inefficiency of the SOE sector, the policy-makers saw corporate governance reform as an urgent task in China. The objective of corporate governance reform is to introduce capital market disciplines, and to place the managers of SOEs under pressure from shareholders, financiers, and the market. The state as a controlling shareholder invests in enterprises and expects proportional returns from enterprise profits. Other shareholders also expect to receive proportional returns on their investments, and bondholders should be paid interest and principal. To meet these expectations, reformed SOE management was encouraged to adopt Western-style effective corporate governance, to select better managers, and to use capital more efficiently. Effective corporate governance ensures that the power to make decisions will be allocated to those people with the best chance of enhancing the performance of the firm. It reorients managerial incentives to engage in more profit-oriented and value-augmenting activities, in line with the owners' interest. It also ensures that reformed SOEs are competitive and can adapt to the changing demands of the market.

The leadership in China encourages the spread of Western corporate governance and expects it to generate more surpluses and lead to more rapid modernization. The Chinese policy-makers believed that the technologies (hard and soft) which would achieve their strategic goals already existed in the advanced market economies of the OECD. And it was assumed that optimal strategies of Western corporate governance would embody OECD-type technologies. The leadership in China has encouraged the spread of Western corporate governance in reformed SOEs, and has encouraged the directors and the managements to implement these operational strategies that were assumed to result in higher levels of surplus (if not profit maximization), to lead to more rapid modernization, and therefore to meet the state's strategic goals (Gabriel 2006, p. 108). Now, facing fast expanding international trade and inward foreign direct investment, the need to further improve effective corporate governance in reformed SOEs in China has taken on added significance (Smyth et al. 2005, p. 3). To compete with the increased competition arising from WTO membership and to attract foreign investment, China's reformed SOEs need to adopt corporate governance mechanisms in line with international practice, and to compete successfully in increasingly competitive global markets (OECD 2000, p. 63).

After the transformation, the corporate governance in reformed SOEs appears to be akin to that in the firms in OECD economies (Lo and Smyth 2005).

Corporatization imposed a limit on state-owner responsibility for reformed SOEs, providing incentives for enterprises to generate more surpluses, and freeing up more surpluses to be invested in modernization. The corporatization of SOEs and the corporate governance reform were implemented to separate the state's responsibility for the survival of SOEs from the state-owner's property rights in SOEs. Before the SOE reforms, there was an implicit contract between the state and the workers, in which the state had unlimited responsibility for the enterprises' survival. After SOEs have been transformed into limited liability companies or shareholding companies, the state would have limited responsibility (up to the actual capital it invests) for reformed enterprises, and the reformed enterprises would have to be responsible for their own profits and losses, to the point of bankruptcy (Lo and Smyth 2005). By imposing a limit on state-owner responsibility for enterprises, the state hardened budget constraints on reformed enterprises. It provided an incentive for directors and managers to implement strategies that would generate the higher level of surplus necessary to meet enterprise obligations. Thus, these reforms would improve cash flows from enterprises to the state and reduce subsidies from the state to enterprises, and at the same time would free up more surplus to be invested in modernization to meet the state's strategic goals (Gabriel 2006, p. 111).

Being put under the hard budget constraint, enterprise strategies to raise surplus and to adopt technologies are in line with the state's strategic goals. Imposing a limit on state responsibility for enterprises has meant that senior management must rely more heavily on the value-generating potential of their work force to meet the expectations of internal and external occupants of distributive class positions. In reformed SOEs, such a hard budget constraint has provided incentive mechanisms to the management and has motivated managers and workers to generate more surpluses, and to invest in new technologies in line with the state's strategic goals (Gabriel 2006, pp. 111–2).

Thus, the overall result of the reforms seems to be boosting state revenues (which will be shown in Sect. 2.2.6), which can be invested in modernization, which leads to more SOE investment in projects that are compatible with state modernization plans (Gabriel 2006, p. 112).

2.2.2 The State as the Majority Owner of SOEs Has Extraordinary Power To Deploy Investable Funds for Technological Modernization

The majority of the total shares of reformed SOEs remain under the control of the central government and related holders of legal person shares, which makes the state the primary claimant to the surplus generated within SOEs, and which furthermore gives the state extraordinary power to deploy investable funds to invest in technological modernization. That the state maintains controlling ownership of key enterprises in the strategic sectors in the pillar industries, and retains a direct surplus appropriation role in the burgeoning market economy, is the "backbone" of the modernization of the Chinese economy (Gabriel 2006, pp. 112–49).

Chinese authorities have made it clear that they will not relinquish state control of the "commanding height" of the economy. Even though lots of small and medium-sized SOEs have been privatized, the state still keeps ownership of the larger SOEs, and it wants state ownership to remain a dominant feature of the economy. Corporatization is a useful step in the SOE reforms, which has restructured SOEs as limited liability companies and joint-stock companies, and has established scientific corporate governance even without significant ownership changes. State ownership still implies the control rights of enterprises after the corporatization of SOEs and the diversification of enterprise ownership. Corporatization sets a stage for selling shares and separating the state from the enterprise, it holds directors responsible for the assets of the SOE, and prevents further asset erosion. It also upgrades the SOE management while preserving the state's controlling ownership stake. In practice, this has been sought by classifying the share of corporatized SOEs into several classes. Therein a controlling holding is represented by state-owned shares or shares held by other state firms (legal person shares, or, say, *faren gu*), both of which remain subject to restrictions on transfer (Chiu and Lewis 2006, pp. 126–31). The State Council and local government leadership delegate ownership control over SOEs to state asset management companies. The state, thus acting as controlling shareholder and primary appropriator of surplus, participates in modern corporate governance of corporatized SOEs (Gabriel 2006, p. 106).

2.2.2.1 The State Shareholder as the Controlling Shareholder in Shareholding Companies in China

The ownership structure of shareholding companies in China's state sector is characterized by the prominent role of the state, the negligible role of financial institutions and institutional investors, and the absence of individuals as significant shareholders (Tenev et al. 2002, p. 103). About two thirds of the value of the issued capital of China's listed companies is held as state-owned shares (by the central government or local governments) and as legal person shares (held by other SOEs, nonbanking financial institutes, and companies in which the state has significant capital ownership). These shares are nontransferable and can only be transferred to domestic institutions if transfer is approved by the China Securities Regulatory Commission (Ho and Hai-Gen 2002; Chiu and Lewis 2006, p. 167). A survey by Tenev et al. (2002) of 257 Shanghai-listed companies found that in 1999 42% of the largest shareholders in the sample held state shares. The state therefore tends to be the controlling shareholder. In 57% of the companies in the sample, the largest shareholder held legal person shares, of which almost all were industrial SOEs. Thus, in more than 95% of the cases, the state directly or indirectly (through SOEs) controls listed companies in China. In about 47% of the companies in the sample, nontradable shares accounted for 70–90% of the total shares. In 41% of the companies in the sample, nontradable shares accounted for 50–69% of the total shares. About 30% of all shares were tradable and mostly held by individuals (Tenev et al. 2002, pp. 76–7). A survey by Liu and Sun (2003) of 1,105 listed companies found that although only 8.5% of companies were directly controlled by the state, many of the nontradable shares of these companies were held by wholly state owned holding companies or state-controlled nonlisted holding companies. If indirect control and direct control are combined to one measure, the 2001 numbers show that there was state control of 84% of all the listed companies, and only 16% were not state-controlled. The institutions of state control in these cases ranged from central government bureaus to provincial bureaus and many other types of state units (Yusuf et al. 2006, p. 89).

Ownership in China's joint-stock companies is concentrated to a considerable degree. The survey by Tenev et al. (2002) indicates that the three largest shareholders on average held about 58% of the total shares, of which the largest shareholders on average held 47%, and the second and the third ones held 8 and 3%, respectively. In almost 49% of the firms in the sample, the three largest shareholders held 60–80% of all shares. Such a high concentration of ownership combined with the relatively small portion of tradable shares implies that control is contestable in few of China's listed companies. The share of companies with highly concentrated ownership has shown a tendency to increase in the past few years. At the initial public offering, the largest shareholder held state shares in 47% of the listed companies, while in 49% of the companies the largest shareholder held legal person shares. By 1999, the percentage of companies with the state as the largest shareholder had dropped to 42%, while the percentage of companies with legal persons (industrial SOEs) as the largest shareholder had increased to 54%.

2.2.2.2 State Shareholders in Control of Corporate Governance in China

These ownership features have a direct bearing on the type of corporate governance that is prevalent in China. The most important implication of the dominant role of state ownership in China's shareholding companies is the government and the party's control over management appointments. While the dominant position of controlling shareholders is not unique, in China the role of state shareholders as controlling shareholders that exert direct control over shareholders' meetings and boards of directors is exclusively Chinese (Tenev et al. 2002, p. 104).

Shareholders appoint 76% of the directors of listed companies. State-owned legal person shareholders select 48% of all directors, and state shareholders select 21% of all directors. Thus, the state is directly and indirectly in control of the companies' directorates, selecting nearly 70% of all directors. Like ownership, control is also highly concentrated. The largest shareholder holds less then 50% of all shares but controls more than 50% of board seats. The share of the three largest shareholders is 59% on average, but they appoint 79% of the directors. The marginal value of control diminishes after the largest shareholder has obtained majority control. Table 2.4 compares the size of the largest shareholding with board control. The share of board seats controlled by the largest shareholder is higher than the share of the shareholder's ownership. This situation is only reversed when the largest shareholder has obtained majority control (more than 50%). Thus, holding companies control

Table 2.4 Discrepancy between size of the largest shareholding and control rights

Largest share (%)	Number of companies in sample	Average size of the largest share (%)	Percentage of directors appointed by largest shareholder
>80	5	87	66
50–80	77	63	62
20–49	78	34	46
<20	11	16	31
Total	171	48	53

From Tenev et al. (2002)

the boards of listed companies. Only 24% of the total of directors are appointed by nonshareholders, of which the executive directors are mainly recommended by company staff, and are sometimes appointed by the government (Tenev et al. 2002, pp. 83–5).

The state agencies as the controlling shareholders exercise effective control. Board chairs exert genuine control over the shareholders' meeting as representatives of the largest shareholder. The controlling shareholder dominates the appointment of the general manager. The board of directors is not independent of the management, and the roles of both the chairman of the board and the general manager are often combined. The executive directors with managerial responsibilities dominate the board, and the general manager acts on behalf of the controlling state shareholder (OECD 2000, p. 71; Tenev et al. 2002, p. 98).

In corporate governance in China, the single majority owner has extraordinary power and the minority owners are weak. In its legislation processes, the entity which is responsible for creating, changing, and enforcing the rules of corporate governance is the majority owner of corporate assets and the primary claimant to the surplus value which is generated by those assets (Gabriel 2006, pp. 149–50). Minority shareholders have no effective right to elect boards of directors in the state-dominated shareholding companies. Their sole right is to receive dividends. A few of these firms have appointed some "outside" directors, but these directors appear to have little power over the company's management, which is appointed by the government and the Party as described above (Qian 1999, p. 39; Yusuf et al. 2006, p. 90).

In short, the type of corporate governance in state-controlled shareholding companies in China can best be characterized as insider-dominated corporate governance, which flows from the role of the state as the largest block shareholder (Chiu and Lewis 2006, p. 175).

It is now clear how the state is able to retain a direct surplus appropriation role and how it maintains the "backbone" of modernization of the Chinese economy. While retaining state-ownership control, the state decentralizes the appropriation and distribution of surplus value to local governments and directors and managers within various state enterprises. This very organization allows the companies' directors and managers as well as the local governments some "leeway" to use some of the surplus value under their control, to acquire and innovate in favored technologies. In the meantime, decentralization generates market competition. Competition among these enterprises was stimulated to motivate directors and managers to use the surplus value for investment in new technologies, as well as to achieve "professionalism" and competitiveness. New technologies have allowed workers to produce products that have improved quality and marketing characteristics, which are necessary to generate sales in a competitive environment (Gabriel 2006).

It can therefore be concluded that the transition of China's economy toward a market economy that is coordinated by state ownership is actually part of a strategy to achieve technological modernization. The economic transition in China was designed to modernize industry, agriculture, research and development, and the military (*the Four Modernizations*). China continuously underwent processes of adoption in the advanced technologies. This can be identified as the cornerstone of the state's economic development strategy to reach a status equal to that of the USA and the EU in this domain. The strategy of making technological transformation the top priority of the economy has been implemented successfully. Chinese SOEs are able to produce and are currently producing a wide range of products with quite sophisticated components for domestic and foreign markets. The success is manifest in the production of spacecraft and the performance of a space walk, Three Gorges Dam, the Shanghai magnetic levitation train, new skyscrapers and airports, a proliferation of automobiles and cell phones, the launching of Chinese-made rockets carrying Chinese-made satellites, as well as thousands of small-scale innovations in new technologies (Gabriel 2006, pp. 153–5). In addition to the fulfillment of technological modernizations in the state sector, China plans to initiate computer-aided design or computer-integrated manufacturing technology in more than 90% of its large and medium-sized state-owned manufacturing firms by the end of 2010 (Anon 2000; Pyke et al. 2002).

