

DISSERTATION

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„Corporate Governance and the Restructuring
of the State-Owned Sector
in the People's Republic of China“

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BoD Board of Directors
CAR Capital Adequacy Ratio
CAITEC Academy of International Trade & Economic Cooperation
CBA China Banking Association
CCGC Chinese Corporate Governance Code
CEO Chief Executive Officer
CSR Corporate Social Responsibility
CSRC Chinese Securities Regulatory Commission
COE Collectively Owned Enterprises
CPC Communist Party of China
EIT Enterprise Income Tax
IAS International Accounting Standards
IFRS International Financial Reporting Standards
FDI Foreign Direct Investment
FOE Foreign Owned Enterprises
GDP Gross Domestic Product
MOFCOM Ministry of Commerce of the People's Republic of China
NIE New Institutional Economics
OECD Organisation for Economic Cooperation and Development
POE Privately Owned Enterprises
SAIC State Administration of Industry and Commerce
SASAC State Owned Assets Supervision and Administration Commission
SETC State Economic and Trade Committee
SHSE Shanghai Stock Exchange
SOE State Owned Enterprises
SZSE Shenzhen Stock Exchange
TVE Township and Village Enterprise

1 Introduction

In the last decade a lot of attention has been paid to corporate governance issues, evolution and growth. Worldwide, a large number of countries have issued governance codes, including recommendations on how to achieve good governance.

The term corporate governance first appeared in publications in the 1980s, after Jensen and Meckling (1976) published articles proposing their *theory of the firm*.

According to Jensen and Meckling, the theory of the firm consists of economic theories, which describe the nature of the company or corporation, including its existence, its behaviour, and its relationship with the market. In 1999, the Organisation for Economic Cooperation and Development (OECD) published the OECD Principles of Corporate Governance and has since become an international benchmark for policy makers, investors, corporations and other stakeholders. According to the OECD Principles of Corporate Governance, released in 2004, corporate governance can be defined as follows;

“Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. It is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance”.

From the Western point of view, corporate governance issues are approached from two perspectives: The shareholder value orientation and the stakeholder orientation. The *shareholder value approach*, prevailing in the Anglo-US system, focuses on the interests of a company’s shareholders, assuming that managers are self-interested

economic agents (Berle/Means 1932; Jensen/Meckling 1976; Fama/Jensen 1983a). The concept deals with how the whole system of corporate governance works, to align the interests of corporate insiders and stockholders. It deals with the question how to discipline managers, so they will act on behalf of the shareholders. It can be defined as follows:

“Corporate Governance covers all the mechanisms by which managers are led to act in the interests of the corporation’s owner” (Brealey/Myers 1981).

Corporate governance approached from a different perspective would be the *stakeholder orientation*, prevailing in Continental Europe and Japan. This approach does not solely focus on the interests of shareholders, but also involves the interests of stakeholders (especially the interests of employees of a company), as well as the equal balance of their interests. Here for example, the banks take an interest in the institution which affect the flow of information to shareholders, and protect their interests (Shleifer/Vishny 1997; La Porta et al. 1997, 1998). This approach mainly concentrates on the continuity and efficiency of the company itself. Shleifer and Vishny (1997) state:

“Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. By giving legal rights to investors and or vesting countervailing power in concentrated ownership, investors find a way to get managers look out of their interests.”

Additionally, they do not only consider the role of shareholders as a supplier of finance, but also the role of external suppliers of finance, like banks that provide financial resources. The stakeholder theory supports the idea that shareholders are only one of a number of important stakeholder groups, like customers, suppliers, employees and local communities. The purpose of the corporation is to serve and balance the often conflicting interests of all stakeholders. Stakeholders having a stake in the company are essential to the enterprise operation and are affected by the firm’s success or failure. Therefore it is important to them that their interests and firm-specific investments have guaranteed protection. The stakeholder theory achieved popularity through the work of Freeman (1984) who suggested that corporations

should look beyond the shareholder theory of profit maximisation, and take into consideration other stakeholder groups that the corporation is associated with and which contribute to the company's achievements. Freeman (1984:25) stated that:

"A stakeholder in an organization is any group or individual who can affect or is affected by the achievement of the organization's objectives. "

All these definitions have an interest in meeting the requirements of different interest groups, which are related to a company. In other words,

"Corporate governance is simply the governance of a particular organizational form – a corporation and the primary goal of a corporate governance system should be the integrity of the firm" (Zingales 1997:3ff).

According to Roe (2003) stakeholders' relative influence on the decision making process varies across countries due to political and social factors. Depending on the prevailing approach and the institutional environment in a country, shareholders' interest and influence in profit maximisation might have priority, or based on the stakeholder approach labor protection and employee welfare might receive higher priority over profit maximisation (Tirole 2001). In the cross-country quantitative analysis of Gourevitch and Shinn (2007), legal and political institutional structures are examined having an impact on differences in minority shareholder protections and ownership concentration among countries. In the analysis, the crucial role of institutional investors is explored in particular, and its influence on shaping political preferences for different rules of corporate governance.

In general, the theory of corporate governance involves the principal-agent paradigm, which focuses on the execution of control within a company, based upon conflicts of interest between various parties – namely the shareholder-corporate management relationship. The key assumption is that profits in a firm should be maximised. In the case that corporate managers achieve a sub-optimal result for the shareholders, there should exist the possibility to replace them. Literature on corporate governance tries to explain the nature of these conflicts, and means by which they may be resolved. Therefore, to comprehend the meaning of the term better, it can be stated that

corporate governance circumscribes the institutional framework, which involves a set of regulations and tools for implementation, with which a company is managed and controlled. In general, it can be subdivided between internal and external corporate governance. Internal corporate governance focuses on the relationship and the interrelation of the different institutions within the company (board of directors and supervisory board). External corporate governance focuses on the relationship of the company to its environment, like the relationship to shareholders and stakeholders (labour, suppliers, customers, banks and public institutions). The most important scholars in this field are Berle and Means (1932), Jensen and Meckling (1976), Coase (1937, 1960) und Williamson (1975, 1985), who contributed with their articles to the clarification of differing forms of contracts, organisational forms and corporate structures. In their contribution on corporate governance these authors criticise the efficiency assumptions of neoclassical economics, with regard to optimal organisation structure and size, implications of separation of ownership from control, optimal form of contracts, motivation of employees in organisations and the target function of an organisation. Roe (2004) analyses the institutions of corporate governance in relation with the principal-agent paradigm, agency costs and shareholder-manager alignment problem. In his article, he outlines the mechanisms that allocate authority among the board of directors, senior management and shareholders that affect, modulate, and control the decisions made at the top of the firm. Denis and Mc Connell (2003) cross-country analysis explores different corporate governance systems around the world, with a focus on Europe, Japan, developing and emerging countries. Their comparisons of differing systems involves the analysis of internal and external corporate governance and their mechanisms in an international perspective and leads to the question whether there exists one single system of corporate governance.

In Western countries, enterprises are working under established corporate governance systems, which rely on functioning institutional, economical and social pillars. Therefore corporate governance systems in developed countries have already entered a mature stage due to a learning process. Transition economies are still on a learning curve, as most of these countries have recently changed their economic systems from a planned economy to a market-based economy. Most of the ex-socialist countries already introduced legal and institutional foundations combined with market-based

mechanisms in order to create structures so that corporate governance can function, but they still did not enter a mature stage.

As mentioned before, the concept of corporate governance does not have a very long tradition and history in transformation economies or in developed economies. At the beginning of economic reforms in China, the understanding of the term corporate governance (公司治理) was quite different to the definition used today. Until the 1980's the Chinese business landscape was characterised by production units and factories working according to a plan. Therefore the term corporate governance was much more related to describing the institutional framework of the government administration managing production units in a planned economy. After the introduction of the stock market and the transformation of these production units and factories into corporations in the 1990's, the term corporate governance took on a complete new meaning, describing the institutional framework of the government administration managing profit-maximising corporations. Within the last twenty years the understanding of corporate governance has changed fundamentally, although an explicit boundary between the old and the new meaning of the term has never been formally defined. In China, the development of corporate governance has gone through several stages, starting with the reform of the state-owned enterprises in 1978. With the introduction of the banking and fiscal reform in 1994, enterprise reform entered a new stage as financing of the state-owned sector was changed. In 2002, the Chinese corporate governance code was introduced to enterprises, followed by the implementation of corporate social responsibility in 2007 (SASAC 2008). Summarising, can be stated that the Chinese model of corporate governance embraces both Western models, including the shareholder orientation as well as the stakeholder orientation.

The increased interest for corporate governance in China is manifold. In the 1980's the debate over the separation of economic activities in the state-owned sector from the government and the party, contributed towards the Chinese leadership becoming more open to the idea of corporate governance. Economic reforms were introduced with the aim of reducing political power concentration in strategically important industries. Low efficiency and low transparency within state ownership was present in almost all industries, and also contributed to the governance debate, thereby

emphasising the urgency and importance that was placed on developing a functioning governance system in the country. Thereby the role of ownership in economic inefficiency was analysed, resulting in an intensive debate over the design and refinement on an overall institutional framework. In the Chinese case the internal corporate governance framework in the state-owned enterprises was adjusted, as well as the external corporate governance framework. Other reasons are the debate for more transparency in the enterprises' decision-making process, as well as recruitment and staffing of the various boards and committees. Furthermore, ongoing globalisation and intense competition for finance on the international capital markets require the design and refinement of a governance system, applicable for China. The intense competition for finance on international capital markets is one of the reasons that Chinese enterprises are under pressure to comply with international accounting standards, especially among enterprises going global. For China, a transformation economy, the change from a planned economy to a market economy involves continuous development of the economy and the society, by simultaneously facing path-dependent issues. By applying new institutional economics, the implementation of standards and regulations has an impact on the economic success of state-owned enterprises and the economic system. In fact, interest in corporate governance in China arises from the need to understand the institutional framework, which involves a set of regulations and tools with which Chinese enterprises are managed and controlled.

In the case of China, in the last few years policymakers combined their efforts to speed up the process of moving towards a market-based economy (Goldman Sachs Group 2004; Tenev et al. 2002). China's declared goal is to achieve an economic environment with sustained and shared growth¹. As a result good corporate governance practices are of critical importance and an important precondition for the government's efforts to develop the financial market. Good corporate governance is

¹ At the 14th National Congress of the Communist Party of China (中国共产党全国代表大会), October 12 to 18, 1992, Deng Xiaoping (Chinese political leader who was twice purged from the Communist party 1967 and 1976) and twice rehabilitated (1973 and 1977) before he became head of the party in China; officially retired as head of state in November 1989) emphasized push for a market-oriented economy. He argued that further reform was necessary to raise China's standard of living. In 1993, Jiang Zemin (General secretary of the Chinese Communist party (CCP; 1989–2002) and president of China (1993–2003) focused moving China into *Socialist Market Economy*, which means to move China's centrally-planned socialist economy into a government-regulated capitalist market economy.

regarded as an essential element in the ongoing restructuring reform of the state-owned sector.