2.2.3 Worker Participation in Corporate Governance

The Chinese government has made provisions in the Company Law for employee participation in the corporate governance of SOEs (Chiu and Lewis 2006, p. 168). Chinese workers thereby gain a number of legal rights in corporate governance to protect their interests. Collective contracting governs the employees' interests regarding compensation, firing, social benefits, working conditions, etc. The role of the labor union in collective wage bargaining has been defined (Tenev et al. 2002, p. 41; Garnaut et al. 2005, p. 143). The workers' congress and trade unions have extensive rights to access consultation and information concerning production plans, the use of public welfare funds, and other matters that could affect employees' interests. In limited liability companies and joint-stock companies that have the government as a controlling shareholder, trade unions have the right to organize workers. They can use this form of organization to oversee and assess the virtues, ability, and achievements of the chair of the board of directors, the general managers, and the high-level management personnel. SOE managers are obligated to report to the employee conference on various business-related expenditures.

In addition to the rights exercised through the workers' congress and the trade unions, employees can be represented on the board of directors and the supervisory board. The Company Law stipulates that a proper proportion of workers' representatives should be elected as board members in limited liability companies, established either with investment from two SOEs, or by two state investment holding companies, or in state-funded companies. Another provision of the Company Law is the proper proportion of workers' representatives on the supervisory board in limited liability companies and joint-stock companies. As these legal regulations show, employees are represented to a significant extent on the board of directors and the supervisory board in the corporatized SOEs in China.

Mandatory worker participation in China's corporate governance, which especially requires employee representation on the supervisory board, is akin to the German corporate model. It also reflects the stakeholder orientation toward corporate governance prevalent in China, which is consistent with the important role of state ownership and the related concept of employees as the masters of enterprises (OECD 2000, p. 66).

An important aspect in the industrial relations system concerns the issue of layoffs. Reformed SOEs may still face significant constraints on dismissals imposed by the government. It is often argued that SOEs do not optimize their labor input. Facing an economic downturn, SOEs would rarely lay off staff according to a fall in the demand for their output. This reflects the fact that SOEs are fulfilling social objectives and how they provide a social safety net for part of the urban workforce, which leads to a lower level of short-term efficiency compared with that in private companies (Dong and Putterman 2002; Yusuf et al. 2006, p. 201; Laurenceson and Chai 2003, p. 40). The data from Meng (2004) indicate that an increase in the capital-to-labor ratio has no impact on state sector employment but significantly reduces employment in the market-oriented private sector. This also has roots in the fact that state firms do not reduce their staff when they implement improved technologies that result in a shift from a low to a high capital-to-labor ratio. In contrast, 10% increase in the capital-to-labor ratio would have reduced employment by 24% in the private sector in 1998 (Meng 2004).

The industrial relations system in state enterprises is likely to concern the wage system as well. As the labor market reform in the state sector accelerated in 1990s, state firms were given autonomy over hiring, firing, and setting wages and bonuses. Wage determination and the incentive-based structure in the state sector became more market oriented. Nevertheless, a seniority-based wage system rather than a pure-market-based wage system dominates in the state sector. State sector employees receive state or firm-provided benefits, such as medical care, housing, and pensions. Private sector employees receive far fewer of these benefits (Garnaut and Song 2004, pp. 149–52). However, wages and major benefits need to be distributed fairly among all the state employees (Garnaut et al. 2001, p. 98). Bonuses also tend to be equally distributed among state employees. In state enterprises the correlation between changes in labor productivity and wages is weaker, the rate of return to education is lower, and the earnings–experience profile is flatter, compared with those in private enterprises. Labor costs in the state sector are thus found to be higher than in the private sector (Garnaut and Song 2004, pp. 149–52).

2.2.4 The State Ownership Coordination Based SOE Groups

2.2.4.1 The State's Active Role in the Formation of SOE Groups

Throughout much of the 1990s and further on into the present, the Chinese government authorities attempted and have been attempting to form enterprise groups out of large state-owned firms, to establish the strategic core of SOE industries. Especially enterprises in the state-designated "pillar industries" are viewed as the driving forces of growth and were preferentially selected (OECD 2000, p. 55; Yusuf et al. 2006, p. 219). These groups of large, state-owned firms were deliberately formed by the state through a top-down process directed by government authorities. They resemble Japanese *keiretsu*. Some of these enterprise groups are sector-specific, while others are conglomerates that control enterprises in several industries (Keister 2000, pp. 68–9; OECD 2000, p. 55).

This kind of enterprise group in China complies with the standard meaning of a business group (Keister 2000, p. 70). It is involved in production, marketing, transportation, finance, research and development, and other aspects of the production process. These groups are normally very large and their range of activities is quite broad. The single firms in the groups have different primary products and are geographically scattered. While for the most part each member firm keeps separate accounts, the group also keeps some joint accounts for the joint activities; e.g., management, joint financing, financial transfer, technology development and dissemination, and research and development activities.

The business group is not a single, legally defined or legally recognized entity. Each member firm of a business group maintains an independent legal status. This arrangement is common among Asian business groups, including Japanese *keiretsu*. The state actively encouraged the groups to form, but the business groups did not report financial information to the state for taxation purposes, and the groups did not have the legal rights and responsibilities of other firms (Keister 2000, pp. 70–2).

The structure of these Chinese business groups involves a core firm together with a number of specialized firms, plus several other firms in related lines of business. The core firm is called the "group company," which uses its own departments to manage the member firms to varying degrees. Relations among the member firms are close-knit and expansive, including cross-shareholdings, interlocking directorships, financing relations, trade relations, and joint production. As the ties among firms in the Chinese group strengthen, they become exclusionary, like in the Japanese *keiretsu*. Member firms in Japanese *keiretsu* tend to deal exclusively with each other. Similar to this practice, member firms in Chinese enterprise groups show a tendency to deal primarily or exclusively with suppliers in their group and to sell to other member firms first (Keister 2000, pp. 69–71). In Japanese business groups, the emphasis on the norms of reciprocity and trusting relations has produced a level of mutual obligation between member firms. Enterprise groups in China are comparably characterized by reciprocity. Another characteristic of Chinese enterprise groups is the high degree of prestige associated with membership and the high degree of loyalty among their member firms (Keister 2000, pp. 92, 115).

The enterprise groups encompass central industries in the Chinese economy. These include the automotive, steel, petroleum, power, transportation, and high-technology industries (Keister 2000, p. 71). Across all these sectors, the number of enterprise groups among the central-government-controlled SOEs has grown from 57 in 1991 to 120 in 1997, and up to 147 in recent years (Chen 2005; OECD 2000, p. 55; Chiu and Lewis 2006, p. 67). Estimates of the proportion of state-owned firms that are members of enterprise groups are difficult to obtain. In 1995, the total assets of SOE groups were 1.12 trillion yuan (US $135.70 billion), one quarter of the country's total state-owned assets (Kan 1996). Since then, the numbers of enterprise groups and their total assets have continued to grow, and most SOEs are now part of business groups (Yusuf 2006, p. 91).

The Chinese government was actively involved in the establishment and development of SOE groups. Government authorities encouraged group formation, circulated guides for establishing groups in strategic industries, and actively coordinated the formation of these interfirm linkages (Keister 2000, p. 77). The state also played a role in deciding which firms would join which groups, as well as in demanding that a firm should either join or remain associated with a particular group, especially concerning firms in those strategic industries (Keister 2000, p. 92). At the beginning of its establishment, each group was required to be approved by and registered with the government bureau. Through the registration process the state continued to play an active role in forming and maintaining enterprise groups. The state required the group to have a parent company or a leading firm, as well as a sound management system. This requirement again allowed officials to influence the structure of the group. In requiring the group to have a "sound" management system, the state could indirectly influence the way the group interacted with member firms (Keister 2000, pp. 72–3). Additionally, government bureaus advised the groups on long-term and short-term plans, such as production policies, fixed investments, consumption funds, credit practices, and foreign exchange. (Keister 2000, p. 77). The Chinese government furthermore privileged enterprise groups by giving preferential treatment to them in terms of credit access and support for technical upgrading and listing priority (OECD 2000, p. 55).

2.2.4.2 The Ownership, Control, and Organizational Structure of Chinese SOE Groups

The core firms of SOE groups are owned completely or in part by the state, and they in turn own completely or in part the subordinated member firms. The core firm and its member firms are all independent firms, even though they are quite interwoven. Once a SOE enters a group, it is controlled by the core firm in the group. If a firm is listed as a state-owned firm, the state relinquishes its ownership and control rights over the company to the core firm in the group (Dong and Hu 1995; Li 1995). This change in status does not imply that the firm is no longer state-owned, but rather that the core firm (a firm that is also state-owned) now owns and controls the firm directly. The core firm is generally a large industrial or commercial enterprise that mostly transacts in the business or industry which is the group's primary industry. Because it has ownership ties with them, the core firm is able to influence the other member firms. The core firm's power of influence increases with the extent of its ownership interest. When the core firm's investment in its subsidiaries is great or when it controls the stock of the firms under it, the core firm normally plays a more significant role in the management of the member firms. The whole enterprise group is managed by the board of directors of the core firm, which includes representatives from specialized firms, from the core firm's production division, and from other member firms. Workers also may have representatives on the board. The board oversees the management of firms. It plans the group's structure, policies, strategy, and direction. It chooses general managers for the firms, oversees the activities of the managers, and makes financial decisions (Keister 2000, pp. 84–93).

For further clarification, Fig. 2.2 depicts the organizational structure of Chinese SOE groups. When a firm enters an enterprise group, its ownership is partially transferred to the core firm in the group; therefore, the owners or stockholders of the core firm are the ultimate authority in the Chinese enterprise groups. However, the term "partial ownership" is used here to describe ownership relations that are similar to the cross-shareholding ownership relations in Japanese *keiretsu*. As the figure illustrates, the core firm's board of directors of Chinese enterprise groups is accountable to the shareholders and oversees the activities of the president of the core firm. The management council or enterprise office of the group is directly subordinate to the president. It forms the management office for the core firm and comprises the vice-presidents and general managers of the firms. The enterprise office has some authority over other subsidiaries and is consequently positioned higher than the subsidiaries.

The finance company, the other specialized firms, the other member firms, and the core firm's production units are all directly subordinate to the management council. The finance division or finance company is responsible for the financial activities of the other member firms. Other special divisions or specialized firms are responsible for activities such as the administration of the group, import and export activities, marketing, and research and development. The core firm's production division produces industrial output, but does not have its own administrative offices (such as those for accounting and sales). The enterprise group's administrative offices or specialized firms perform these tasks for the core firm's production unit and for other member firms. In contrast to the core firm, member firms have their own factories, as well as administrative offices, which are responsible for accounting, purchasing, sales, and other administrative activities. Figure 2.3 depicts the general organization of the member firms. The member firm is headed by a board of directors, which oversees the chairman of the board. The president and the general manager of the firm report to the chairman and oversee the firm's executive committee, which comprises the vice presidents for administrative divisions and the managers of the production divisions. The administrative offices coordinate accounting, sales, research and development, and other administrative activities only for the individual member

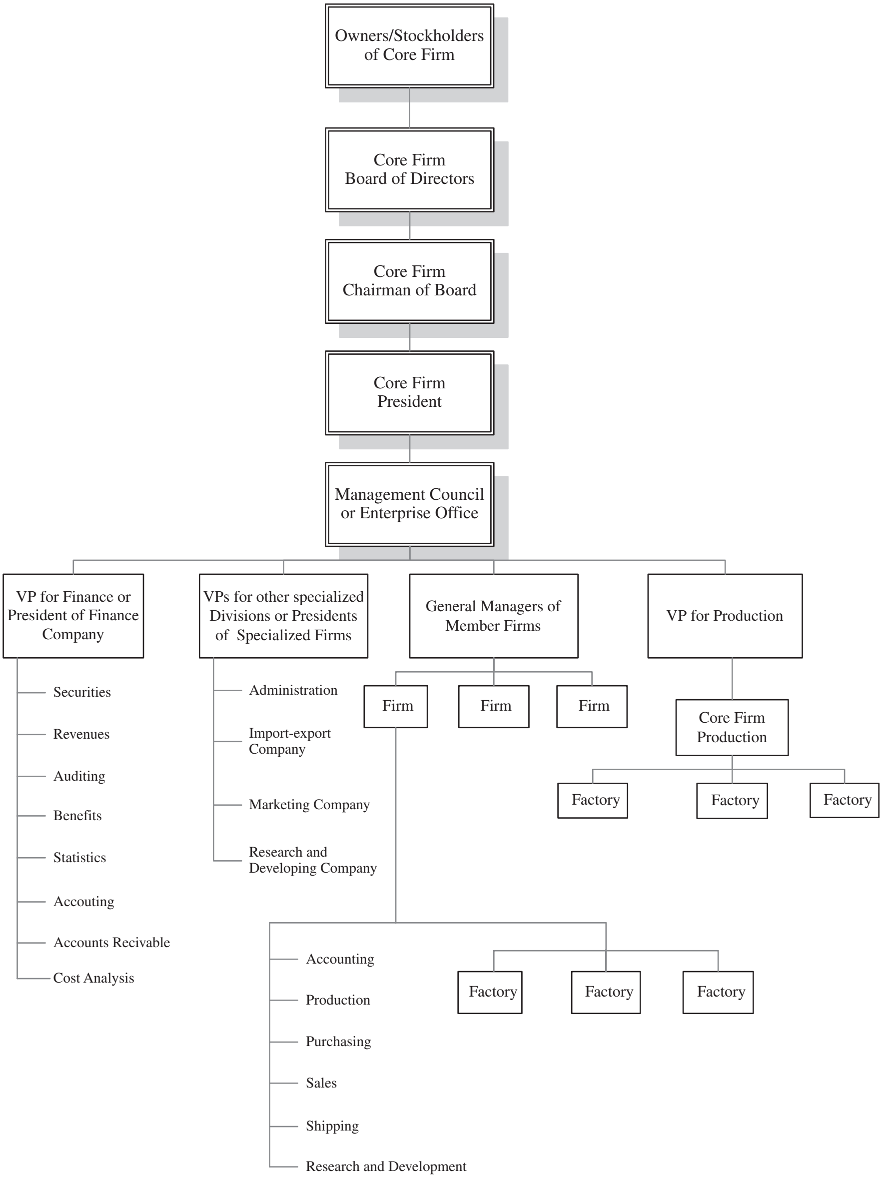

Fig. 2.2 The organizational structure of the Chinese state-owned enterprise group. (From Keister 2000, p. 89)

firm, but no tasks that are conducted by the group's administrative offices (Keister 2000, pp. 88–91). When an enterprise group lacks a particular specialized firm, the appropriate division of the core firm fulfills the function for the member firms. If a group lacks, for example, a marketing company, the marketing division of the core firm will assist the member firms in marketing matters (Li 1995; Shanghai 1995).

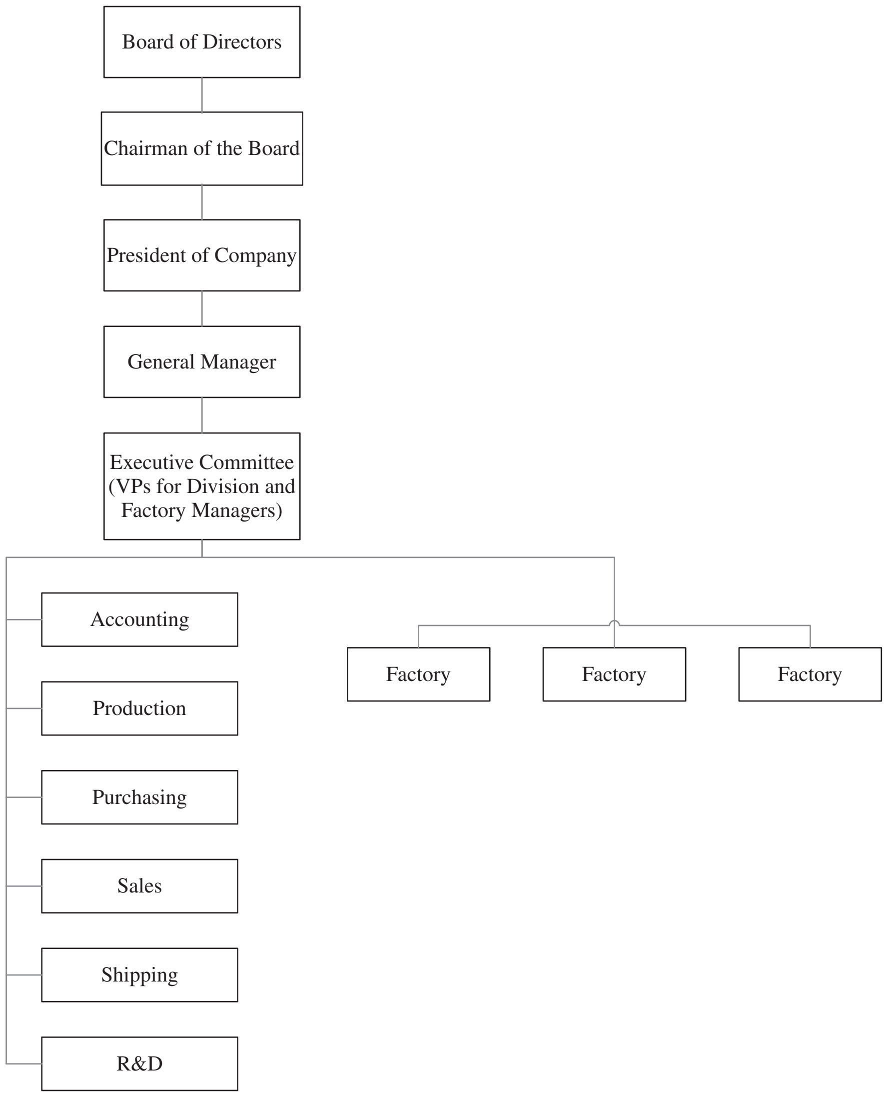

Fig. 2.3 Organization structure of the member firm. (From Keister 2000, p. 91)

2.2.4.3 Key Players in Chinese Enterprise Groups

The Core Firm

The core firm manages not only its own divisions but also, to a certain degree, the specialized firms, such as the finance company, and other member firms. In many cases, the former administrative bureau has become the core firm. It is also still controlled by the state, especially in the strategic and central industries. The core firm has multiple investors, including the state, legal persons, and individuals. It has the managerial latitude to coordinate other member firms, and to expand the group into various industries (Keister 2000, p. 93).

The Finance Company

The Japanese *keiretsu* model has provided a great deal of motivation for Chinese reformers, especially in the financing pattern within a business group. It is common for a bank to be at the center of a Japanese business group *keiretsu*. The Tokyo Stock Exchange is not truly an option for corporate finance. Rather, government-related banks supply funds to the *keiretsu*, and firms find it more efficient to obtain capital from the banks affiliated with the groups. In Japan, firms normally develop a close relationship with a bank, on which they rely for the major part of their financing (Gerlach 1992; Miyashita and Russell 1994; Keister 2000, pp. 96–7).

After 1990, the finance companies spread rapidly throughout all industries in China. By the mid-1990s, all of the largest enterprise groups had finance companies (Keister 2000, p. 98). State reformers promoted the formation of finance companies to aid firms in raising funds for growth and expansion, and to remove some of the burden from underfunded state-owned banks (Li 1995). Firms which were member firms of enterprise groups had access to an additional source of credit, the finance company. The finance company received deposits primarily from member firms, provided funds for the member firms in the group, aided the firms in making investment, and also acted as a bank to the member firms (Shi 1995; Keister 2000, p. 131). The finance company also enabled member firms to meet research and development needs that might have gone unmet without access to credit (Li 1995). The finance company as a means of "insider lending" permits firms to mitigate informational asymmetries, to reduce transaction costs, and to substitute for the existence of a formal financial system. It fulfills thereby the task of presenting opportunities for funds to be allocated more efficiently within a particular group and giving member firms a degree of control over their access to resources, which might otherwise not be available (Goto 1982; Lamoreaux 1986; Keister 2000, p. 131). Similar to the prospering of Japanese *keiretsu* in their early stages of development, firms (especially core firms) in Chinese enterprise groups with a finance company performed better financially, and were more productive, than firms in an enterprise group without a finance company (Keister 2000, p. 132). Moreover, the finance company itself performed well financially (Li 1995).

The Administrative Company

The administrative company fulfills purchasing, marketing, shipping, and engineering functions, which are peripheral to production. It is also responsible for legal matters, human resources, asset management, customer relations, etc. In many cases, the member firms have their own administrative offices, but they normally can relinquish some responsibility to the administrative company in their group and take advantage of economies of scale. Above all, the member firms would not be able to perform these administrative functions as well as the administrative company can, because the administrative company is professional in this field and has sufficient resources and knowledge about the proper means of performing these tasks (Keister 2000, pp. 99–101).

The Research and Development Company

Chinese enterprise groups had just begun to develop research and development companies by the mid-1990s. The research and development company in an enterprise group centralizes the research and development function, and makes available the benefits of technological advances to all members of the group. The research and development company aids member firms in gaining access to advanced technology and innovations. It thus can improve the competitiveness and performance of the group's member firms (Keister 2000, pp. 101, 132).

The finance company, the administrative company, and the research and development company are the most common specialized companies in Chinese SOE groups. The enterprise groups also occasionally have an insurance company, an import–export company, a marketing company, educational and training institutes, and other specialized firms, which play crucial roles in the functioning of the group. The purpose of establishing these specialized firms is to fulfill specific needs that most member firms have in common (Keister 2000, p. 95).

2.2.4.4 Interfirm Relations in Chinese SOE Groups

In addition to connections with the core firm and with the specialized firms discussed in the previous section, member firms are also connected to each other through various types of interfirm relations. Like Japanese *keiretsu*, in which member firms have interfirm relations through cross-shareholding, interlocking directorates, financing arrangements, and production arrangements, member firms in a Chinese SOE group are also interconnected in four basic ways: cross-shareholding, interlocking directorates, debt and financing relations, and production and management relations.

Cross-Shareholding

After the reforms, it became possible for the SOEs to acquire ownership of each other in China (Ni and Zhu 1994). As a consequence, cross-shareholding took place in Chinese SOE groups. When cross-shareholding exists in a group, each firm has a direct interest in the performance of the other. These ties breed mutualism among member firms, by which the member firms feel they have shared interests, and are willing to work together. Thus, cross-shareholding results in more joint projects among member firms, increased investment in research and development, and also in more investment in other future projects that would otherwise be too risky (Keister 2000, p. 103).

Interlocking Directorates

That the same individual holds positions on the boards of directors of two or more firms generates interlocking directorate relations among the firms. In the Chinese case, those can be identified as the result of state or core firm appointments (Li 1995; Keister 2000, p. 104). When the state or the core firm assigns representatives to the boards of two member firms, it is often the case that the same individual is assigned to both boards.

Interlocking directorates facilitate information flow among firms and reduce information asymmetries (Haunschild 1993, 1994). Thereby, they also reduce the transaction costs. Given the high level of uncertainty in the Chinese economy, membership in an enterprise group with interlocks indicates increased access to inputs, financing, and the market. Interlocking directorates play an important role in Chinese enterprise groups, and all firms in enterprise groups with interlocking directorates benefit from the director interlocks and perform better financially than firms in enterprise groups without interlocks (Keister 2000, p. 130).

Financing Relations

Member firms in Chinese enterprise groups are moreover related to each other through financing relations. Within an enterprise group, it is common for the core firm to finance the member firms through its finance division or through the group's finance company as discussed in the preceding section. It is also common for member firms to grant loans to each other. This kind of interfirm financing creates another form of tie among firms within an enterprise group, that is, ties through financing relations.

Production and Management Relations

Member firms in Chinese enterprise groups are also connected to each other through production and management relations. Member firms usually develop long-term trading relations with each other, make joint planning and strategy decisions, and jointly complete special projects that they would not be able to complete alone. Member firms, in addition, have administrative linkages through a specialized firm, namely, through the administrative company, which serves all group members (Keister 2000, pp. 105–6).

2.2.5 The Financing Pattern of SOEs Independent of Short-Term Profitability

Except for the financing from the state enterprise groups' financing companies, as mentioned in the preceding part, state enterprises heavily rely on financing from China's banking system. State enterprises also have preferential access to China's stock markets, while majority state shares are not allowed to be freely traded.