By analysing the compatibility of corporate governance in a transformation economy, the internal and external corporate governance framework in China is examined. On the basis of OECD principles of corporate governance, the internal corporate governance framework in Chinese enterprises is observed. Internal aspects include ownership structure, rights and obligations of shareholders, equitable treatment of shareholders, and the role of stakeholders, disclosure and transparency and responsibilities of the board. Per definition, the corporate body of a Chinese corporation consists of the board of directors, the board of supervisors, independent directors and stakeholders. The analysis attempts to provide relevant features for the internal governance framework in Chinese enterprises and the institutional change within state-owned enterprises. The analysis shows, that the internal organisation of Chinese listed enterprises is characterised by strong relationships between the owner and managers, and a clear separation between the state and the company's management is not achieved. Chinese corporations are promoting and protecting the economic position of the state and the Communist Party, and this is regarded as the most sustainable form of internal corporate governance. The examination of external corporate governance is undertaken on the basis of institutional change from a planned economy to a market-oriented economy, taking the restructuring process of the state-owned sector, the banking system and capital market reform. The introduction of market-oriented elements into the economy resulted in a structural change in the relationship between the state and the state-owned enterprises. Thereby the state has retreated from its dominant role in the economy, but its intervention in strategic decision-making is still present.

The thesis distinguishes the state from the party². At first glance, both are pursuing a policy to strengthen the Chinese economy. At second glance, the dissociation is justifiable, as the state as well as the Communist Party pursues differing priorities in the course of economic reforms. The state is acting as a modernisation agent with the aim of improving efficiency and transparency within state-ownership. The

² Further explanation related to the political distinction between the Chinese state and the Communist Party, see Weigelin-Schwiedrzik (2007) and Zheng (1997).

Communist Party is acting as a mediator in preserving the integration of economic and socio-political interest, with the aim of the realisation of a harmonious society within the framework of reform. Several scholars are differentiating in their analysis of the Chinese system between the state and Communist Party. Lieberthal/Oksenberg (1988) portray in their book on policy making in the energy sector the different roles of the state and the Communist Party. By providing three case studies of energy policy making they are showing the different levels of power in leadership, bureaucratic structures and policy processes. Lieberthal (1995) examines the governing role of the Communist Party, including its struggle for power, elite political conflicts and policy initiatives as well as the governing role of the state concerning the organizational structure in contemporary China. Zheng (1997) disaggregates the Chinese state from the Communist Party with a comprehensive analysis of institutional change after 1949 in China.

The concept of corporate governance is primarily designed to support market economies in improving coordination mechanisms among differing market participants. By analysing the compatibility of corporate governance in China, the thesis shows, that differing Chinese specific internal and external corporate governance mechanisms and controls are active to reduce inefficiencies within state-ownership. The thesis attempts to challenge the validity of general assumptions within the corporate governance framework for transformation economies. Differentiation is important as corporate governance regimes in developed countries cannot be used for transformation economies. This criticism does not want to question the theory of corporate governance in principle. More so it attempts to show that differing coordination mechanisms are active when corporate governance is addressed. It is assumed that these coordination mechanisms are working according to varying modes dependent on the environment of institutional change. Therefore it is significant to know which mechanisms are supportive for institutional change and which are not. In China, corporate governance mechanisms and controls are designed to reduce the inefficiencies within state-ownership that arises from agency problems, a property rights regime in favour of the state and soft budget constraints. Internal corporate governance controls monitor activities of the management and take measures to accomplish state and party defined goals. External corporate governance controls encompass the state, the Communist Party and external stakeholders

exercising control over the organisation. By analyzing the compatibility of corporate governance in China, this thesis shows that corporate mechanisms are applied for the realisation of the transformation process and the introduction of a sophisticated legal and regulatory framework. It is clear that the implementation of corporate governance standards is playing an immense role within the transformation process, having a strong impact on the economic reform process, but at the same time it also has its limitations.

This thesis applies the new institutional economics approach for the analysis of the restructuring of the Chinese state-owned sector, and assesses the impact of corporate governance on the state-owned sector. Principal agent, transaction costs and property rights theories represent the supporting theoretical pillars of a corporate governance system. All three elements refer to the discipline of new institutional economics, and are leading approaches in respect to the analysis of organisations in economics. In contrast to neoclassical assumptions, new institutional economics postulates that individuals have incomplete information, cope with uncertainty resulting from an information lack and assume that economic actors are behaving irrational. In order to overcome the lack of information, individuals are facing transaction costs and risk. The approach applied tries to find an answer for economic change, by understanding economic actors' incentives and motivations and beliefs, as well as their norms and rules in pursuit of the realisation of their objectives (North 1994). For China, the concept of new institutional economics is applied in regard to the identification in what way a planned socialist economy can be gradually transformed into a market-oriented system. What kinds of restrictions are dominating the process of evolutionary institutional system change under economic transformation? Furthermore, this thesis attempts to clarify to what extent institutional change in China is feasible despite path dependence, which theoretically implies that it is nearly impossible to break out of an existing economic system. The thesis will show that the break out of an existing economic system is feasible to a certain degree by taking system-specific conditions into consideration.

The transformation process requires the balancing of conflicting interests among differing socio-economic actors. The main socio-economic interest groups identified in the Chinese transformation economy can be split into three: (1) the Communist

Party apparatus, (2) the state and the bureaucracy, (3) the manager level beyond the board of directors and the workers of the state-owned sector. Each of these three groups are characterised by rent-seeking and opportunistic behaviour, whereby bargaining over resource allocation is common in order to take advantage of individual wealth-maximising opportunities. Consequently, this behaviour results in reduced efficiency at the expense of the economy. Each group consists of principals and agents, who are interacting with each other within given rules. Due to rent-seeking and opportunism, they strive for changes in these rules on their behalf. Therefore, the economic and political interaction and exchange among the differing groups also determines the transformation path a system follows. Ex-socialist countries are challenged to transform rent-seeking and opportunistic behaviour into profit-seeking and rational behaviour, which results in a compromise over administrative and market institutions within an economy.

Analysing the Chinese transformation process is in fact an examination of principal agent problems in a socialist economy. Principal-agency theory deals with the problem that arises with the execution of control within corporations, based upon conflicts of interest between various parties – namely the relationship between shareholders and the corporate management. The key assumption is that profits in a firm should be maximised. Due to information asymmetry between the principal and the agent, governance mechanisms should guarantee that corporate managers act in the best interest of owners. China's situation is characterised by ownership concentration, shaped by dominant state control. The institutional setting of developed economies bases on the assumption that large institutional shareholders behave as agents whose basic purpose is to maximise profits and return on investments for their investors (Demsetz 1986; Shleifer/Vishny 1991). Gillan/Starks (2003) examine the relation between corporate governance and ownership structure, and the role of institutional investors in an international context, since in many countries; institutional investors have become dominant players in the financial markets. Another cross-country analysis investigates what enterprise- and country-level characteristics attract investment by institutional investors, such as a strong preference for large and liquid stocks with good governance practices (Ferreira/Matos 2008). Additionally, the study shows that preferences for investments by institutional investors are also depended on the maturity of international capital markets and the

proportion of domestic, foreign and independent institutional ownership in enterprises. The importance of institutional investors is also increasing in China, particularly insurance companies and collective investment funds have grown rapidly since 2004, but the portion of total equity (non-tradable as well as tradable) held by institutional investors is still relatively low compared to more advanced OECD countries (OECD 2010:86).

Centrally planned economies are specially affected by agency costs as appropriate incentive systems and optimal contracts are missing. Furthermore, as markets do not exist in a centrally planned economy and prices are not determined by demand and supply, neither the principal, nor the agent knows the accurate value of their products produced under the plan. As only planned prices exist, product-assessment does not account for quality and demand criteria or other relevant measures. Agency costs appear as higher expenses for monitoring and metering and costs get even higher during the transition in comparison with a country that already has a relatively stable market structure. By analysing the role of the interest groups from an internal and external corporate governance perspective, this thesis attempts to clarify to which degree and in which direction vested interests have the opportunity to influence a change in the organisational and institutional structure.

Overall, the implementation of a corporate governance system in a corporation has to consider the complexity of various components and influencing factors. The focus of considerations of the thesis is to which extent the adoption of internationally defined corporate governance standards is applicable for the Chinese state-owned sector, and to which degree the implementation of corporate governance standards has a positive impact on the transformation process. The implementation of corporate governance standards has an influencing character in the decision-making process of corporate management and in a company's performance. Therefore, institutional requirements play an important role in the scope of the management's action, and in the relationship among differing - with the corporation aligned - interest groups. In Western literature, corporate governance issues are analysed either from the perspective of the shareholder or stakeholder approach, thereby primarily analysing information and incentive problems in Western developed economies. The main target of the thesis is to analyse the implementation of corporate governance in a

transformation economy, taking into consideration the balancing of conflicting interest among differing stakeholder groups.

In the last few years a considerable amount of research has been done in the field of corporate governance in an international context, but research on China is still limited. China is seen as the largest developing country, with a population of 1.3 billion. Since the reforms in 1978 the country achieved on average 8-11 per cent annual GDP growth rate, and the government stated its goal of achieving an average annual growth of over 7 per cent between 2000 and 2020 (OECD 2010:20). Progress in the transformation economy has been substantial over the past thirty years. The implementation of corporate governance standards addresses the challenge for a dynamic and sustainable growth process.

1.1 Problem Statement

International capital markets are observing an increasing amount of competition for scarce financial resources. As a result, companies are compelled to meet shareholder and investor demand for transparency of a company's critical factors for success and processes for success. In the recent past Western countries have undertaken many efforts to meet the necessary requirements. Western industrialised economies require listed companies to disclose publicly their financial accounts. International accounting standards are introduced to provide shareholders and investors with a uniform standard valuation for their assessment. The OECD Principles also note that (OECD 2004a:13):

“The degree to which operations observe basic principles of good corporate governance is an increasingly important factor in investment decisions. Of particular relevance is the relationship between corporate governance and the increasingly international character of investment. International flows of capital enable companies to access financing from a much larger pool of investors. ... Even if corporations do not rely primarily on foreign sources of capital, adherence to good corporate governance practices will help to improve confidence of domestic investors, reduce the cost of capital, underpin the good functioning of financial markets, and ultimately induce more stable sources of financing.”

In Western developed economies, two successful frameworks of corporate governance can be identified, which have become accepted in the international business environment. In Anglo-Saxon countries the corporate governance system is applied to align management actions with shareholder's interest. Management is obliged to maximise the market value of the shareholders' equity. In Continental Europe and Japan the corporate governance systems serves not only to align management and shareholder's interest, but also to consider the interests of stakeholders. Corporate governance mechanisms are meant to build up long term relationships and to balance various interests. This thesis tries to shed some light on the question to which degree the introduction of a Western model of corporate governance is compatible with a transformation economy in China. In order to do so, it looks at the emerging corporate governance system in China in particular. China is considered to have a state-dominated business environment, where a clear separation of ownership from control (from government) has not yet been realised so far in Chinese enterprises.

Given that corporate governance systems are quite different among countries and there is no one-size-fits-all model, this thesis addresses the question as to what specific features of Chinese corporate governance are highly linked with the enterprise reform, the bank sector and financial sector reform. This thesis will focus on the following questions:

- **Question 1: *What role is corporate governance playing in a transformation economy like China, what contribution does it make to the reform process and where does it meet limitations?***

Furthermore, this thesis attempts to explore the impact corporate governance reforms have on the relationship between the state and the state-owned sector.

- **Question 2: How has the relationship altered between the state and Chinese state-owned enterprises (SOE)?**
 - a) **From an internal corporate governance perspective?**
 - b) **From an external corporate governance perspective?**

Both questions are chosen consciously in order to identify the specific features of corporate governance in China. The goal of this thesis is not to undertake an analysis of the two differing corporate governance approaches present in Western countries – but instead to undertake a detailed analysis of the internal and external corporate governance perspective in China. Great importance is attached to the *role* of corporate governance in China and its *contribution* to more efficiency and transparency within the state-owned sector. However, its *limitations* in the transformation process will also be analysed.

1.2 Methodology

Background information regarding the reasoning for the implementation of the Western corporate governance concept in China's state-owned sector is hard to come by. Official publications on corporate governance in China only offer general information, mostly based on the international OECD principles of corporate governance. This explains why most studies on China's corporate governance only provide an overview of economic reforms in China and only shortly remark on corporate governance.

This thesis starts by reviewing some of the key issues in implementing a Western concept in a context of both state ownership and a transformation economy. On the basis of OECD principles of corporate governance five parameters relevant for the internal corporate governance framework in enterprises are observed: (1) rights and obligations of shareholders, (2) equitable treatment of shareholders, (3) role of stakeholders in corporate governance, (4) disclosure and transparency, and (5) responsibilities of the board. Furthermore, this thesis examines the corporate structure of China's top 20 enterprises by studying the annual reports and websites of the enterprises in 2010, in addition to the economic methods commonly used in the field of new institutional economics. The board structure of these enterprises, which are mostly state-owned, are analysed. The data covers information about position, party membership, professional and educational background of the chief executive officers and directors. Because of this it is possible to construct the actual corporate institutional environment and learn about the internal aspects of the corporate governance system.

In a second step this thesis studies official documents and publications³ published by the state and the Chinese Communist Party in the framework of economic reforms since 1978, which gives an understanding of the external aspects of the corporate governance system. Generally speaking, official documents and publications represent incremental reform steps; these policies set the framework within which economic issues have been debated before informally among differing interest groups. Debate participants had the desire and ability to push the parameters of the debates in directions that are different from what political leaders had chosen, and thus were able to affect the policymaking process according to their own reform agendas (Fewsmith 1994). Thanks to the official documents, more information is disclosed on national economic policies, thereby offering a deep insight into the differing objectives of several interest groups within the framework of corporate governance implementation. Moreover, in order to capture the interaction between the central state, the Chinese Communist Party and the enterprises, the change in their relations is examined by comparing the situation before and after the introduction of corporate governance standards.

2 China's Emerging Corporate Governance System

Worldwide it is recognised that there is not a single model of good corporate governance (OECD 2004a:2; Tenev et al. 2002). Globalisation has contributed a lot to international standardisation, but until now worldwide convergence on corporate governance practices could not be observed. Instead, it can be observed that different societies have built up different specific characteristics, according to their stage of industrialisation and their economic environment. In the following section, the basic principles of the corporate governance system will be elaborated upon and an overview of the actual status of China's corporate governance discussion will be provided.

³The published official documents include statistical yearbooks, government report, and newspapers articles.

2.1 Terms and Definitions

2.1.1 Definition of Corporate Governance Code

Codes of corporate governance contribute to improving corporate governance structures by setting standards that capital market players can use for guidance and orientation. Corporate governance codes are designed to increase transparency for national and international investors concerning the regulations of the corporate management and corporate control. For this reason, compliance with the corporate governance code should provide confidence in the capital market and the corporate management in companies. Corporate governance codes are not legislated by law, but are rather understood as a guideline of best practices. Nowadays there are a multitude of national and international corporate governance codices and principles, such as the OECD Principles of Corporate Governance, the US Sarbanes Oxley Act, the British Combined Code and the German Corporate Governance Code.⁴

Corporations are governed by corporate law, which is the fundamental pillar of corporate governance. Corporate law in all jurisdictions generally involves a body of law enabling the creation of an entity with five structural characteristics: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralised management under a board structure, and (5) shared ownership by shareholders (Hansmann/Kraakman 2000). Corporate law covers on the one hand corporate governance, which handles the various power relations within a corporation, and on the other hand corporate finance, which sets rules on how capital is used.

2.1.2 Definition of OECD Principles of Corporate Governance

The OECD Principles of Corporate Governance do not have a binding characteristic for their member states and need to be adjusted in the light of a dynamic and changing corporate environment. The OECD (2004a) specifies the following elements crucial to good corporate governance; it is organised in six sections:

⁴ See corporate governance codes released worldwide on the homepage of the European Corporate Governance Institute; http://www.ecgi.org/codes/all_codes.php.

- (1) Rights and obligations of shareholders
- (2) Equitable treatment of shareholders
- (3) Role of stakeholders in corporate governance
- (4) Disclosure and transparency
- (5) Responsibilities of the board
- (6) Appendix

By using the OECD Principles of Corporate Governance framework, each element will be explained in detail:

Rights and obligations of shareholders

The corporate governance framework should protect and facilitate the exercise of shareholder's rights. Shareholders' rights include being able to participate and vote in general shareholder meetings and to elect and remove members of the board. Furthermore, it should be granted that they receive relevant information about the company on a regular basis. Shareholders have a right to receive a dividend (residual profit). As far as it concerns minority shareholders, their rights must be protected. Information disclosure on decision making processes and transparency in the operations of the company should be ensured. Shareholder's obligation includes the use of voting rights.

Equitable treatment of shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. In the case of violation of their rights, the opportunity to avenge should be guaranteed. Within a class of shares, all shares should carry the same voting rights and should be treated equally.

Role of stakeholders in corporate governance

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises. In the case of violation of their rights, the opportunity to avenge should be guaranteed. Relevant and reliable information in the operation of a company to the interests of stakeholders should be provided on a

regular basis. Stakeholders make a relevant contribution to the performance of the company therefore their role in the corporation should be encouraged.

Disclosure and transparency

The corporate governance framework should ensure that timely, detailed and accurate disclosure of information is made regarding the corporation, including the financial situation, performance, ownership and governance of the company. An (internal) audit committee should be established.

Main points of transparency include disclosure of information on:

- Financial and operating results of the company
- Responsibilities of the board
- Short- and long term goals of the company
- Ownership structure
- Remuneration policy for members of the board and key executives
- Existing risk factors in a company's environment
- Issues regarding employees and other stakeholders
- Governance structures and policies

Responsibilities of the board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of the management by the board and the board's accountability to the company and the shareholders. The decision making process of the board should be based on high ethical standards and should take into account the interests of stakeholders. Non-executive members of the board should be introduced to the board, which are independent from executive members of board. Their task should be to form independent judgements, especially with respect to the company's strategy, performance, asset management and management appointments. Executive management compensation should be related to the company's general level of profitability and overall performance. Total compensation, as well as procedures for determining compensations should be disclosed in financial statements.

In the course of globalisation, the OECD values improvement of competitiveness and access to capital in global markets as crucial. Furthermore, the OECD emphasises the

importance of transparency and disclosure by announcing: “The disclosure of the corporation’s contractual and governance structures may reduce uncertainties for investors and help lower capital costs by decreasing related risk premia. Such transparency may also encourage a common understanding of the “rule of the game”, and provide employees with information that may help reduce labour friction.”

Chapter 5 addresses the importance of financial disclosure and transparency. By strengthening disclosure regimes for listed companies, the protection of investors can be assured and greater accountability by a company’s board and management can be ensured. By providing accurate information to stakeholders, who include investors, employees, suppliers etc, a win- win situation can be achieved.

2.2 Chinese Corporate Governance Code

In the last few years, the financial collapse of multinational companies as Enron and Worldcom have triggered an intense discussion over the quality of corporate governance in Western companies in the USA and Europe. In almost the same manner, a number of listed companies in China have violated provisions relating to financial reporting and management. Amongst others, Guangxia (Yinchuan) Industry Co. Ltd., Sanjiu Pharmaceutical Co., and Macat Optics and Electronics Co., Ltd. can be mentioned⁵. Such cases of mismanagement drove authorities to take measures to improve corporate governance.

2.2.1 Development of Chinese Corporate Governance Code

In the Anglo-American corporate governance model which is based on a functioning stock and capital-market, hostile takeovers⁶ play a central control function concerning the efficiency of corporate management. In Continental Europe and Japan, where the German corporate governance model is prevailing; institutional investors, especially banks, insurance companies and investment funds, play a central role, whereby employee representation is significant. Both concepts represent different interest

⁵ Corporate scandals in China are reported by, Shi/Weisert 2002; Zhang 2004; Asian Times 2004: <http://www.atimes.com/atimes/China/FL07Ad04.html>, New York Times 2002: <http://query.nytimes.com/gst/fullpage.html?res=9D0DEFD9143DF935A2575BC0A9649C8B63&sec=&spon=&pagewanted=all>, Zhang 2004; International Herald Tribune 2005: <http://www.ihl.com/articles/2005/04/03/bloomberg/sxyuan.php>.

⁶ Hostile takeovers are possible due to a functioning bankruptcy law.

groups that are in the position of having an impact on corporate behaviour. In China, since the end of the Maoist era and the end of the planned economy, corporate governance standards and regulations needed to be established from scratch, especially in view of the evolving market-based environment. Planned economies neither have a tradition of corporate governance, nor the required foundation for the establishment of a corporate governance system. The state recognised the necessity to install new corporate organs within the enterprises in order to control them better and to comply with international standards. The concept of the Chinese corporate governance code is based on the model of US legal and regulatory systems (Shi/Weisert 2002:44) and expanded by the German model of the supervisory board. Generally speaking, the code has to be seen in context with the actual reform of the Chinese banking sector and stock market.