Therefore, state enterprises are exempt from fluctuations of the stock markets. A "control oriented" instead of an "arm's length" banking system and nonexposure to fluctuations of the stock market depict how state enterprises in China have access to financial capital independent of short-term profitability.

2.2.5.1 The Insider and Bank-Based Financial System in the Chinese State Sector

A distinction is often made between two models of financial systems as to whether they are stock-market-based or bank-based. This is measured according to whether banks or financial markets (i.e., organized markets for securities such as bonds, stocks, futures, and options) play the major role in the allocation of resources and in corporate governance (Allen and Gale, 2000; Mayer, 1994, p. 189; Whitley 1999). The first model is labeled the "outsider and stock-market-based approach", and is pervasive in the USA and the UK. Firm ownership is diffuse, and individual shareholders are outsiders in the sense that they only have arm's length input into the firm's decision-making through a board of directors. Corporate governance is performed primarily through a market for corporate control. The stock market plays a central role in corporate governance via the takeover mechanism. Banks play a minor role in this model, which is labeled as an arm's length banking system. The second model is labeled the "insider and bank-based model," and is pervasive in Germany and Japan. Here, firm ownership is concentrated in the hands of a few key shareholders that rarely trade their shares. Corporate governance is performed from within the firm by these insiders rather than through a market for corporate control. Banks, rather than stock markets, feature predominantly in the insider and bank-based model. They are important suppliers of external finance, holders of firm equity, and hold seats on the firms' supervisory boards. They play a control-oriented role in the corporate governance (Corbett, 1994, p. 316; Laurenceson and Chai 2003, pp. 88–9).

China's financial system in the state sector remains heavily bank dominated, because the banks and not the stock market provide the main source for business finance. Banks play an effective role in the corporate governance of the state enterprises. Moreover, the ownership of SOEs is concentrated in the hands of a few key shareholders (the state or other SOEs) that rarely trade their shares. Corporate governance is then performed from within the firm by insiders rather than through a market for corporate control. Owing to the above-mentioned characteristics, the financial system in the Chinese state sector has more in common with the financial systems of Japan and Germany, than with those in the USA and the UK, where the stock markets and markets for corporate control play the central role (Laurenceson and Chai 2003, p. 88; Chiu and Lewis 2006, p. 207).

Most enterprise financing in China is "indirect" rather than "direct," and hence takes place indirectly through the financial institutions, instead of through raising funds directly from financial markets. Nowadays, the stock market and the bond market provide alternative sources of financing for enterprises in China. However, the stock market and the bond market are small sources of finance relative to bank

Table 2.5 New finance raised in Chinese financial markets, 1995–2004

	1995	1998	2001	2002	2003	2004
Total (billion yuan)	1,152.0	1,395.0	1,655.5	2,397.6	3,515.4	2,902.3
(Percentage of total)[a]	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)
Bank loans	1,014.0	1,152.0	1,255.8	1,922.8	2,993.6	2,406.6
(Percentage of total)	(88.0)	(82.6)	(75.9)	(80.2)	(85.1)	(82.9)
Government bonds	22.0	15.0	259.5	346.1	352.5	312.6
(Percentage of total)	(1.9)	(1.1)	(15.7)	(14.4)	(10.0)	(10.8)
Corporate bonds	15.0	84.0	14.7	32.5	33.6	32.7
(Percentage of total)	(1.3)	(6.0)	(0.9)	(1.4)	(1.0)	(1.1)
Stocks	101.0	144.0	125.2	96.2	135.7[b]	150.4[c]
(Percentage of total)	(8.8)	(10.3)	(7.6)	(4.0)	(3.9)	(5.2)

Notes:
[a]Owing to rounding errors, percentages may not add up to 100.
[b]Includes convertible bonds of 18.1 billion yuan
[c]Includes convertible bonds of 20.9 billion yuan
Source: Chiu and Lewis 2006, p. 206.

intermediation (Chiu and Lewis 2006, p. 209). Table 2.5 shows the growth of financing by bank loans, bonds, and equities over the years from 1995 to 2004. Despite what the People's Bank of China (2003) described as a significant buildup of funding in the stock market in 2003, equity issues in reality represented only 3.9% of finance raised by enterprises. The issues of corporate bonds accounted for only 1% of fund raising. Both equity issues and bond issues have declined in relative importance since 1998, when they together constituted 16% of total financing (Chiu and Lewis 2006, p. 206). Until recently, the financial system was still bank-based. Most capital is raised in the form of bank loans (83% in 2004), and only little finance is raised through the equity issue market or the corporate bond market (together about 6% in 2004) (Chiu and Lewis 2006, p. 212).

2.2.5.2 China's Banking System Reform

Firstly, China's state-owned banks have become commercial banks with modern corporate governance.

Since 1995, China's state-owned banks have been reformed and have become commercial banks. The objective of a commercial bank in a market economy is to maximize expected profits subject to risk constraint. Commercial banks should thus allocate loans to those projects that offer the highest expected financial return. They should also diversify their loan portfolios and maintain a strong capital base to effectively manage risk. The performance of a commercial bank can largely be determined by measures of financial return such as profitability and measures of solvency such as capital adequacy (Laurenceson and Chai 2003, p. 46). In the Commercial Banking Law of the People's Republic of China, state commercial banks are required to assume greater responsibility for their own profits and losses, and take into account the likelihood of repayment before extending loans. The General

Lending Rules, an order of the People's Bank of China in 1995, explicitly states that profitability is now to be used as a basic principle to guide lending. As state commercial banks, their operations should remain solvent (Laurenceson and Chai 2003, p. 50). Henceforth, state commercial banks should allocate credit to enterprises on the basis of sound commercial lending principles, rather than on the basis of government mandates (Chiu and Lewis 2006, p. 80).

Commercial banks in China have done a great deal to improve their own corporate governance without fundamentally changing their ownership structure. They have become more transparent by using international accounting standards and reputable external auditors. Banks improve board practices by setting up various committees, such as audit committees and risk management committees, and by appointing independent directors to chair some of these committees. Chinese commercial banks have also made significant progress in improving their corporate governance and financial performance through entering into technical assistance arrangements with reputable international financial institutions, and by attracting strategic investors, including foreign ones. As banks adopt modern corporate governance approaches, their credit decisions are more likely to become sound. A strong capital base will also allow banks to take a long-term approach to their strategic lending decisions (Tenev et al. 2002, p. 67).

Secondly, China's state-owned banks took significant reform measures in the mid-1990s.

In general, the banking reform program in the mid-1990s consisted of the following major components: the establishment of policy banks and the introduction of a new commercial banking law, which separated policy lending from commercial lending; the relaxation of the credit plan in favor of asset-liability management principles; transforming the People's Bank of China into a real central bank, separated from the Ministry of Finance and policy lending, and recentralizing the People's Bank of China to avoid local government interference; deregulating the banking sector and establishing new banks and various financial institutions that coexist with state commercial banks, which remain the main entities; solving the problem of non-performing loans (Laurenceson and Chai 2003, p. 48; Tenev et al. 2002, p. 18, Chiu and Lewis 2006, p. 213).

Since 1995, the four state owned banks, that is, the Industrial and Commercial Bank of China, the Agriculture Bank of China, the Bank of China, and the Construction Bank of China, which account for approximately 75% of all loans in China, have become state commercial banks (Holz and Zhu 2002). A new Commercial Banking Law was approved in 1995 to regulate commercial banks (Garcia-Herrero et al. 2006). Also in that year, three new policy banks, that is, the China Development Bank, the Import–Export Bank of China, and the Agricultural Development Bank of China, were established to take on the policy loans of the commercial banks (OECD 2000, p. 87). They are designated as the main vehicles for policy-based lending in the future (Tenev et al. 2002, p. 18). After this reform step, policy-related finance is largely separated from commercial lending (Chiu and Lewis 2006, p. 213).

In 1998, the government took a major step in the reform of credit allocation by phasing out the credit quota system that was applied to the four state-owned banks and replacing it with asset liability management (Tenev et al. 2002, p. 18). The government announced that commercial banks should act on a commercial basis (Chiu and Lewis 2006, p. 207).

Further extensive reform steps have been under way to establish sound lending standards and improve prudential standards. These steps include the use of internal credit rating standards based on enterprise credit history and financial conditions, and the establishment of strict accountability of individual loan officers and their senior managers for containing nonperforming loans (OECD 2000, p. 87). Considerable effort has been made to upgrade accounting skills and standards for assessing credit worthiness and monitoring loan performance. Also remarkable is the development of a national "credit registry" system, similar to those used in Germany, Italy, and several other European countries, which is set up to provide information to potential lenders about the credit history and financial performance of loan applicants. Commercial banks have also been given greater flexibility to vary interest rates from official benchmark levels to better incorporate risk into loan pricing (OECD 2000, p. 88).

A further step was taken in 1999 to cleanse the state banks of nonperforming loans through a debt–share swap (Chiu and Lewis 2006, p. 80). To achieve this goal, four bank asset management companies (BAMCs) were established to take on the nonperforming loans of the four major commercial banks that were incurred before 1996 (OECD 2000, p. 88). Chinese banks had accumulated a huge number of nonperforming loans owing to the credit quota system. As mentioned above, the state set up four BAMCs, one for each state commercial bank, and supplied them with money through the Ministry of Finance, the People's Bank of China, and nontradable bonds. Then, BAMCs provided money to the firms, and the firms paid their loans back to the banks. BAMCs also provided nontradable bonds to the big four state commercial banks in exchange for nonperforming loans (Chiu and Lewis 2006, pp. 77, 235). In total, the BAMCs were authorized to acquire 1.2 trillion yuan of nonperforming loans, amounting to nearly 18% of the total loans of the four state commercial banks (OECD 2000, p. 88). Subsequently, the firms' debts were turned into shares held by the BAMCs on behalf of the state. Banks appeared to be in a healthier condition after getting rid of the bad loans in exchange for debt claims issued by the BAMCs, while the SOEs were less highly geared (Chiu and Lewis 2006, pp. 77, 235). The establishment of separate entities to deal with nonperforming loans allows more flexible means to work out the loans, and is consistent with "best practices" which emerged from international experiences (OECD 2000, p. 88). The transfer of old bad loans to the BAMCs in 1999 and 2000 was to create a clean balance sheet from which the state commercial banks could start out anew with purely commercial lending (Holz and Zhu 2002).

The government also started to deregulate the banking sector and to lower the barriers to entry. This resulted in the establishment of new banks. Nonstate commercial banks and various financial institutions, even foreign banks, entered China's market (Tenev et al. 2002, p. 18). The old monobank system was replaced with a multitiered one (Garcia-Herrero et al. 2006), in which, however, state commercial banks remain the main entities (Chiu and Lewis 2006, p. 213).

The People's Bank of China still lies at the heart of the financial system, but its role has greatly changed. Its commercial banking activities have been transferred to the four state commercial banks, whereas policy lending is now undertaken by the three policy banks. Bank supervision responsibilities, which the People's Bank of China assumed with the growth of an array of shareholding, city and regional banks, along with other financial institutions, were removed and vested with the newly established China Banking Regulatory Commission in 2003. It is the China Banking Regulatory Commission that now oversees the reforms and regulation of the banking sector, allowing the People's Bank of China to focus on monetary policy. While the State Council is ultimately responsible for key monetary policy decisions, the 1995 act guaranteed the People's Bank of China a high degree of independence from other levels of government, including provincial governments and central government ministries. The People's Bank of China has used this independence to change from direct to indirect controls. In 1998, it ended its controls on loan limit ceiling. The People's Bank of China utilizes a combination of central bank loans, rediscounting, open market operations, interest rates, exchange rates, and lending policy to control the macroeconomy. The monetary policy targets are both stability of the exchange rate and GDP growth (Chiu and Lewis 2006, pp. 202–3).

In 1998, the People's Bank of China underwent significant restructuring that was aimed at reducing provincial and local government intervention in credit allocation and monetary policy. The People's Bank of China replaced 31 provincial branches with nine regional branches. The old provincial branch system had been based on administrative jurisdictions, in which the provincial governments had a strong influence over the decisions made by the subordinate provincial branches. The move from a provincial branch system to a regional branch system was expected to minimize such influence and improve the central bank's independence (Tenev et al. 2002, p. 18).

Taken as a whole, the financial reform measures that were adopted represent important progress toward establishing sound commercial lending standards and financial discipline. There is widespread agreement that banking loan standards and credit quality have indeed improved significantly since 1996 in China (OECD 2000, p. 88).