In January 2002 the China Securities Regulatory Commission (CSRC) passed the final version of the Chinese corporate governance code (CSRC 2002). Before the enactment of the code, the Chinese Securities Regulatory Commission released a draft⁷. Over several conferences, organised by the Chinese Securities Regulatory Commission in corporation with the OECD and the World Bank, the draft was peer-reviewed. Since 1997, the CSRC has put a lot of effort into the establishment of a Chinese corporate governance code. In 2003, the Chinese government established the State-owned Assets Supervision and Administration Commission (SASAC), whose main task is to modernise and restructure 151 Chinese major SOEs (SASAC 2008). However, it is necessary to address the fact that the new economy in China has inherited many features of the old planned economy. Therefore, an overlap is observable. The government is in a dilemma, on the one hand it wants to be a key figure in corporate governance, both as drafter and enforcer of rules, and on the other hand it wants to be a major shareholder of listed companies (Tomasic 2006:16).

Corporate governance was installed with the primary goal of separating the activities of the government and the party from operations in state-owned enterprises. As far back as the Third Plenary Session of the 11th Central Committee of the Communist Party of China in 1978, policymakers stated that:

⁷ On September 11, 2001, the CSRC released for comment a draft of its Principles of Corporate Governance for Chinese listed companies.

“... one of the serious shortcomings in the structure of economic management in our country is the over-concentration of authority, ...

...it is necessary to act firmly in line with economic law, attach importance to the role of the law of value, consciously combine ideological and political work with economic methods and give full play to the enthusiasm of cadres and workers for production;

... it is necessary, under the centralized leadership of the Party, to tackle conscientiously the failure to make a distinction between the Party, the government and the enterprise and to put a stop to the substitution of Party for government and the substitution of government for enterprise administration, to institute a division of responsibilities among different levels...” (Beijing Review 1978)

In addition, in the 1980's, Deng Xiaoping placed great importance in his speech *On the reform of the system of the Party and State Leadership* (党和国家领导制度的改革) to the separation of the party from the government, the reduction of political power concentration from the hands of selected groups and a necessary degree of decentralisation (Renminribao 1980). At that time policymakers agreed that the party should design national policies, while the central government should make and implement policies to carry them out (Goldman/MacFarquhar 1999:11).⁸ With regards to economic decisions and orders, it was up to the State Council and the Central Economic and Financial Leading Group to issue them, thereby the occurrence of different voices coming out of the central leadership was avoided (Zhao Ziyang 2009). These moves targeted limited political reforms (政治改革) in China, but had a strong impact on the following economic reforms (经济改革) in the country. In order to support the economic modernisation program, policymakers launched reforms with the aim of establishing an effective and efficient government administrative system at the central and provincial levels⁹. The government as well as the Communist Party

⁸ In addition to Deng Xiaoping, especially Zhao Ziyang advocated the shift of functions from the Communist party to the government administration. See: “*Advance along the road of socialism with Chinese characteristics*”; report delivered at the 13th National Congress of the Communist Party of China on October 25, 1987 by Zhao Ziyang. His efforts came to an abrupt end with the demonstrations at the Tiananmen Square in 1989 (Zhao Ziyang 2009).

⁹ At that time, central and provincial party committees were advised not to interfere or to make decisions concerning government work. See: Nie, Gaomin et al.: *Guanyu dangzheng fenkai de lilun tantao* (Theoretical discussions on separating the party from the government). After a quote from Zheng (1997:193).

agreed on emphasising economic efficiency in the country (Zhao Ziyang 2009). Currently, the Chinese debate on the separation of the state from the Communist party has been resumed (Du Gangjian 2001; People's Daily (2007c); He Jiadong 2004). The Chinese Communist Party approaches its members by emphasising its focus on their party work only, and not to drift towards other activities (News from the Chinese Communist Party 2009). Therefore, quality and sustainability of party work will be improved.

The corporate governance model is still a relatively new concept. Before 1978 most companies in China were state-owned and the government was both owner and manager of the state-owned enterprises. Beside the state-owned sector, collective ownership also existed. I will simply describe the different stages of corporate governance development, by identifying the milestones of its evolution.

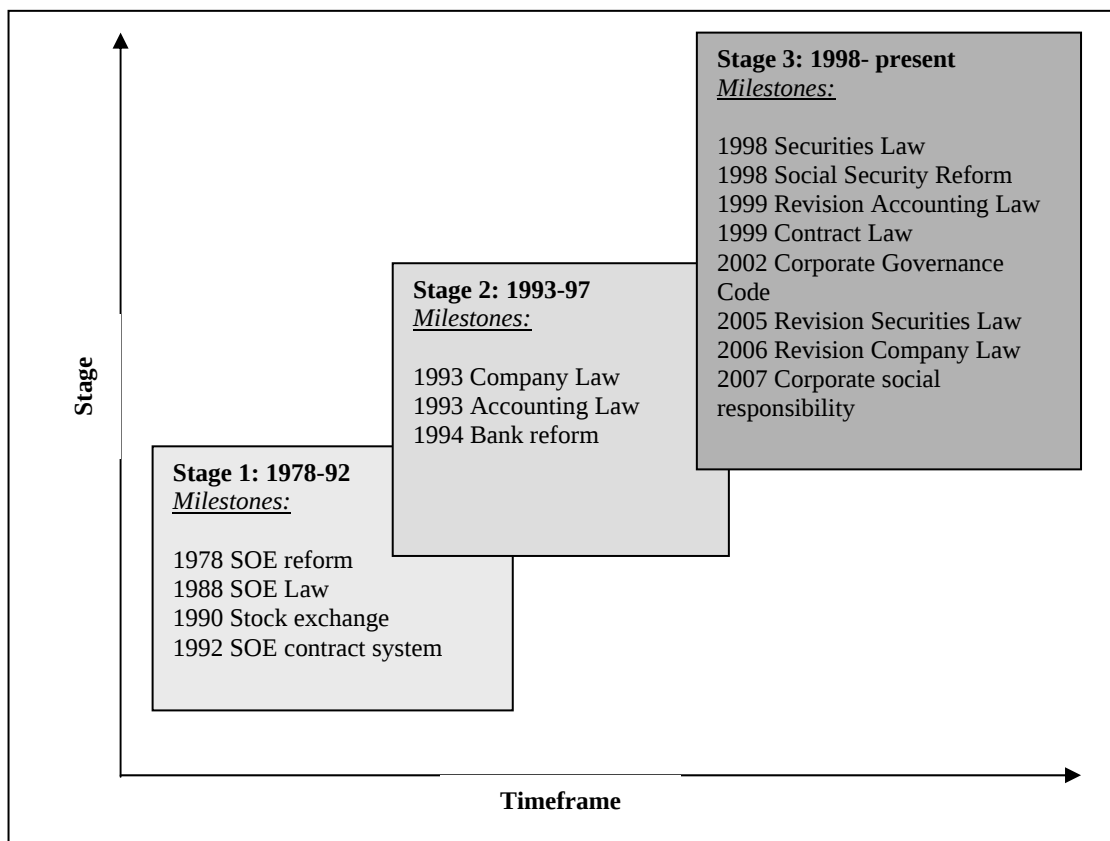


Figure 1: Milestones of corporate governance in China

With the introduction of the First Five-Year Plan (中国五年计划) in 1952 (1953–57), the State Planning Commission (国家计划委员会) adopted the Soviet style economic model, based on state ownership in the industrial sector, collectivism in agriculture, and strictly centralized planned economy system. Under the leadership of the Communist Party of China, the state demanded absolute ownership of all assets, including managerial rights in SOEs. All policies and regulations concerning the state-owned sector were centralised ruled and created by departments of government, but the planning and allocation were often done at provincial and county levels rather than by Beijing (Walder 1999; Yusuf et al. 2005:50). The economy was planned through the help of Five-Year Plans. Government bureaus determined prices, production quotas and allocation of resources, and SOEs had to fulfil the plan. Chinese state-owned enterprises provided an important source of revenue for the state, as the central government had direct access to their revenues.

Stage 1:1978-1992

After Deng Xiaoping took over leadership in 1978, domestic economic reforms were officially introduced nationwide. In 1978, the 3rd Plenum of the 11th Central Committee of the Communist Party of China decreed an end to the period of class struggle, by focusing on economic modernisation. The aim of the introduction of economic reforms was to transform China into a country with a mixed economy: *Socialism with Chinese characteristics* (具有中国特色的社会主义). Transition was realised, as the planned economy and the state sector were gradually complemented by the steady introduction of competition and market based mechanisms (Naughton 1995). By adopting this gradual approach, the old planned economy was not displaced but instead reformed, while market based elements were allowed to be established. Resistance from differing interest groups within the Communist party characterised each reform period and resulted in a periodical slowdown of the reform process. The reforms of the 1980s were strongly influenced by Chen Yun, who played an important role in the reform period of Deng Xiaoping. Chen Yun was a representative of the *birdcage economy* (鸟笼经济)¹⁰, that insisted on a predominantly planned economy and who showed reservations towards a dynamic

¹⁰ The cage is the plan, and it may be large or small. But within the cage the bird (the economy) is free to fly as he wishes (Zhao Ziyang 2009).

reform program. Chen Yun opposed the direction the reforms were taking, since he believed that more freedom in the economy would lead to more tolerance in social, cultural and even political arenas. Nevertheless, transition was realised through the reorganisation of a planned economy based on a dominating public ownership of means of production, into an economy that encourages the simultaneous operation of publicly and privately owned enterprises. The following ten years can be regarded as an initial pilot for the market economy concept, which had the aim of improving incentives, freeing up prices, introducing market competition and increasing the market scope for efficient resource allocation. Collectives and private enterprises were allowed on a limited scale and competed with state-owned enterprises. In 1986, the contract responsibility system¹¹ was introduced with the aim of improving SOEs performance and efficiency. The contract responsibility system was adopted as a further initiative towards the decentralisation of the enterprise management system and allowed greater management autonomy to state-owned enterprises, at least formally. The adoption of performance contracts in state-owned enterprises did not meet expectations, as incentives were not appropriately chosen and did not generate expected performance targets (Yusuf et al. 2006:68; Qian 1996). In the 1980's the state sector was in deficit, partly due to high inflation resulting from an overheating economy. Reformers acknowledged that the SOE reforms did not show the expected results and progress, and alternative measures were deemed necessary to corporate governance regimes in developed countries cannot be assumed for transformation economies allow the country to enter into a new stage of reform. A partial decentralisation was introduced to the state-owned sector, as less state-owned enterprises were under the direction of the central government. The establishment of private enterprises (个体户)¹² was allowed to a minor degree only. Joint Ventures¹³

¹¹ Tenev et al (2002:13) analyzed four common elements. First, all of them involved a contract –based relationship between the enterprise, usually represented by its directors, and its supervisory agency. Second, the directors faced substantial risks and rewards as a result of participating in these programs, because their performance was linked to their enterprises' performance. Third, these schemes involved open selection (as opposed to direct administrative appointment) of enterprise directors. Finally, most of these systems had multiyear targets and incentives in order to weaken the ratchet effects.

¹² After 1978, the government allowed the development of private enterprises as a supplement to the state and collective sector. The establishment of private enterprises is based on individual entrepreneurship and self-employment in the non-state business sector, and was created in response to the increase of unemployment and economic stagnation in the country.

¹³ The creation of Joint Ventures played an incremental role in the reform process of state-owned enterprises, by having a main emphasis on technology transfer. In this context, the implementation of corporate governance was not linked to the creation of Joint Ventures.

were allowed under the condition that the state held a share of at least 51 per cent. In 1990, the stock exchanges in Shanghai and Shenzhen were established.

Stage 2: 1993-1997

After Deng Xiaoping's journey to south China in 1992, economic reform in the country got a new, strong impetus. As a result of the 3rd plenum of 14th National Congress of the Communist Party of China, the "Decision of the CCPCC on Several Issues Concerning the Establishment of a Socialist Market Economic Structure" (Renminribao 1993) was issued. Policymakers started to focus on the establishment of a *modern enterprise system* in China. The system involved corporate structure, governance, and management based on the principles of corporation, and with provisions for full separation of the state's exercise of ownership rights from the enterprise's exercise of legal person property rights. Furthermore, this decision encouraged the development of diversified forms of enterprise ownership, including privately owned, individually owned and foreign invested companies (Tenev et al. 2002:16). In 1993, the Company Law was adopted in China. The transformation of state owned companies into public corporations was initiated and the importance of establishing a modern corporate system underlined. Through the Company Law, the government sought to bring organisational standards in line with Western-style corporate governance (Guthrie 1998). In 1994, the government initiated the first steps towards banking reform and separated policy from commercial lending. In 1994, the value-added tax system was adopted in China, applicable to all enterprises, regardless of which ownership type they were. This decision redefined relations between the government and SOEs, as it reduced the state's dependence on enterprise profits, which was at this point the primary income source for the government. With the introduction of the tax system, all enterprises were obliged to pay a defined percentage tax rate. This was a first step toward the tax system reform, which is currently still a topic in China (Hauff 2002, Wong 2005).

Although the stock exchanges in Shanghai and Shenzhen were established in 1990, a boom of listed enterprises on the stock exchanges and the value of shares issued came three years later. In 1993 there were 183 companies listed on the Shanghai and Shenzhen stock exchange, and RMB 9.6 billion in shares were issued and sold (Chinese Statistical Yearbook 2007). The companies listed on the stock exchange

were determined by government, and were mainly state-owned enterprises. The listing of state-owned enterprises aimed to provide external access to financial channels, either domestic ones or from abroad. Furthermore, domestic private investors were provided with an alternative to putting their savings in the state-owned banks or keeping it at home.

Stage 3:1997-present

The Standing Committee of the Ninth National People's Congress (NPC) promulgated the Securities Law in 1998. Since China's accession to the World Trade Organization (WTO) in 2001, the Chinese leadership agreed on dismantling trade barriers and reducing customs tariffs. The deregulation of industries was declared as a goal, although industries such as banking and telecommunications remain highly regulated (China Daily 2006a).

In 2001, the CSRC promulgated the code of corporate governance for listed companies. In 2002, when the 16th National Congress of the Communist Party took place, Chinese policymakers decided to put their efforts behind the reform of the state-owned assets management. The reform of state-owned assets management took place by means of privatisation, corporatisation and through the listing of SOEs. Furthermore, the building of market-supporting institutions, including legal institutions, has become the focus of the reform, although deeper institutional reforms are still necessary. In 2008, the State-owned Assets Supervision and Administration Commission promulgated the guidelines on corporate social responsibility for state-owned enterprises. One-year later separate guidelines were published for the state-owned banking sector (China Banking Association 2009).

2.2.2 Legal Character of Chinese Corporate Governance Code

Legal provisions concerning the corporate body structure of a company, rights and responsibilities and delegation of decision-making power are important determinants of corporate law. In addition, it is significant as to whether parties involved can realise and enforce their rights and to which degree they have trust in the national rule of law.

In contrast, the corporate governance code functions as a guideline to improve communication between the capital market and a company. Furthermore it covers ethical values and good practices. Two basic principles were adopted, namely that it would only apply to Chinese listed corporations and that it would not be mandatory by law. According to the Chinese government, the code of corporate governance is formulated

“...to promote the establishment and improvement of modern enterprise system by listed companies, to standardize the operation of listed companies and to bring forward the healthy development of the securities market of China” (CSRC 2002).

The Company Law of the People’s Republic of China (中华人民共和国公司法)¹⁴, the Securities Law (中华人民共和国证券法) promulgated in December 1998 and the Chinese Corporate Governance Code for Listed Companies (上市公司治理准则) issued by the China Securities Regulatory Commission and State Economic and Trade Commission; represents the legal groundwork for corporate governance in China¹⁵. The Company Law requires corporations to form three statutory and indispensable corporate governance bodies: (1) the shareholders, acting as a body at the general meeting; (2) the board of directors; and (3) the board of supervisors. In addition, the Law introduced two statutory corporate positions – the chair of board of directors and the chief executive officer (Schipani/Liu 2001:6). The new, revised PRC Company Law took effect on January 1, 2006 and was adopted by the Standing Committee of the National People’s Congress on October 27, 2005. The main purpose of the revision was to encourage the protection of minority shareholders¹⁶ and to improve corporate governance¹⁷. The Security Law was also revised with the aim strengthening regulations of Chinese listed companies.

¹⁴ Adopted at the 5th Session of the Standing Committee of the 8th National People's Congress on December 29, 1993; revised in 2006. The Company Law of 1993 (Corporate Law) is the first comprehensive piece of legislation on business corporations since 1949 when the People’s Republic of China was founded.

¹⁵ Shi/Weisert (2002:40) also mention the Certified Accountant Law (issued 1993), Audit Law (issued 1994), People’s Bank of China Law and Commercial Bank Law (both issued 1995), and Accounting Law (issued 1999).

¹⁶ The new Company Law introduces a number of measures aimed at increasing the protection of minority shareholders. Shareholders now have a statutory right to receive information, require a repurchase of their shares and petition for dissolution of the company.

¹⁷ The new Company Law allows the corporate veil to be lifted in certain circumstances, which may result in the controlling shareholder being held personally liable for the debts of the company.

In the last few years, the Chinese government has been actively revising and improving the regulatory framework for corporate governance. Ever since 1992 when the CSRC was established, the Chinese legislative and administrative authorities have stipulated more than 300 laws, regulations, rules, standards, and guidelines concerning the securities and future market.

The establishment of a corporate legal system cannot be taken for granted as under Mao's defined ideology the party was regarded as being above the law, and not as being interacting with society in accordance with a legal system. In fact, the state of lawlessness in China started with the Anti-Rightist Campaign in 1957, and reached its climax in the Cultural Revolution (Zheng 1997:163), which resulted in a disruption of law and order. The establishment of a legal system aims to create a new basis of legitimacy for the Communist party, and to maintain social order and stability in the country (Zheng 1997:164). Earlier in 1978, a report to the State Council, submitted by Hu Qiaomu, pointed out that economic laws are *objective* and for the sake of the country must not be violated (Fewsmith 1999:55). Indeed, the report reflected the ultimate need for legal development in the framework of economic reforms. The publication of this report signified a first step towards a retreat from ideology and from the party's claim on truth. Thereby party members as well as state bureaucrats were advised to observe the law. Today it is apparent that abidance by the law is still subject to an intense conflict among party members, as it demands control loss and severe restriction on their room for manoeuvre. With the introduction of the new party constitution in 1982, policymakers undertook a commitment that required all party organisations and members to operate within the framework of law. With the legal reforms in 1982 of the state constitution, all state organs, public organisations and enterprises were required to abide by the law. This move marked the separation of the party from the government. This step caused great tension, as the principle inherent in bureaucratic rationality conflicts with the privileged claim on truth on which the party originally based its legitimacy (Fewsmith 1999:55).

China has so far heavily relied upon a legal and regulatory approach to corporate governance. Chinese regulatory bodies, like the Chinese Securities Regulatory Commission (中国证券监督管理委员会), the National Development and Reform

Commission (国家发展和改革委员会), the Shanghai Stock Exchange (上海证券交易所) and Shenzhen Stock Exchange (深圳证券交易所), have issued them. However, laws and regulations are only a part of the whole corporate governance scene; it still needs other institutional infrastructure for effective corporate governance such as mature markets for securities, corporate control, executive labour and intermediaries (Ho 2003:10) and enforcement mechanisms.

The Chinese corporate governance code is a market-based element implemented within the course of economic reforms. The Chinese corporate governance code strongly follows the published recommendations of the OECD principles, including some variations. Variations account for Chinese specific features in context of China's tradition, history, culture and corporate law system. It is questionable whether or not the corporate governance code can function as rule for management behaviour on behalf of the shareholders of a company, as in the Chinese context corporate governance does not necessarily meet the same institutional conditions as in Western countries. In fact, Chinese corporations installed a two-tier board system, in contrast to the unitary board system applied in Anglo-American corporations. In regards to the role of the controlling shareholder and the regulatory objective of minority shareholder protection, the code follows the recommendations of the Anglo-American model. Minority shareholder protection has low priority in China, in particular as the state holds the majority block holdings in most Chinese listed companies. Minority shareholders only play an inferior role in Chinese corporate structure. At the time when corporate governance code was adopted, the Chinese government aimed to attract international investors' capital. In order to gain the trust of international investors and to comply with international standards, the legal protection of minority shareholder was important. The agenda of the Anglo-American corporate governance code is in many aspects contradictory to the Chinese law system and administration system. Most relevant laws have been enacted, but enforcement mechanisms remain poor, and Chinese courts do not possess of a lot of experience and expertise in dealing with such cases. In socialism, China does not have the necessary foundation for corporate governance in a market-based sense and consequently processes in the corporate legal system have been adapted and changed by state administration. By implementing the corporate governance code, Chinese

economic policymakers adopted regulations and standards in conformance to the requirements of a transition economy, and not a pure market-based economy. Concluding, the Chinese corporate governance code neither complies one hundred per cent with the Anglo-American model, nor the Continental-European model. Rather it is understood as a mixed model, containing elements of both and further extended by Chinese specific features – a model with Chinese characteristics, which will be outlined in the next chapters.