2.2.5.3 China's Statist Banking System Concentrates Financing on State Enterprises

One of the distinctive features of the Chinese financial system is that all domestic financial institutions are either state-owned or state-controlled (OECD 2000, p. 80).

Table 2.6 sets out the various classes of financial institutions as of the end of 2003, and their shares of banking assets. The numbers illustrate that the financial system in China is fundamentally statist, with all levels of the banking system being state-dominated. Starting at the top, the three policy banks and the four state commercial banks together have a 62% share of banking assets. The three policy banks are 100% owned by the state. The four large and nationwide state commercial banks

Table 2.6 Chinese banking institutions, end 2003

	Number of institutions	Assets (100 million yuan)	Percentage of total assets
Policy banks[a]	3	21,247.0	7.7
State-owned commercial banks[b]	4	151,940.6	55.0
Joint-stock commercial banks[c]	11	381,69.7	13.8
City commercial banks[d]	99	14,621.7	5.3
Rural commercial banks	NA	384.8	0.1
Urban credit cooperatives[e]	3,240	1,468.3	0.5
Rural credit cooperatives[e]	41,500	26,509.2	9.6
Nonbank financial institutions[f]	NA	9,100.0	3.3
Postal savings institutions[g]	21,000	8,984.4	3.3
Foreign-funded financial institutions	180	3,969.0	1.4
	Total	27,6394.5	100.0

Note:
NA: not available.
[a]China Development Bank, Import–Export Bank of China, and Agricultural Development Bank of China
[b] Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, Construction Bank of China
[c]Bank of Communications, CITIC Industrial Bank, China Everbright Bank, Huaxia Bank, Shenzhen Development Bank Corporation Ltd, Guangdong Development Bank Corporation Ltd, China Merchants Bank, Shanghai Pudong Development Bank Corporation Ltd, China Minsheng Banking Corporation Ltd, Industrial Bank Corporation Ltd, and Evergrowing Bank Corporation Ltd
[d]Numbers as at end of 2001
[e]Numbers as at end of 1999
[f]Nonbanking financial institutions as a category include finance companies, trust and investment companies, and financial leasing companies.
[g]Number of branches as at 1995. Assets refer to deposits collected and deposited with the People's Bank of China.
Source: Chiu and Lewis 2006, p. 205.

were fully state owned until the strategic foreign investments in 2005 in the Bank of China, the Construction Bank of China, and the Industrial and Commercial Bank of China, and they remain majority-state-owned. The next tier consists of the smaller regional joint-stock commercial banks and of the main banks of the SOEs, which are owned either by the local government or by SOEs, and issue nearly 20% of loans. There are then the credit cooperatives, postal savings banks, and nonbank financial institutions (financial companies, trust and investment companies, and leasing companies), which all have predominantly shareholding ties with the central state or the local government or are controlled by SOEs. Urban credit cooperatives in 1995 were compelled to forge shareholding links with municipal governments, which became the largest shareholders. City commercial banks were formed by amalgamating the urban cooperatives. Financial companies are amalgams of financial institutions and state enterprises, with equity raised from state enterprises in the group. They are owned by the parent companies, which are again state enterprises. Trust and investment companies mobilize financial resources for investment projects. Among 386 trust and investment companies in 1995, 11 belong to central government departments, 170 belong to the specialized state banks, and 205 belong to local governments. Financial leasing companies finance the rental and leasing of equipment to enterprises, the capital of which is held by state-controlled shareholding companies. Postal savings institutions are operated by the Ministry of Post and Telecommunications. They collect deposits and transfer them to the People's Bank of China, which pays interest on the funds. Only the 180 foreign banks can be said to be truly nonstate owned. They were restricted from taking local deposits until the end of 2003, and relied mainly on deposits from joint ventures or foreign firms operating in China. Their share of assets was only 1.4% in 2003 (Chiu and Lewis 2006, pp. 204–12).

Another distinctive feature of China's statist banking system is the concentration of financing on state enterprises. State policy banks and state commercial banks have been committed to lending to the state sector, and their core business continued to be funding the state sector (Chiu and Lewis 2006, pp. 204–7). Until 2000, about 80% of loans of state banks went to the state sector, and the share of state banks in total lending by all financial institutions was about 77% (see Table 2.7).

Still in recent years, the great bulk of bank lending has gone to the state sector. State enterprises receive three-quarters of state banks' short-term loans and about 60% of the state banks' medium-term to long-term loans for fixed assets (Chiu and Lewis 2006, pp. 207–13).

2.2.5.4 State Commercial Banks Pursue Developmental Objectives by Lending Predominantly to the State Sector

Being under state ownership control, the state commercial bank is akin to a development bank. The objective of a development bank is to maximize the development impact of lending, subject to the necessary condition that its operations remain solvent (Bhatt, 1982, p. 61; Laurenceson and Chai 2003, p. 49). The objectives that Chinese state commercial banks follow are outlined in two pieces of legislation: the 1986 Interim Banking Control Regulations of the People's Republic of china (IBCR), and the 1995 Commercial Banking Law of the People's Republic of China (CBL). IBCR states that the activities of all financial institutions "shall be aimed at the economic development, the stabilization of currency, and the promotion of beneficial social and economic results" (ACFB 1990, English edition, p. 177; Laurenceson and Chai 2003, p. 49). The CBL specifies that profitability is not to be the sole criterion state commercial banks are to consider. It states, "A commercial bank shall conduct its loan business in accordance with the need for the development of the national economy and social progress, and under the guidance of the state industrial policy." Therefore, the objectives of state commercial banks are now a combination of development and commercial goals, or likewise a combination of developmental returns and financial returns on lending (Laurenceson and Chai 2003, p. 50).

State commercial banks attach greater importance to the development impact of their lending than to financial returns. Consequently, the particular criteria that state

Table 2.7 State bank lending

	1978	1980	1985	1990	1995	1996	1997	1998	1999	2000
Total loans (billion yuan)	185.00	214.43	6,20.62	1,516.66	3,939.36	4,743.47	5,931.75	6,844.21	7,369.58	7,639.375
Growth over previous year (%)	–	–	–	–	–	20.41	25.05	15.38	7.68	3.66
Total lending to state-owned enterprises (billion yuan)	168.46	215.60	5,28.79	1,289.82	3,307.66	4,004.66	4,907.67	5,666.75	5,989.05	6,044.784
Growth over previous year (%)	–	–	–	–	–	21.07	22.05	15.47	5.69	9.31
Lending to state-owned enterprises for investment in fixed assets (billion yuan)	0.00	5.55	70.53	224.57	1,002.56	1,203.42	1,472.46	1,974.43	2,279.17	2,640.609
Growth over previous year (%)	–	–	–	–	–	20.03	22.36	34.09	15.43	15.86
Share of total lending (%)										
State-owned enterprises	91.06	89.30	80.90	85.04	83.96	84.42	82.74	82.80	81.27	79.13
Argriculture	6.25	7.29	6.71	6.84	4.88	4.99	5.16	5.17	4.95	3.54
Urban collective enterprises	2.69	3.23	5.00	5.38	2.71	2.53	–	–	–	–

Table 2.7 (continued)

	1978	1980	1985	1990	1995	1996	1997	1998	1999	2000
Individual-owned industry and commerce	0.00	0.00	0.17	0.10	0.09	0.11	0.27	0.30	0.41	0.46
Foreign-funded enterprises	–	–	–	–	2.28	2.57	2.89	3.25	3.63	3.51
Others	0.00	0.17	2.91	2.63	6.08	5.37	8.93	8.48	9.74	13.36
Total loans by all financial institutions (billion yuan)	–	–	–	1,768.07	5,053.80	6,115.28	7,491.41	8,652.41	9,373.43	9,937.107
Share of state banks in total lending (%)	–	–	–	85.78	77.95	77.57	79.18	79.10	78.62	76.88

State banks comprise the People's Bank of China (until 1983 it was a commercial bank as well as the central bank, since then it has been the central bank only), the four state commercial banks [Industrial and Commercial Bank of China (since 1985), Agricultural Bank of China (since 1980), Bank of China (since 1980), Construction Bank of China (since 1985)], Bank of Communications (since 1990), CITIC Industrial Bank (since 1990), and the three development banks (State Development Bank, China Import–Export Bank, and Agricultural Development Bank of China) since 1995.

Lending to state-owned enterprises comprises lending to industrial production enterprises, material supply enterprises, commercial enterprises, construction enterprises, and lending for investment purposes. Beginning with the 1998 data, "investment in fixed assets loans" have been relabeled "medium-term and long-term loans," while all other loans, apart from a small category of "other loans," are now labeled "short-term loans."

Lending to agriculture since 1998 is the sum of lending to "agriculture" and (a newly published category) "township and village enterprises." Lending to agriculture is in part or perhaps even predominantly lending to state-owned agriculture.

All financial institutions comprise the People's Bank of China, the three development banks, the four state commercial banks, other commercial banks, urban commercial banks, urban credit cooperatives, rural credit cooperatives, post offices, financial trust and investment companies, finance companies, and financial leasing companies.

From China Financial Statistics 1952–1996 (Beijing: China Fiscal Economy Press, 1997), pp. 12–4; China Financial Yearbook 1997, p. 464, 471; China Financial Yearbook 1998, p. 508–9; China Financial Yearbook 1999, p. 384–5; China Financial Yearbook 2000, p. 401–2; Zhongguo jinrong, no. 2 (February 2001), pp. 47–8 commercial banks use to evaluate potential borrowers have a direct relationship to the development objectives of the country. Thus, testing the development impact of state commercial bank lending is a necessary addition to evaluating the performance of state commercial banks (Laurenceson and Chai 2003, p. 50).

According to the findings of Laurenceson and Chai (2001, 2003, p. 53) and Liu and Li (2001), the investment funded through state commercial bank loans has been productive, and the development impact of state commercial bank lending has been great. One channel through which state commercial banks may have positively influenced economic development is by selecting relatively productive state enterprises for their lending programs, and by promoting the productivity of state enterprises through their effective role in the corporate governance of the state enterprises. There have been improvements in areas such as accounting and disclosure standards that have made it easier for state commercial banks to identify productive state enterprises. Cull and Xu (2000) and Lee (1997) found a positive relationship between bank credit and firm productivity. Bank loans, as the chief source of external finance, have placed financial institutions in a strong position to exert corporate governance over state enterprises (Laurenceson and Chai 2003, p. 54).

The second channel through which state commercial banks may have positively impacted on economic development is by directing credits to certain state strategic industries, and thereby correcting market failure. During the financial liberalization in the early stage of reform, state commercial banks began to channel credit toward areas of the economy where short-term profitability was available. As a result, investment in several key industries with long-term development potential and strategic value fell significantly, and they became bottlenecks to development. To correct this short-sighted investment structure, the state tightened its grip on state commercial bank lending and directed the credits toward the state strategic industries (Laurenceson and Chai 2003, p. 55), based on state ownership coordination.

The third channel through which state commercial banks may have promoted economic development in China is by lending predominantly to the state sector; inflationary pressures and the scope for moral hazard to occur in lending have been moderated. When the economic reform began to erode the traditional tax revenue base – the remitted profits of SOEs – the government was forced to borrow from the state banking system to meet current expenditures. This implies that there exists little room for noninflationary bank lending to the private sector. The fact that Chinese state commercial bank lending to private firms has been limited could partly explain the superior performance of China in the area of price stability, compared with other transitional economies (Laurenceson and Chai 2003, p. 55).

The final channel through which state commercial banks may have positively influenced economic development is their continued support of the state sector, through which many positive externalities have been conferred on the private sector. One example here is that state sector development has provided a stable environment, in which the private sector can flourish; state enterprises have also constructed an infrastructure and facilitated private sector economic activity (Laurenceson and Chai 2003, p. 56).

2.2.5.5 The Main Banks in China Participate in the Corporate Governance of State Enterprises

The main bank (*zhuban yinhang*) relationship, resembling that in Japan, has been promoted by the Chinese government since 1996 to transform state enterprises into efficient and modern corporations. The idea was to promote a key monitoring role for the main banks to participate in the corporate governance of state enterprises, and to develop a stable bank-centered financial environment for these enterprises to make them more efficient modern corporations (Tam 2000; Chiu and Lewis 2006, p. 170).

According to China's Ninth Five-Year Plan, a main bank relationship should be established between a state bank and a state enterprise. This was supposed to provide the participating main bank with a more comprehensive ability to monitor the performance of the state enterprise. According to the *Interim Regulations for the Administration of the Main Bank*, the state enterprise should allow the main bank to monitor the firm's major business and financial activities, and to further facilitate this process. The main bank could audit all dealings between the firm and other banking institutions. Moreover, it was enabled to implement any punitive credit measures on behalf of itself and other banks against the firm, if the firm was found to be evading its obligations as a debtor. On the other hand, when the state enterprise cannot meet its "reasonable" credit needs, the main bank should help by allocating loans as the lead lender. The participating enterprise has access to credit facilities of the main bank to meet most of its borrowing needs, and also enjoys preferential treatment in obtaining financial services from the main bank, such as settlements and the provision of information and advice. (Chiu and Lewis 2006, pp. 170–1).

As mentioned above, the Chinese version of a main bank system resembles the main bank system in Japan (and the *Hausbank* system in Germany), which is labeled as a "control-oriented" banking system, and described as "corporate governance by intervention." The Japanese–German model of the banking system is different from the Anglo-Saxon model of the banking system, which is labeled as an "arm's length" banking system, and is described as "corporate governance by objective" (Aoki and Kim 1995). Banks in arm's length banking systems neither need to interfere with the corporate management directly nor need to monitor enterprises too closely, because they are paid according to a formal contract and their loans are backed by collateral, or security, including the enterprises' physical assets.

The "arm's length" banking system does not fit into the institutional environment in China, and faces two obstacles. The first obstacle persists because of ill-defined property rights, which makes it unlikely that a market for enterprises' physical assets will exist. The second obstacle is due to moral hazard, because enterprises may not provide full information on the risks involved, or which might make them unwilling to repay loans. Thus, reliance on collateral or security to ensure the repayment of loans is not possible. In these circumstances, the banks would provide finance only on the basis of certain strict conditions being met, including the exertion of control over the corporate management, particularly in the case of poor performance. The banking system in China is thus likely to evolve into a control-oriented system, similar to the Japanese–German model.

In the "control-oriented" banking system, mutual trust might be enhanced. If an enterprise is assured of a long-term relationship with a bank, which is prepared to share some risk in the case of financial distress, the enterprise has an incentive to provide full information. Banks may agree to a long-term main bank relationship and may be willing to share some risk with enterprises if they are assured of participation in enterprise governance, and of their right to make changes to the management (Chiu and Lewis 2006, pp. 171–2).

2.2.5.6 Access of State Enterprises to Stock Market Financing: Majority-State-Owned Shares Are Not Allowed To Be Freely Traded

China's financial system is fundamentally statist. This is not only so for the banking system, but also holds for the stock market, since most securities firms are state-controlled (Chiu and Lewis 2006, p. 212), and state enterprises typically enjoy preferred access to equity and bond market financing.

Treasury and fiscal bonds have been issued by the Ministry of Finance, capital construction bonds have been issued by the State Planning Commission, and enterprise bonds have been issued by various ministries. Many corporate bonds are also issued by the state banks or by the state enterprises. They are then placed directly with various state institutions, obviating the need for secondary market trading. Some of these bonds are a refinancing of loans from the state banks to the state enterprises. Nonstate firms have played a minor role in this market. This is also true for the stock market, which has served as a funding market for the state enterprises. "The Securities market is essentially a state securities market conceived and designed to support corporatized SOEs"(Huang 2003, p. 128; Chiu and Lewis 2006, p. 209). A strict quota system was implemented by the central government on the number of firms to be listed, and state enterprises have had priority to be listed (Chiu and Lewis 2006, p. 209). Private enterprises have been largely prohibited from either listing or assuming majority control of listed firms through market takeover (OECD 2000, p. 82). As of January 2005, there were 1,377 listed companies on the stock markets, very few of them being private firms (Huang 2003, p. 128; Chiu and Lewis 2006, p. 209). Thus, the stock market has been an insignificant source of financing for private enterprises (Laurenceson and Chai 2003, p. 91).

China's stock markets consist of the primary market, where firms make their initial offering, and the secondary market, where the stocks are traded. There are various types of shares in China, including state shares (owned by the state), legal person shares (owned by corporate or other institutional units with legal person status, and which are mainly state owned), individual shares (owned by individual Chinese citizens, known as A shares), and domestically listed foreign-held shares (available to foreigners, known as B shares). State-owned shares include shares directly owned by state agencies and shares owned by legal persons. The trading of directly state owned shares on the secondary market is prohibited and the trading of legal person shares is mostly confined to other legal persons. Therefore, state-owned shares, which constitute nearly two thirds of all shares, are effectively removed from active secondary trading (OECD 2000, p. 82). That makes state enterprises exempt from fluctuations of the stock markets, and ensures their insider-dominated corporate governance.

In China most listed companies have been transformed from SOEs. The Chinese government insists that listed companies, which are transformed SOEs, must still be subsidiaries of a state-owned holding company, with the state-owned holding company retaining the founder's stock. Table 2.8 shows the equity structure of stocks listed on Chinese stock markets from 1992 to 2004. Outstanding features of the table are the extent of the founder's stock, the dominance of state ownership, and the relatively low proportion of shares that are traded publicly (Chiu and Lewis 2006, pp. 209–10).

Table 2.8 Equity structure of stocks listed on China's stock markets, 1992–2004 (percentage of total shares)

Share type	1992	1997	2000	2003	2004
I. Shares not yet in circulation	69.25	65.44	64.28	64.46	63.54
1. Founder′s stock	58.59	55.50	57.11	59.23	58.43
a. State share	41.38	31.52	38.90	47.39	46.83
b. Domestic legal person shares	13.14	22.64	16.94	10.88	10.61
c. Foreign legal person shares	4.07	1.34	1.22	0.95	0.99
2. Fund-raising legal person shares	9.42	6.72	5.65	4.82	4.82
3. Internal-employee shares	1.23	2.04	0.64	0.17	0.13
4. Other (transferred allotment)	0.00	1.18	0.65	0.23	0.16
II. Shares in circulation	30.75	34.56	35.72	35.27	36.04
1. Domestically listed renminbi shares (A shares)	15.87	22.79	28.44	26.67	27.87
2. Domestically listed foreign capital shares (B shares)	14.88	6.04	4.00	2.72	2.75
3. Overseas-listed foreign capital shares (H shares)	0.00	5.74	3.28	5.87	5.42

From China Securities and Futures Statistical Yearbook 2000 and China Securities Regulatory Commission Web site, accessed in April 2004, 2005

Because only a third of the share capital (about 35% of total shares) is traded, while majority-state-owned shares are not allowed to be freely traded (Chiu and Lewis 2006, pp. 209–11), state enterprises are exempt from fluctuations of the stock markets. In addition, as we analyzed in the preceding part, the type of corporate governance in the state-controlled shareholding companies in China is insider-dominated, resulting from the role of the state as the largest block shareholder.

2.2.6 Good Performance and Long-Term Innovation Strategies of SOEs

2.2.6.1 The Performance of SOEs Has Been Significantly Improved by the Reforms

The reform efforts in the state sectors have been fruitful. They have introduced a number of efficiency-enhancing elements into the state sectors. Establishing shareholder meetings and boards of directors and less involvement by the state leads to efficiency gains. The reformed SOEs are actively upgrading their production technologies and processes (Yusuf et al. 2006, p. 209).

The overall performance of the reformed SOEs has been significantly improved since 1998. Table 2.9 illustrates the main financial indicators of industrial SOEs and the relative important position of SOEs in the Chinese economy from 1999 to 2004. From 1999 to 2004, the total profit increased from 220 billion yuan to 913 billion yuan. The return on assets increased from 1.3 to 4.5%.

According to the statistics from the Ministry of Finance, state enterprises in China achieved sales revenues of 13.7 trillion yuan in 2006, an increase of 19.5% over 2005. The profit achieved was 1.1 trillion yuan, an increase of 19.7%.[1] In 2007, the total profit of SOEs reached a record of 1.62 trillion yuan, and their sales revenue grew to 18 trillion yuan.[2]

Owing to industrial restructuring, the total number of state enterprises decreased. However, because the state enterprise profit has continually and dramatically increased, the state-owned assets and the state-controlled assets have increased accordingly. During the period 1998–2003, state-owned assets continually increased, with an average annual rate of 8%.[3] In 2006, state-owned assets amounted to 29 trillion yuan, and had increased by 45.7% since 2003, with an average annual increase rate of 13.4%.[4] In 2007, state-owned assets increased by 23.1% over 2006.[5]

According to the *Fortune* 2004 listing of "The China 100," it is apparent that the ranking is dominated by transformed SOEs. For example, Petra China is 90% owned by China National Petroleum Corporation, which is 100% state owned. Other examples of state ownership of successful large enterprises are Sinopec (84%), China Mobile (75%), China Life (73%), CNOOC (71%), and Baoshan Iron and

---

[1] Profit in state-owned enterprises exceeded RMBI.1 trillion for 2006, online:http://findarticles.com/p/articles/mi_hb048/is_200702/ai_n18815017 [30.11.2007].

[2] China′s state-owned enterprises post 32% rise in profits (24.01.2008), online: http://english.people.com.cn/90001/90776/90884/6344066.html [24.01.2008].

[3] *Guoyou jingji kongzhili buduan zengqiang* (17.11.2004), *in Shanghai zhengjuan bao*(newspaper), online: http://finance.sina.com.cn/roll/20041117/080141914t.shtml [30.11.2007].

[4] SOE competitiveness has enhanced (16.10.2007), online: http://cn.chinagate.com.cn/enterprises/2007-10/16/content_9065723.htm [24.01.2008].

[5] SOEs realized profit 1.62 trillion yuan in 2007 and made a new historical record (24.01.2008), online: http://cn.chinagate.com.cn/enterprises/2007-10/16/content_9065723.htm [24.01.2008].

Table 2.9 Number of state-owned enterprises (*SOEs*) in China's industrial sector and related financial data, 1999–2004

Year	Number of enterprises	Total assets (billion yuan)	Total profits (billion yuan)	SOEs as percentage of all enterprises	SOE assets as percentage of total assets	Average asset size of SOEs (million yuan)	SOE profits as percentage of total profits	Return on assets of SOEs (%)
1999	154,882	11,238	220	37	68	134	44	1.3
2000	158,749	12,398	426	34	67	155	56	2.9
2001	168,799	13,418	466	28	65	184	50	2.7
2002	178,876	14,479	562	24	62	210	47	2.9
2003	193,483	16,707	815	19	57	260	46	4.0
2004	212,648	18,984	913	15	53	317	49	4.5

Data for 2004 are until October 2004. From Garnaut et al. (2005, p. 8)

Steel (61%). Around 30–50 large state enterprises have been nurtured to become "national champions" and "globally competitive" multinationals by 2010 (*Fortune*, 6 September 2004; Chiu and Lewis 2006, p. 78).

The good performance of large-scale SOEs has been crucial for China's growth (Nolan 1996, 2001; Nolan and Yeung 2001a, b; Nolan and Wang 1999; Nolan and Zhang 2002; Lo 1997, 1999b; Smyth 1997, 2000; Lo and Smyth 2005, p. 12). The large-scale industrial SOEs normally stay in upstream industries. They form the core of and retain their vital position in the economy. The rapid growth in upstream industries, through supplying producer goods and establishing substantial linkages, has fueled growth in downstream industries (Nolan 1996).

2.2.6.2 The Relatively High Portion of State Ownership Has a Positive and Significant Impact on Firm Performance

The research on the performance of Chinese corporatized SOEs by Sun et al. (2002) found that neither too much nor too little state ownership is beneficial for a firm's efficiency, and that state ownership (whether in the form of state shares or legal person shares) has a positive and significant impact on firm performance. The benefit of state ownership is generated as the state shows commitment to the firm by:

- Retaining a relatively high portion of the firm's equity
- Coordinating and monitoring based on the state ownership
- Formulating enterprise-supporting policies

It may be beneficial for a reformed SOE to maintain a certain degree of state ownership rather than to change completely from the state-owned to private status (Garnaut et al. 2005, p. 166). Sun et al. (2002) do not differentiate between state shares and legal person shares, and combine both in the category of state ownership. Figure 2.4 compares the three performance indicators ("profitability" – return to assets; "unit cost" – the percentage of the material and operational cost over the revenue; and "labor productivity" – the revenue contributed by a worker) of sample firms with different ownership patterns (wholly state owned, state-controlled, and privately controlled firms) which were investigated by Garnaut et al. (2005, p. 159). State-controlled firms appear to be the best performers in the sample, followed by privately controlled and wholly state owned firms.