2.3 Internal corporate governance and institutional change in state-owned enterprises

Modern corporations are governed by internal and external factors which must interact effectively with each other. Internal factors are the institutional framework within the company (e.g. shareholder's meeting, board of directors, supervisory board) and external factors are the framework outside the company.

The following section tries to give an insight to which degree the guidelines and recommendations of the corporate governance code are applied and where it meets limitations in the Chinese context. The corporate governance code meets the expectations of domestic and international investors, who regard the code as a standard for best practices and ethical values related to managing, directing and overseeing listed corporations. The implementation of the code requires new impulses for disclosure, transparency, auditing and coverage which have not been required in a planned economy.

The code consists of 8 different parts with 95 articles. Part 1 deals with shareholders and the general meeting; part 2 with controlling shareholders and listed companies; part 3 with the management board; part 4 with the supervisory board; part 5 with performance evolution, incentives and control mechanism; part 6 with the relationship to stakeholders; while part 7 deals with information that should be disclosed to ensure transparency. The last part is the appendix.

<i>(1)Shareholders and the General Meeting</i>	<i>股东与股东大会</i>
<i>(2)Controlling Shareholders and Listed Companies</i>	<i>控股股东与上市公司</i>
<i>(3)Directors and the Board of Directors</i>	<i>董事与董事会</i>
<i>(4)Supervisors and the Supervisory Committee</i>	<i>监事与监事会</i>
<i>(5)Performance Evolution, Incentives and Control Mechanism</i>	<i>绩效评价与鼓励约束机制</i>
<i>(6)Stakeholders</i>	<i>利益相关者</i>
<i>(7)Disclosure and Transparency</i>	<i>信息披露与透明度</i>
<i>(8)Appendix.</i>	<i>附则</i>

2.3.1 Shareholders and Board Meeting

In the first chapter, the Chinese code of corporate governance underlines the significance of shareholder's rights. In a first step, the code discusses (1) rights of shareholders and (2) rules for a shareholder meeting (CSRC 2002).

- *Article §§ 1 of the code states that regarding shareholder rights, shareholders should enjoy the full exercise of their legal rights, which also includes bearing the corresponding duties based on the shares they hold.*

- *Article §§ 3 requires the listed company to establish efficient channels, so that shareholders will be provided timely with accurate, company-related information.*

- *Article §§ 4 provides shareholders the right to protect their interests and rights through civil litigation or other legal means in accordance with laws and administrative regulations.*

In agreement with the Company Law, the shareholders' meeting decides upon the most important issues: arranging the policies, investment plans, recruiting and

removing directors and supervisors, and approving quarterly and annual reports. Although the code in Article §§ 2 states that minority shareholders should have equal status with other shareholders, the Company Law does not provide any detailed provisions for the protection of the interests of the minority shareholders. Furthermore, the Company Law does not stipulate a legislative basis for undertaking legal actions. In the case that minority shareholders want to take action and sue directors or state representatives, they cannot trust upon receiving legal support. Regarding the rules for the shareholders' meeting,

- *Article §§5 states that convening and voting procedures should be set out in the behalf of the shareholders, by means of its articles of association, including rules governing such matters as notification, registration, etc. The shareholders can either be present at the shareholder's meetings in person or they appoint a proxy vote on their behalf, and both means of voting possess the same legal effect.*
- *Article §§ 8 requires listed companies to use modern telecommunication technologies in shareholder's meeting to improve shareholder participation.*
- *Article §§11 encourages the role of institutional investors in the decision making process, including the appointment of company directors and in the compensation and supervision of management.*

In order to provide guidelines for meetings of shareholders in listed corporations, the Chinese Security Regulatory Commission (CSRC) issued the "Standard Opinions on Meeting of Shareholders in Listed Corporations" in February 1998 and amended it on May 18, 2000. As the name Standard Opinions already says, they are not mandatory or legally binding.

2.3.2 Controlling Shareholders and Listed Companies

In the second chapter, the Chinese Code of Corporate Governance discusses (1) behaviour rules for controlling shareholders, and (2) the independence of listed companies.

Regarding the behaviour rules for controlling shareholders (CSRC 2002),

- *Article §§ 15 stipulates that during the restructuring and reorganisation of a company that plans to list, the controlling shareholders should observe the principle of “first restructuring, then listing”, and shall emphasise the establishment of a reasonably balanced shareholding structure.*
- *Article §§ 16 requires that listed companies do not include non-operational institutions and welfare institutions in their operation.*
- *Article §§ 18 notes that reforming labour, personnel and distribution systems, transforming operational and managerial mechanisms are tasks to be done by the controlling shareholder. The aim should be to establish systems such as management selection through bidding and competition in the employment of employees based on competitive selection and an income distribution scheme that provides sufficient incentives.*
- *Article §§ 19 requires the controlling shareholder not to take advantage of his privileged position in the company to gain additional benefit and to respect shareholders legal rights and interests.*

Regarding the independence of listed companies,

- *Article §§ 22 requires a listed company to be separated from its controlling shareholder in aspects such as personnel, assets and financial affairs - It shall also be independent in institution, and business, shall practice independent business accounting, and shall independently bear risks and obligations.*

Furthermore,

- *Article §§ 26 gives controlling organs like the board of directors, the supervisory committee and other internal offices more weight in operating in an independent manner, not subordinated by a company's controlling shareholder.*

2.3.3 Controlling Body

The code attempts to strengthen the roles of the controlling body in a listed company as the board of directors, board of supervisors and independent directors.

2.3.3.1 Board of Directors

In the third chapter, the Chinese code of corporate governance looks at the role of directors and board of directors in six aspects (CSRC 2002): (1) election procedure of directors, (2) duties and responsibilities of directors, (3) duties and compensation of the board of directors, (4) rules and procedures of the board of directors, (5) independent directors (2.3.3.3 Independent Directors) and, (6) specialised committees of the board of directors.

The Chinese Company Law complements the main provisions of the code of corporate governance, especially when dealing with the board of directors. The Company Law stipulates five rules: (1) limited liability companies and joint stock companies are required to set up a board of directors, (2) the number of directors should range from three to thirteen for a limited liability company and five to nineteen for a joint stock company, (3) the board of directors has the responsibility of appointing and removing management, (4) directors and managers must faithfully perform their duties, protect the company's interests and ultimately answer to shareholders, (5) and a director's appointment should not exceed three years, subject to re-appointment for a further term.

The main points are outlined in the following (CSRC 2002):

According to

- *Article §§ 29 and §§ 31 a listed company must establish standardised and transparent procedures for director election and detailed information*

regarding the candidates for directorship shall be disclosed. Listed companies in which the major shareholder has a stake of more than 30%, shall adopt a cumulative voting system to ensure the voting rights of minority shareholders.

- *Article §§ 33 and § 36 lists the duties and responsibilities of the board of directors of listed companies*
- *Article § 38 requires listed companies that in the case of violation of laws or regulations or a listed company's articles of association, which causes losses to the listed company, directors should be liable for compensation.*

The board of directors represents inside and outside directors of the company, including the CEO. In practice, in the 1990's over 70 per cent of directors and board chairmen were appointed by the state and legal person shareholders, and over 50 per cent were appointed by the controlling shareholders in proportion to their shareholding (Ho 2003; Tenev et al. 2002:83; Yusuf et al. 2006:194). In general, only rarely were individuals or outside shareholders elected at the shareholder's meeting or board seats (Xu/Wang 1999). How strong the influence of the controlling shareholder is affecting the corporate governance reform will be illustrated below.

In 2004 the government body SASAC¹⁸ (State owned Assets Supervision and Administration Commission of the State Council) invited seven Chinese companies to participate in a pilot project on the BoD-reform (Wang Chenbo 2004). SASAC extended the experimental exercise to 14 companies in 2006 and to 30 in 2007, inviting foreign managers and CEOs to be part of a more transparent corporate governance system (Fernandez-Stembridge/Huchet 2006:34). The pilot included the Shenhua Group, Shanghai Baosteel Group, China Tietong Group, China Yiyao Group, China Gaoxin Investment Group, China Chengtong Group, and the China Guolu Group. Originally, in all these companies BoD already existed, but were highly influenced by interest groups close to the state. These kinds of BoD are also called in

¹⁸ SASAC (namely, the former State Economic & Trade Committee) was established in 2003, before a multitude of government ministries and other bureaucratic entities got to have their say in the daily operations of SOEs. With the creation of SASAC, China had clarified and simplified its state-assets management system (Fernandez-Stembridge/Huchet 2006:32). SASAC is exercising the government's ownership rights with the objective to improve enterprises performance.

Chinese terms *One person BoD* (Wang Chenbo 2004). The reason for this expression was that in the 1990's Chinese companies started to move in the direction of establishing a modern corporate governance system. By forming new institutions within a company, former managers of the SOEs became the new members of the BoD and former party committee secretaries or the SOE director became the new chair of the BoD. This created a high possibility that the BoD would be controlled by insiders (Zhou 2003; Xu/Wang 1999); therefore, insider control is dominant (Lawton/Cheng 2005:30). According to §§Article 120 (1) of the Company Law, the chair of the BoD is authorised to perform certain duties of the BoD between BoD meetings, in the case that the BoD is not holding meetings. The result is the concentration of power in the hands of one person. Consequently, no external managers were recruited and the members of BoD continued to be recruited from among the internal personnel. Therefore, companies cannot get rid of old practices and old monitoring systems. The ultimate responsibility remains with one person – the chair of the board of directors. During the pilot project on BoD reform, the companies involved also started to recruit external directors. The selection of the potential candidates proved to be quite difficult. According to the Company Law, no state officials were allowed to be recruited. Apart from the difficulties in finding candidates with appropriate qualifications, the SASAC, which originally initiated the reform, participated in the recruiting process. Finally, the companies had to wait for the approval of the government body SASAC before they could hire a new member for their BoD. This proves that government agencies are still playing a decisive role in the appointment of executives, on behalf of the major shareholder.

The difficulties observed regarding the recruitment of potential candidates also pinpoints the fact that the Company Law does not provide a standard job description or profile concerning the qualifications and responsibilities of directors. The appointment of the chair of BoD is mainly dependent on the political position in hierarchy of the candidate. In the past it has been proven that primarily high-ranking cadres and local party committee's secretaries were appointed (Garnaut et al. 2005:122; Tenev et al. 2002). Close relationship between the government and former SOEs continue and government interference persists (Lawton/Cheng 2005:30; Tenev et al. 2002:98, 99).