Especially the outside state ownership has a strong positive impact on the performance of the firm, and it helps a firm improve its profitability and labor productivity. Outside state ownership exists in legal person shareholding companies, in which the attribute of the fundamental property right of legal person stocks is state ownership. The holders of legal person stocks are more effective than the holders of state shares in the corporate internal governance. This is so because legal person stocks have more characteristics of personalization of "economic persons" compared with state-owned stocks, and the shareholder representatives of legal person stocks will be more able to assume the risk in partaking in making decisions than the representatives of the shareholder of state shares – government officials (Chen and Jiang 2000,

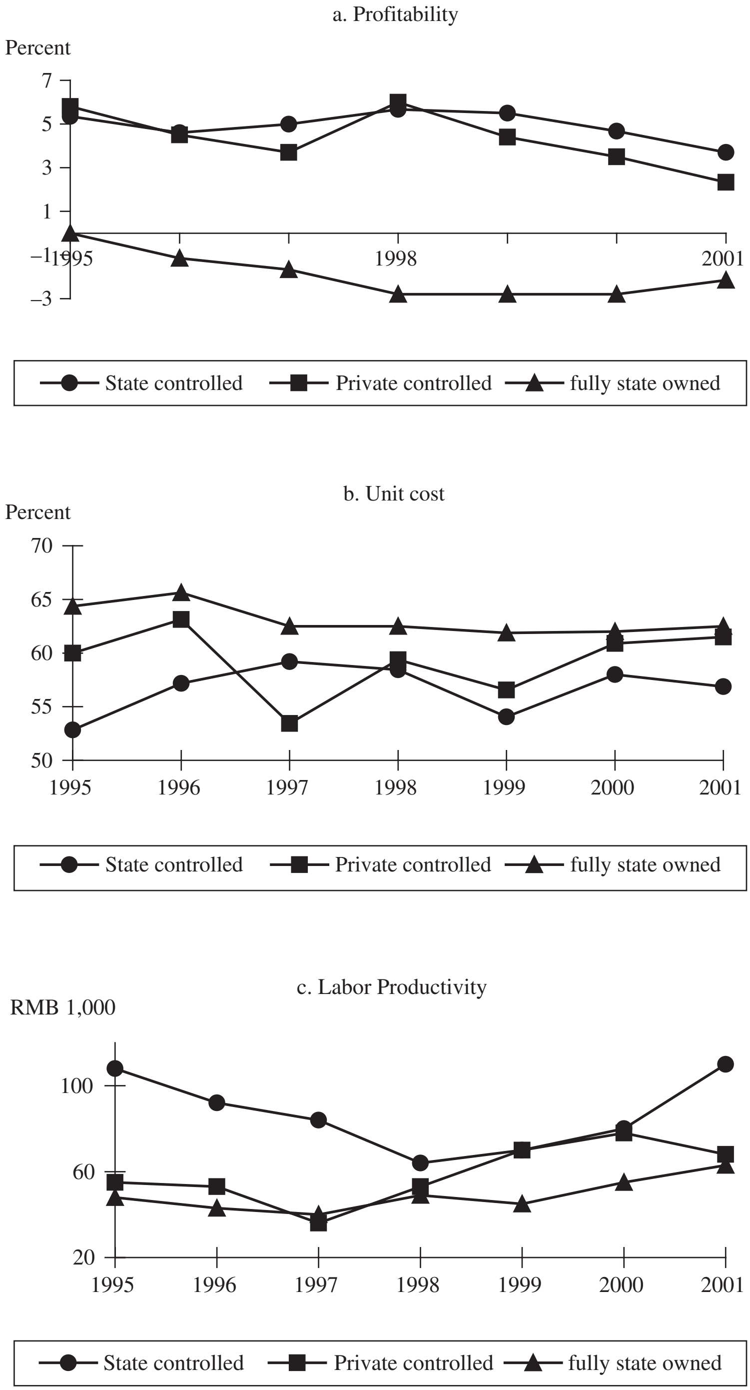

Fig. 2.4 Comparison of private and state-controlled firms on three performance dimensions, 1995–2001. (From Garnaut et al. 2005, p. 161)

Shi 2000, Xu and Wang 2000; Chen and Huang 2001). The advantages of outside versus inside state ownership are also based on the power of outsiders to modify the implicit contracts within the firm that entrench managers and employees. Outsiders find it easier to introduce changes that affect managerial practices. An outside SOE may not be able to establish work discipline among its own employees, but it may have more leverage to do so with the employees in the new firm. Thus, outside state shareholding shows a positive and statistically significant association with profitability, labor productivity, and overall performance (Garnaut et al. 2005, pp. 168–74). A study with substantial evidence also indicates that in the competitive areas the performance of the legal person controlled listed companies is higher than that of the state-controlled listed companies (Chen and Jiang 2000, Shi 2000, Xu and Wang 2000; Chen and Huang 2001). The finding that outside state ownership has an important positive impact on the performance of a firm has important implications for our understanding of state ownership. With a relatively high degree of autonomy to participate in the market, China's SOEs can be effective agents of change and find it easier to put reforms into effect in other state enterprises. The state as the ultimate owner can also use agents effectively to monitor other agents, which contrasts with the conventional view that SOEs fail because public ownership provides an inadequate incentive structure within the firm. In the Chinese context, outside state ownership may bring more advantages to firms relative to outside private ownership (Garnaut et al. 2005, pp. 168–74).

2.2.6.3 The Objectives of SOEs: Long-Term Profitability and Long-Term Strategies for Economic Development and Innovative Enhancement

Profitability is only one of the objectives of the reformed SOEs. The state has used SOEs to attain a variety of goals, such as the promotion of economic development, technological transformation in key areas, establishment of a social security system, and employment (Yusuf 2006, p. 90; Laurenceson and Chai 2003, p. 5). For pursuing the state's strategic goals, SOEs have a higher capital intensity than non-SOEs; thus the profitability of SOEs seems to be hurt twice by the higher ratio of equity to sales revenue. For a given amount of sales revenue, SOEs incur higher financial charges (because they have more liabilities), as well as a larger volume of depreciation. Financial charges and depreciation are subtracted from the sales revenue and lower the residual profit. Second, the ratio of profit to equity is lower because of the larger volume of equity, given a certain amount of profit (Holz 2002). SOEs have essentially constituted China's social security system by providing benefits to workers such as pensions, subsidized housing, and medical care (Hu 1996, pp. 126–9). The provision of such services will increase costs and so reduce the profitability of SOEs. The state retains the ownership over strategic industries to minimize urban job losses from industrial restructuring. This means a conflict with short-term profit maximization from the shareholder's point of view (Yusuf et al. 2006, p. 235). Thus, the objectives of SOEs are fundamentally different from those of non-state-owned units in China and from those of firms in a liberal market economy, which are solely attempting to maximize profits. Financial profitability alone can therefore not be the sole criterion for evaluating SOE performance (Gabriel 2006, p. 112; Laurenceson and Chai 2003, pp. 5–44; Chiu and Lewis, 2006, p. 125). Long-term growth and long-term strategies for pursuing economic development and innovative enhancement but not short-term profit maximization are the objectives of SOEs.

2.2.6.4 The State Ownership Coordinated Firms' Governance Structure of SOEs Pursues Long-Term Strategies

A state-controlled shareholding company in China is usually headed by a holding company. The holding company is again usually controlled and majority-owned by a state asset management committee. State holding companies tend to be heavily influenced by their upper-level state asset management committees, which are the representatives of the state, and act as investors of state assets. The holding companies and the asset management committees become the channel for the government. Thus, the shareholding companies are majority-owned by the holding companies directly, and are indirectly controlled by the government. The ultimate controller might motivate state shareholding companies to pursue a long-term strategic goal different from short-term profit maximization, which is in line with the state's strategic goals (Watanabe 2002; OECD 2000, p. 70).

The effective control of limited liability companies and limited liability shareholding companies, which is based on state dominant ownership, involves selecting the top management and influencing the composition of the board of directors. This kind of state ownership coordinated governance structure supports long-term strategies other than short-term profit maximization.

2.2.6.5 The Governance Structure of the Reformed SOEs Is Stakeholder-Oriented: Focusing on Productive Efficiency Rather Than on Allocative Efficiency

The corporate governance of modern SOEs is a stakeholder accountability system, which has a rigid institutional arrangement appearing antithetical to the principles of the market, and hence is prone to cause allocative inefficiency. However, the corporate governance of reformed SOEs in particular, and the corporate governance system of stakeholder accountability in general, should rather be assessed against broader criteria of economic development, than just the allocative efficiency alone. There are a range of arguments which suggest that the corporate governance system of stakeholder accountability does have its distinctive advantages vis-à-vis shareholder accountability (Aoki 1986, 1990, 1995, 1996; Amsden 1991; Lo 1999a; Lo and Smyth 2005, p. 22). The possible sacrifice of allocative efficiency under the long-term-oriented system could be compensated by gains in productive efficiency. In other words, the long-term commitment of major stakeholders of enterprises offers potential for collective learning, intensive horizontal cooperation, and continuous incremental innovations, which are important sources of productive efficiency, which could not be materialized under a shareholder accountability system (Lo and Smyth 2005, p. 22).

In Chinese SOEs' corporate governance, the management focuses on long-term growth and incremental innovation, which is similar to the orientation of the managements of Japanese firms. Nolan and Yeung (2001a, p. 463) found that the senior management "worked for growth within their industries, rather than for the short-term profit maximization." Most of the large Chinese SOEs and enterprise groups plow back a large proportion of retained earnings to finance further expansion and modernization. For example, in the mid-1990s, 60% of retained earning in Shougang was devoted to technological modernization and to improving production capabilities (Steinfeld 1998, p. 196; Lo and Smyth 2005, p. 22). This is similar to the stakeholder accountability arrangements in the typical Japanese firm. In these Japanese firms most of the capital is retained within the firm to finance further expansion; hence, the dividend-to-profit ratio is much lower than in liberal market economies.

Chinese SOEs have used a high proportion of retained profits to import technologies, adapt them to local conditions, and promote incremental innovation. This has been well documented in a number of large Chinese SOEs. For example, the giant Shougang made large purchases of equipment from Europe and the USA and then updated and adapted it to local conditions (Nolan and Yeung 2001a, pp. 446–7; Steinfeld 1998, pp. 201–2). This is also similar to what Japanese enterprises have done. After the Second World War, Japanese enterprises mainly imported technologies from the USA and Europe and made improvements through incremental innovation (Lo and Smyth 2005, p. 23).

In terms of rigid institutions, which are a characteristic of the stakeholder arrangement, Chinese SOEs are also similar to Japanese enterprises. The rigid institutions in Japan are reflected by the main bank system, that is, the close relationship between the main bank and the Japanese firm. Because the risk bearing and the control functions of the main bank are asymmetric and the Japanese firm benefits from some degree of soft budget constraint, the rigidities in the main bank system seem like an allocative inefficiency. However, there is an important offsetting feature of the Japanese firm, which is that the major stakeholders – like banks, shareholders, and workers – make a long-term commitment to the firm. This promotes productive efficiency through cushioning the firm from the full rigors of the financial and labor markets, and through collective learning, intensive horizontal cooperation, and continuous incremental technical innovations. This is similar to the large SOEs in China, suggesting that a trade-off exists between allocative efficiency and productive efficiency. The rigidities characteristic of China's reformed SOEs, in terms of close government ties, low labor mobility, long-term relationships with their stakeholders, and the lack of exit options for failed firms, though detrimental to allocative efficiency, might have been conductive for the productive efficiency (Lo 1997, 1999b; Lo and Smyth 2005, p. 23).

The preceding discussion can be generalized to suggest a trade-off between stakeholder accountability and shareholder accountability. The corporate governance system of shareholder accountability is based on the market mechanism. It centers on the notion of information. The relative efficiency attribute of this model is allocative efficiency or economies of scale. This model is reflected in the stylized

Anglo-American firms. The corporate governance system of stakeholder accountability is founded on the coordinated institutional arrangements. It centers on the notion of knowledge, which is generated through collective learning. The relative efficiency attribute of this model is productive efficiency or economies of scope. This model is reflected in the stylized Japanese and German firms (Lo and Smyth 2005, pp. 21–5). The corporate governance of Chinese SOEs is also a stakeholder-oriented corporate governance structure, in which the possible sacrifice of allocative efficiency, generated from rigid institutions under the long-term-oriented system, can be compensated by gains in productive efficiency, incremental innovations, and technological transformation.

2.2.7 The Corporate Governance of SOEs Resembles the German–Japanese "Insider" Model

2.2.7.1 Insider" Corporate Governance (German–Japanese Model) and "Outsider" Corporate Governance (Anglo-Saxon Model)

The OECD (1995) suggested that existing systems of corporate governance can be classified into two opposing models: an outsider model and an insider model.

The outsider model is prevalent in Anglo-Saxon countries. In the outsider model, shares are widely held and shareholders have little direct say. The shareholder's control is exercised through the market for corporate control. When the firm is poorly managed, investors react by selling shares, thereby depressing the stock price, and exposing the firm to a hostile takeover. To prevent this from happening, the management lifts the performance and strives for short-term profit maximization. Such a mechanism in the outside model supposes an ample disclosure of information and a good information flow, as well as liquid stock markets, and widely held shares. The outsider model breaks down when shares are held by a few owners only.

The outsider model is actually a type of shareholder-oriented corporate governance. The representation on boards has remained restricted to the shareholders, the disclosure of accounting information to shareholders is mandatory, while the use of insider information in stock transactions is prohibited. Legislation prevents the formation of concentrated shareholdings and cross-shareholdings between large companies, which would reduce the efficacy of the stock market. In some countries, including the USA, banks are also prevented from holding large blocks of shares.

The relationships with workers are market-based. Long-term job security is low, labor market competition is high, and group cohesiveness is being eroded. Worker participation arrangements are largely absent and employees have few formal mechanisms to counter the management.

Concerning the contractual arrangements with suppliers, the outsider model is characterized by formal contracts, which can be enforced by law. These contracts tend to be on a short-term arm's length basis. The formal contracts also specify the items supplied and the responsibilities of the contracting parties in detail (Chiu and Lewis 2006, pp. 141–2).

The alternative "insider" model is prevalent in Japan, Germany, and other Germanic countries (Austria, Switzerland, the Netherlands). It is actually a stakeholder-oriented corporate governance model, which recognizes more diverse groups of "stakeholders" than simply shareholders. These include workers, banks, nonfinancial companies with close ties to the company, and the government. Insider systems are also characterized by a concentrated shareholding and by a cross-shareholding among companies. The external corporate control in the insider model is weak (Chiu and Lewis 2006, p. 142). The insider model has evolved differently in Germany and Japan, and this will be illustrated in the following.

The German Model

In the enterprises of the Germanic countries, the two-tiered board system separates the executive and supervisory responsibilities. All directors, executives, as well as nonexecutives are appointed by the controlling shareholders. The executive board encompasses the top-level management team, while the supervisory board includes outside experts, such as bankers, executives from other corporations (e.g., interlocking directorships), and employee representatives. The supervisory boards are legally obliged to watch over the corporate enterprise as a whole, rather than only over the interests of the shareholders. Hence, the governance function in enterprises in the Germanic countries has a broader setting than in those of Anglo-Saxon countries.

Creditors, especially banks, play a prominent role in corporate governance in Germany. The German universal banks grant loans to firms and also own part of their equity. Financial companies and nonfinancial companies own large blocks of shares of firms.

The shareholdings are concentrated. Block shareholders monitor firms through representation on the supervisory boards (Vitols, 2005). Cross-holdings among companies are fairly common. Cross-holdings of large blocks of equity provide a means to monitor actions by associated firms, and they are an effective instrument to reinforce long-term relationships between companies. The supervisory boards of German firms consist in part of members of the management board of other companies. This network is also effective in disseminating information and preventing opportunistic behavior.

Cross-holdings of shares, bank control of voting rights at general meetings, and legislation concerning the number of votes required to replace the management at general meetings made hostile takeovers unknown in Germany until very recently.

In Germany, contractual arrangements with suppliers (contractual governance) are characterized by relational contracts. Personal reputation plays an important role. This is different from the outsider model of contractual governance, which is characterized by formal and complete contracts.

In the German model, the employees are treated as one group of stakeholders, and codetermination laws underpin the work governance. These laws require half of the supervisory board members to be employee representatives. According to those laws, the functions of the supervisory board are to control and to monitor the management, to appoint and dismiss members of the management board, to fix their salaries, to approve major decisions of the management board, and to appoint auditors (Gomme 2005). Thus, workers are guaranteed a significant voice in the process of corporate decision-making in Germany. The labor contracts are relational and long-term-oriented. Long-term job security and institutions providing protection of employee rights support worker participation in the corporate governance (Chiu and Lewis 2006, pp. 143–5).

The Japanese Model

Industrial structures in Japan are characterized by industrial groups, the *keiretsu*. Most large groups contain manufacturing firms and a number of banks and insurance companies, which provide the member firms with credit as well as with equity capital. These industrial groups are centered around a leading bank, forming the main bank system. The bank executives are appointed to managerial positions and to boards of other member firms. Banks are the primary suppliers of external funding for firms. Although a firm can obtain loans from a number of banks, the main bank is normally the largest lender. The banks own significant portions of the equity of the firms to which they lend, and they play an important role in their corporate governance. The commitments between bank and member firms or between member firms in the *keiretsu* are for the long term.

Another feature of *keiretsu* is cross-shareholdings among member firms with close trading ties. The cross-shareholdings are also accompanied by interlocking directorships. Because of these mutual relationships and commitments, the consensus decision-making structure is a distinctive feature of the *keiretsu*.

The contractual governance in Japanese *keiretsu* is highly informal, implicit, and long-term-oriented. Compared with the Anglo-Saxon contractual arrangements that are based on formal contracts, and with the German ones that are based on relational contacts, the Japanese type is based on strong internal relationships and trust between group members.

The implicit, informal contracting extends to the work governance in Japanese *keiretsu*. Work governance is built on consensus management (decisions are made at the top, but are shared at all levels), lifetime employment, and large bonuses according to the performance of the firm (Chiu and Lewis 2006, p. 145–6).

2.2.7.2 The Modern Corporate Governance of SOEs in China Resembles the "Insider" Corporate Governance (German–Japanese Model)

The German–Japanese model is in many ways the one that Chinese authorities would find the most congenial. The Chinese reformers have certainly considered the German–Japanese "insider" model of corporate governance (Chiu and Lewis 2006, p. 170–1). Thus, the inspiration for the Company Law in China came largely from the civil law tradition of continental Europe, Germany in particular, and from Japan (Jordan, 1998; Lin 2000).

Firstly, the Chinese state enterprise group system is similar to the Japanese *keiretsu* structure.

There are similarities between the Chinese SOE groups and the Japanese *keiretsu* in terms of the formation of enterprise groups and concerning the financing pattern within a group. The firms in Chinese SOE groups are interconnected through cross-shareholding, interlocking directorates, financing arrangements, and production and trade relations, like those in Japanese *keiretsu*.

The Chinese reformers were also motivated by the financing pattern within Japanese business groups, regarding the bank placed at their center. The Chinese state reformers promoted the formation of finance companies within all of the largest SOE groups to aid member firms in raising funds for growth, and to remove some of the burden from the underfunded state-owned banks.

Secondly, Chinese corporations resemble the Germanic ones as regards the supervisory board and employee representation.

As in enterprises in Germanic countries, the Chinese corporation has a two-tiered board structure, which consists of an executive board and a supervisory board. There are also similarities between Chinese corporations and the Germanic system in terms of the supervisory board structure. The Company Law in China has provisions which allow employee participation in the corporate governance of SOEs through their representation on the supervisory board as in Germany. The mandatory employee representation on the supervisory board reflects both countries' stakeholder orientation in corporate governance.

Thirdly, concentrated shareholding, cross-shareholding, and interlocking directorship in the Chinese SOE model resembles the German–Japanese models.

Similar to the German–Japanese models, concentrated shareholding, cross-shareholding, and interlocking directorship are also features of the Chinese SOE model. This kind of corporate configuration generates mutual relationships, mutual commitments, and a consensus decision-making structure. It also makes hostile takeovers among enterprises unlikely to happen in these countries.

Fourthly, work governance in the Chinese SOE corporate governance is similar to the German–Japanese models.

As in the German–Japanese models, worker participation is encouraged in Chinese SOE's corporate governance and employees are treated as one group of stakeholders. The workers have a role in the corporate decision-making process, and such consensus management is supported by long-term labor contracts.

Fifthly, "voice" instead of "exit" is the form of corporate control in the Chinese SOE corporate model as in the German–Japanese models.

Albert Hirschman depicted the corporate control choice as "voice," i.e., directly influencing the management, or "exit," i.e., disposing of poorly performing shares. In the USA and the UK, small shareholders use exit, with takeovers as the ultimate disciplinary means over the management. In Germany and Japan, voice becomes the tool, with banks and other firms as stakeholders enforcing accountability via complex links (Chiu and Lewis 2006, p. 175). In China, exit of SOEs is uncommon (Chiu and Lewis 2006, p. 176), because the existing ownership and control structure of Chinese listed companies makes hostile takeovers unlikely (Tenev et al.

2002, p. 115). The controlling shareholders as well as the stakeholders, such as the government, other firms, and employees, normally use voice to discipline the management and lift performance.

Sixthly, the "control-oriented" banking system used in China is similar to the German–Japanese models.

Aoki and Kim (1995) draw a distinction between two types of banking systems: the "arm's length" and the "control-oriented" ones. The "control-oriented" banking system is similar to the German–Japanese model, and the "arm's length" banking system is the typical Anglo-Saxon model. The Chinese main bank system, resembling the Japanese main bank system, is also a "control-oriented" banking system. The main banks play an important role in the corporate governance of Chinese state enterprises.

Seventhly, the contractual governance in the Chinese SOE group is similar to the Japanese *keiretsu* model.

In terms of contractual governance, the Chinese model is build on strong internal relationships and trust between the member firms in an enterprise group, and the commitment and arrangement is long-term-oriented, as in the Japanese *keiretsu* model.

Finally, the "stakeholder"-oriented corporate governance in Chinese state enterprises resembles the German–Japanese model.

The corporate governance of Chinese SOEs aims for stakeholder accountability arrangements, long-term strategies focused on economic development, productive efficiency with incremental technical change, and long-term profitability, all of which resemble features of the German–Japanese model. It is quite different from the Anglo-Saxon model, which focuses on shareholder accountability arrangements, short-term profit maximization, and allocative efficiency.

The governance structure of Chinese SOEs tends to be characterized by a complex web of compromises and balances among the main stakeholders, each having a long-term commitment to the enterprise. The state, as the most important stakeholder, focuses on the enterprises' long-term strategies, related to the economic development and technological transformation. The banks as important stakeholders, being the main source of external financing for industrial enterprises, continue to provide credit to the enterprises, even during the period of secular decline in industrial profitability. The workers as a group of stakeholders have a strong collective voice in influencing the decisions of the enterprises over surplus distribution as well as in their bargaining positions (Lo and Smyth 2005, p. 21).

2.2.8 The Different Types of Coordination Between SOEs and the Firms in Coordinated Market Economies

The coordinated firms' governance structure of Chinese SOEs is in general similar to the coordinated firms' governance structure in coordinated market economies. What differentiates China's model from the model of coordinated market economies is firstly the identity of the controlling shareholders and secondly the primary coordinating mechanism.

The ownership structure of Chinese corporatized SOEs is concentrated at levels similar to those of the firms in coordinated market economies, like those in most of western Europe. But the controlling shareholders in Chinese SOEs are the state or SOEs (Tenev et al. 2002, p. 82).

The main mechanisms with which the firms arrange their activities differ also between the different types of governance structures of firms. In the Anglo-Saxon model, the firms' governance primarily relies on the market mechanisms. We therefore name this kind of governance structure "market-based firms' governance structure." In the German–Japanese models, the firms' governance more heavily relies on coordinating mechanisms based on institutional nonmarket arrangements, such as association or network-based cross-shareholding, network monitoring, information-sharing, collaboration between firms, and employer–employee interdependence. We therefore name this kind of governance structure "institutional coordinated firms' governance structure." In the Chinese SOE model, the primary coordinating mechanism on which corporate governance is based is "state coordination through controlling state shareholding." We therefore name it "state ownership coordinated firms' governance structure."

The state ownership coordinating mechanism can only play a role within the state sector; thus, the state ownership coordinated firms' governance structure is confined to the state sector. The coordinating mechanism in coordinated market economies, which is based on nonstate institutional arrangements, plays the coordinating role for the whole economy. The institutional coordinated firms' governance structure therefore extends to the whole economy.

It is easier for economic transformation to happen if it is – like in China – led by the state, based on state ownership coordination, than if it proceeds in extensive institutional coordination arrangements – like in Germany, Japan, and other countries with coordinated market economies.

http://www.springer.com/978-1-4419-0035-7

The Governance Structures of Chinese Firms
Innovation, Competitiveness, and Growth in a Dual Economy
Liao, C.
2009, XXVI, 206 p. 8 illus., Hardcover
ISBN: 978-1-4419-0035-7