The last policy dialogue on corporate governance of state-controlled listed companies in China in 2007, hosted by the Shanghai Stock Exchange and the OECD, also observed this unwanted development (OECD 2007a). Hu Ruying, Director of Research of the Shanghai Stock Exchange in China identified three areas that show weak distinction between government and enterprises, namely recruitment, incentives and oversight (OECD 2007a:3):

- *There has been no fundamental change in the traditional practice of appointing government officials to leadership positions in state controlled-listed companies. A majority of board chairs and CEOs hold civil service ranks. The market for management personnel is underdeveloped and market-based mechanisms for management selection have not been put in place.*
- *Civil service management and government intervention still heavily influence the procedures and mechanisms for deciding executive remuneration in state controlled-listed companies.*
- *The government generally does not govern SOEs based on ownership functions and reliance on a strong board.*

Senior officials, business leaders and scholars from China and OECD countries concluded that board operations still lack independence and efficiency (OECD 2007a).

2.3.3.2 Board of Supervisors

The fourth chapter deals with the supervisors and the board of supervisors. In order to reduce the risk of insider control, corporate governance regimes in Western countries solve the problem by introducing independent directors. This chapter briefly examines the duties and responsibilities of the supervisory board.

The board of supervisors includes at least three members who are either shareholder representatives or employee representatives, with the percentage of representation of each group to be stipulated in the articles of association. The corporate employees in democratic elections elect the employee representatives on the board of supervisors. In order to secure the impartiality of supervisors, directors, executives and financial managers may not concurrently serve as supervisors (Company Law 1993:§§124).

According to the Chinese Company Law, Chinese corporate governance structures provide for a two-tier board system. This structure is similar to the German model. The German law stipulates a two-tier system for large publicly held corporations. German listed companies (*Aktiengesellschaften*) are composed of an elected supervisory board (*Aufsichtsrat*), which appoints the board of directors (*Vorstand*), consisting of senior corporate managers. In Germany, the supervisory board's main task can be defined as overseeing the management of the company. Furthermore, they have the power to appoint and dismiss members of the board of directors and the power to represent the corporation in its dealings with members of the board of directors. The Chinese corporate governance resembles on the surface the German model, but there are substantial differences between these two systems because they are not based on the same social and philosophical considerations (Tam 1999:86). On the contrary, the role of the supervisory board in Chinese corporations is still limited and shows many weaknesses. The institution of the supervisory board in Chinese listed companies is challenged by many factors, mainly because it cannot fulfil its attributed function.

- *Article §§ 59 states that the board of supervisors should overlook the corporate finance, the legitimacy of directors, managers and other senior management personnel's performance of duties, and shall protect the company's and the shareholders' legal rights and interests (CSRC 2002).*

For instance, according to a Chinese survey in 2001, only 37 per cent of company representatives estimated that the supervisory board fulfils its tasks concerning financial issues and the BoD. The same survey revealed that 81 per cent of Chinese managers agreed that the decision-making process is centred within the BoD only (China Enterprise Confederation 2001). The Chinese supervisory board does not have any competencies related to the appointment or dismissal of the BoD.

- *Articles §§60 and §§61 state that members of the board of supervisors must be permitted access to information related to the companies operational status and must be allowed to hire independent intermediary agencies for professional consultation, without interference from other company employees (CSRC 2002).*

The reporting duty of the BoD to the supervisory board is also missing. Although according to the law, the supervisory board has formally the competency to control and monitor the field of activity of the BoD, in reality they do not possess any direct tools to put sanctions on them. The ineffectiveness of the supervisory board is due to the Company Law, which merely provides it with limited powers and are not sufficient enough to effectively implement the monitoring function.

Factors influencing the function of the supervisory board in a negative way can be identified as follows (Dang Wenjuan/Yuan Like 2006b:114ff.): Firstly, major shortcomings exist in the construction of the institution of the supervisory board itself. Originally, most Chinese listed companies were state-owned enterprises. Members of the management and board of directors mainly derive from the political cadre system of former days. As a result, it remains difficult to change their idea of management practices and their understanding of modern management instruments within a short time period. Today it can be still observed that the real power in a Chinese company is concentrated in the board of directors and the management, which in turn are nominated by the major shareholder, the state. Supervisory boards lose their effectiveness in particular because they do not become the centres of company operations and do not bear ultimate responsibility for them (OECD 2007a).

Secondly, according to Chinese corporate governance structures the decision-making power and the monitoring power are two separated functions. The board of directors is in charge of the decision-making function and the supervisory board is in charge of the monitoring function. In comparison to the German board of supervisors, the Chinese board of supervisors lacks the power to execute its function. A Chinese idiom says: “哪里有权力，哪里就需要监督；哪里有监督，哪里就必须有权力” (Dang Wenjuan/Yuan Like 2006b:115) which translates as *Where there is power, there you need monitoring; where there is monitoring, there must be power*. This idiom explains in a simple way the complexity of the discrepancy of the whole concept in China. In reality, the supervisory board is not endowed with the necessary powers by the Company Law¹⁹ to monitor the board of directors. It is self-explaining

¹⁹ The Company Law (1993), Article 126 stipulates the supervisory role of the board of supervisors by just saying that they should have the following powers, without delegating any power to them. The supervisory board shall exercise the following powers:

(a) reviewing the finances of the company;

that their effective monitoring function is therefore not guaranteed or even put into practice.

As mentioned above, the two-tier board system consists of two organs, the board of directors and the board of supervisors. These are elected by the shareholders and are required to submit information to the board meeting. Both are equally independent, which means that the decision-making function and monitoring function are of equal significance. However, in reality the practice is different to the theory. In Chinese listed companies only the role of the board of directors is regarded as meaningful and important, the role of the supervisory board is likely to be overlooked. China's Company Law neither provides instructions on what the supervisory board should do if the board of the directors refuses their suggestions (Lawton/Cheng 2005:36), nor does the Company Law stipulate that the board of directors and management have to report regularly to the supervisory board (Tenev et al. 2002:100). In fact, the board of directors controls the company. In contrast to the German model, the Chinese supervisory board has no power to appoint and remove members of the management or the board of directors. The independency of the supervisory board can be regarded as a formal one only, without having any means to execute its monitoring function in an effective way. Thus, it has no controlling power and it can be stated that it is also deprived of the power of participating in the strategic decisions; neither can it participate in the decision-making of the board of directors, nor the management.

Thirdly, a large number of supervisors lack profound business experience and a management background. They are not involved into the daily business and operations of the company, as directors and managers might be. Besides the lack of important management knowledge and the company's ongoing operations, they rely even more on the management board. Publications on the topic discussed whether supervisors should be rather regarded merely as subordinates of the board of directors and managers, than an independent institution within the corporation (Dahya et al.

- (b) exercise supervision over the actions of directors or the manager when they are performing their duties, which actions violate laws, administrative regulations or the articles of association;
 - (c) requiring directors and the manager to remedy a situation when the acts of such directors or manager harm the interests of the company;
 - (d) propose the convening of interim meeting's of shareholders general committee; and
 - (e) other authorities stipulated in the articles of association.
- Supervisors shall be present at board meetings.

In October 2005 the Chinese Company law has been revised.

2003:317). By knowing this power imbalance within the company, it is easier to understand why the supervisory board's hands are tied and why they cannot carry out their monitoring function.

- *Article §§ 63 requires listed companies that in the case of violation of the laws, regulations or the company's articles of association by directors, managers or other senior management personnel, the supervisory board may report directly to securities regulatory authorities (CSRC 2002).*

Because of the reasons mentioned above the probability that they will report malpractices to the authorities is quite low.

Last, information asymmetry can explain the ineffectiveness of the supervisory board. According to the principal agent approach, the agent has an information lead over the principal, as the agent can use information over characteristics, intentions and actions in his own interest (Jensen/Meckling 1976; Grossman/Hart 1983). Exactly the same can be observed between the board of directors, the management and the board of supervisors. The supervisors have only limited access to a company's information and current operation activities. Consequently, they rely heavily on information from the management board, which in turn is not required to provide information on a regular basis. The supervisory board is not well informed on the actual performance of the company, and again cannot carry out its monitoring function in an effective way. Knowing the close relationship between the management board and the major shareholder in the company, the reliability of the information provided must also to be put into question.

Summarising, Chinese companies face problems in corporate governance similar to those of Western corporations. Because of several company crises during the last few years the operational capability of the supervisory function in Europe, especially in Germany, has been put in question. According to public debates, coalition building between the German board of directors and the supervisory board exist. In contrast, other commentators argue that in German groups the two functions of management and supervision are strictly separated, according to stock corporation law structure (Fallgatter 2003:703f)

The detachment of the management and supervisory function results in an information asymmetry, as the management, due to its closeness to the operative

business, has an information lead. Information received by the supervisory board is only rarely provided, and its sufficiency and reliability must be put into question (Lawton/Cheng 2005:28). Perhaps the key to improving supervisors' independence lies in further economic and political reform, perhaps by reducing political control over corporate affairs (including the hiring and firing of supervisors) by the government and the Communist party (Daya et al. 2003:318).

2.3.3.3 Independent Directors

Recent publications discuss the current role of independent directors in the Chinese corporate governance framework (Dang Wenjuan/Yuan Like 2006ab; Deng Li 2006; Clarke 2006) although the Chinese corporate governance code only touches on this topic in short (CSRC 2002).

- *Article §§ 49 requires listed companies to introduce independent directors who are independent from the listed company that employs them and the company's major shareholders. An independent director may not hold any other position apart from independent director in the listed company.*

The organisation of independent directors in the Chinese corporate governance framework is related to the organisation of the board of directors. Actually, the Company Law does not make any stipulations corresponding to the organisation of independent directors. In August 2001, the Chinese Securities Regulatory Commission (CSRC 2001) issued the "Guidelines for the Introduction of an Independent Director system in listed companies". These guidelines include all companies listed on domestic stock exchanges, but not Chinese companies listed overseas. The institution of independent directors has to fulfil three tasks (Shi/Weisert 2002), which are (1) to represent the interests of small shareholders, (2) monitor the executive management and prevent the emergence of corporate misbehaviour and scandals. (3) and bear responsibility for society, as they are taking part in the shaping of perceptions regarding capital markets in society.

- *Article §§ 50 states that independent directors shall carry out their duties independently and protect the interests of minority shareholders from being infringed (CSRC 2002).*

Thus, many of the criticisms of existing independent directors centre on their powerlessness to protect the interests of small and medium shareholders from the depredations of large shareholders and management (Clarke 2006:169). Protection of small and medium shareholders is crucial, since the financial market is regarded as an alternative to former traditional social protection schemes, the missing and still developing pension and social security system, and the limited access to private business sector lending. Many independent directors find it difficult to exert any substantial influence, other than symbolic, within the board (Schipani/Liu 2001:29).

In general, five major shortcomings can be identified concerning the current situation of independent directors in Chinese listed companies (Deng Li 2006:158): Firstly, above all, it is still quite unclear in which direction the Chinese system of independent directors will evolve. The most specific problematic characteristic of Chinese corporate governance is the concentrated ownership structure compared to companies based in the US and UK, which mostly have a dispersed ownership structure. Due to the dominant shareholder structure, small shareholder interests are difficult to protect. In China, companies with widely dispersed public ownership where no individual owns a controlling block of shares is virtually and perhaps completely, non-existent (Clarke 2006:169). Secondly, the number of independent directors represented in the board is still low. Taking the proportion of independent directors participating in the general meeting compared with the international average shows that the proportion still falls far short. In the USA 75 per cent of the BoD consists of external directors. The CRSC mandated that in a first step by June 30, 2002 at least two independent directors have to participate in the general meeting. In a second step, by June 30, 2003 the general meeting had to at least consist of one third of independent directors. By the end of 2004, 4,681 independent directors were employed by 1,377 Chinese listed companies in total, equivalent to an average of three independent directors for each listed company (OECD 2005a:2). Thirdly, the issue identified is maybe the most crucial one. In practice independent directors in Chinese listed companies are not independent, but rely heavily on the decision making of the major shareholder.

In reality, the board of directors and the board of supervisors nominate independent directors, which in turn are highly influenced by the major shareholder. Recently published research on corporate governance in China proves that independent directors still lack independence as the majority shareholder (OECD 2007a) nominates 90 per cent²⁰ of independent directors.

In economic terms, the interests of the majority shareholder are represented, and not the interests of the minority shareholders. The term independence refers to the condition that potential candidates should be independent from the listed company, management and the major shareholder. As they are independent, independent directors are required to have knowledge about economic and corporate governance related issues. Another function which should not to be underestimated is to serve the public interest and to act on their behalf. This would include acting as an institution that guard against the malpractice of individual interests and possible offences against law and discipline within a company. The major shareholder exerts a strong influence on the election procedure and as a result the efficiency of their monitoring function within the company has to be put into question. In addition, the board of directors not only nominates independent directors, but also remunerates them. As this organ is executing both functions, the result is a relationship of dependence and independence remains weak and needs further examination.

Fourthly, the establishment of an incentive system for independent directors must be strengthened. In general, an incentive system must be transparent and objective and affect a certain type of behaviour. Deng Li (2006:158) proposes an incentive mechanism that consists of two components, namely that independent directors should be paid a fixed component, such as an annual salary and the payment for attending meetings. The fixed component should not be related to the company's short-term or long-term performance. Actually, the concept behind the installation of a board of independent directors had in mind was to have a positive impact on the long-term performance of the company. Moreover, a variable component should also include independent directors remuneration, through these independent directors can participate in the company's performance, e.g. stock options. In summary, from the Western point of view, the deployment of variable compensation is an important

²⁰ A study conducted in 2003 came to the same result as that controlling shareholder or management (China Finance Online 2006) nominates 90 per cent of independent directors.

incentive to increase the achievement of individual performance standards (Hewitt 2004). In Chinese listed companies, the deployment of variable compensation e.g. stock options; is still not very common, rather the deployment of fixed compensation is prevalent.

Fifthly and last, the institution of independent directors in China still lacks qualified directors. Recently, in Shanghai and Beijing, the CSRC started to introduce long-term training for independent directors. The goal is to improve their knowledge about shareholder and corporate governance culture. These trainings include classes on management organisation of specified industries, establishment of standards and regulations and the understanding of ethics and industry behaviour. Although there is a rising tendency of people participating in these trainings, the number remains low. At the same time, the demand for qualified independent directors is increasing.

2.3.3.4 Performance Assessments, Incentives and Disciplinary Systems

Chapter five of the code of corporate governance deals with performance assessment and incentives and disciplinary systems. Three areas can be identified: (1) performance assessment for directors, supervisors and management personnel, (2) selection of management personnel, and (3) incentive and disciplinary systems for management. The following major rules should be outlined (CSRC 2002):

- *Article §§ 69 requires listed company establish fair and transparent procedures for the assessment of the performance of directors, supervisors, and management.*
- *Article §§ 70 state, that the evaluation of the directors and management personnel shall be conducted by the board of directors or by the remuneration and appraisal committee of the board of directors. The evaluation of the performance of independent directors and supervisors shall be conducted through a combination of self-review and peer review.*
- *Article §§ 71 states that a listed company should adopt recruitment standards. No institution of individual shall interfere with a listed company's normal recruiting procedure for management personnel.*

According to

- *Article §§ 71 compensation should be determined by performance assessment only.*

The suggestions given by the corporate governance code regarding performance evaluation, incentives and control mechanism also imply limitations. By trying to establish a better understanding for the design of an adequate compensation and reward system for Chinese directors in Chinese listed companies, the most important characteristics of Mao Zedong's established policy of the *three old irons* have to be taken into consideration. Therefore one might possibly explain the current issues facing the design and implementation of adequate performance assessment, incentives and disciplinary systems for Chinese directors. Before 1978, when the reform policy was introduced to China, the compensation system was centrally managed by the Chinese government, an appropriate incentive and disciplinary system did not exist so far. The compensation system consisted of the *three old irons* (旧三铁) system (Ding/Warner 2001:317), which was formative for Chinese state-owned companies during the time period from 1950 to 1978; and was completely controlled by the government. The three supporting pillars of this system were (1) the *iron wages* (铁工资), (2) the *iron rice bowl* (铁饭碗) and (3) the *iron chair* (铁交椅). The *iron wages* is a synonym for the state-administrated reward system, the low-wage policy, flat wage structures and complicated and inflexible wage schemes. The *iron rice bowl* is a synonym for unified job allocation, guaranteed life-time employment, and cradle to grave welfare. The *iron chair* is a synonym for factory directors regarded as state cadres, the appointment of directors directly by government authority, based on political selection and with an absence of punishment for poor business performance. State-employees who were entitled to a working contract based on the *three old irons* system, also benefited from the fact that their children were also qualified to work for the same company. Therefore state-owned enterprises secured employment for future generations. Cadres and directors, working for state-owned companies obtained credibility by being a loyal member of the party. Nowadays, most Chinese listed companies are former state-owned companies, which have all shown these characteristics before reform. The main point is that in earlier day's performance and

productivity of the company did not represent the key criterion for compensation and selection of management personnel, instead it was an individual's loyalty to the party.

²¹ Additionally, privileges associated with the size of the SOE, such as rank and influence, brought more personal gain to the directors than efficient production or profits (Lawton/Cheng 2005:26). Listed companies lack innovative compensation mechanisms, such as stock option programs, so a manager's compensation is linked to his individual performance. A lot of efforts have been undertaken to move away from this old system, but bad habits still persist.

2.3.3.5 Stakeholders

- *Article §§ 81 to §§ 86 discusses the legal rights of stakeholders, which are a main driver for a company's healthy and sustainable development (CSRC 2002).*

In Western literature, the relationship between the company's board and its stakeholders has led to an intense discussion among academic scholars (Freeman 1984; Smith 2003; Friedman/Miles 2006; Charreaux/Desbrières 2001). The stakeholder-oriented approach does not primarily focus on the interests of the shareholders but also takes into account the interests of other company-related groups like employees, customers, suppliers, government, public and banks. Stakeholders are seen as important contributors to the corporate long-term sustainable value of a company, as they are undertake firm-specific investments in the company's favour (Blair/Stout 1999; Zingales 1997; Rajan/Zingales 1998ab). Stakeholder theory alleges that different groups have a stake in the activities of the firm.

In the case of China, it is essential to point out that nearly all stakeholders are strongly related to the state or local governments. In the Chinese case, the distinction between shareholders and stakeholders is complex to a certain degree, since the several state-related areas at the national as well as local level are acting as shareholders as well as stakeholders at the same time. SOEs are operating under the

²¹ In Chinese state owned companies, the key criterion for promotion of a cadre was explained by the catchword 又红又专 (Warner/Ding 2001:325; Zhu/Dowling 1998:119). On the one hand this catchword refers to *red*, which means the relation to the party and on the other hand it refers to *expert*, which means expertise. Especially during the Cultural Revolution a lot of intention was paid to the term *red*. Only under the condition that a cadre was 又红, close to the party, he could consider to get a promotion.

control of the central or local governments, which are the dominant shareholders. SOEs employees are state employees/ local government employees. Most Chinese banks are state-owned/ local government-owned. SOEs management is highly connected to the party and government bureaus, in regard to their important role in appointment and promotion. SOEs suppliers are mainly SOEs themselves, as the state is interested in supporting domestic plant utilisation. SOE customers are not necessarily individual costumers but also SOEs, which are purchasing industrial products. Obviously an average Chinese SOE is surrounded by an environment, namely stakeholders, which are highly influenced in their decision making by the state and local government themselves. Thus, one stakeholder group in China are government bureaus and officials, as well as state-owned units. Highly influenced stakeholders can be regarded as a reason for the inefficiency SOEs, which increases through collusion among stakeholder groups (Cauley et al. 1999:203). Furthermore, incentive schemes to motivate these stakeholders to operate more efficiently are missing (Cauley/Sandler 1992; Tirole 1986). Therefore these stakeholders are making no effort to undertake firm-specific investments as they are not acting in their own interest but as a sub-agent for the state or local government's interests. The second stakeholder group in China are employees and workers. With the introduction of the People's Republic of China Employment Contract Law (中华人民共和国劳动合同法) promulgated in June 2007 and effective as of January 1, 2008²²; the state acknowledges the significance in improving regulations concerning employment relations. The new law responds to the demand for stronger labour rights and labour protection in the economy. Recently a debate was started in China as to whether the state or the public is the owner of the state-owned enterprises; and whether capital interests or workers interests should be given priority. By definition the employees are the owner of the state-owned enterprises, and the state is performing its duty on exercising its property rights on their behalf. Wang Hui (2009) argues that the state has to take over a smoothing function in order to balance shareholders and workers interests. Thereby the state has to bring its labour standards into conformity with

²² §Article 2: This Law governs the establishment of employment relationships between, and the conclusion, performance, amendment and termination of employment contracts by enterprises, individual economic organizations and private non-enterprise units in the People's Republic of China ("Employers") on the one hand and workers in the People's Republic of China on the other hand.

Where state authorities, institutions or social organizations establish employment relationships with workers (other than civil servants and those working personnel who are managed with reference to the Civil Servants Law), the conclusion, performance, amendment and termination of the employment contracts between them shall be handled pursuant to this law.

basic internationally recognised worker rights, which do not support conditions such as artificially low wages, long and often unpaid overtime, few legal protections and unsafe working conditions. In 2006, employees of a state-owned enterprise in Jiangsu took legal action to fight for stronger labour rights and better working conditions in their enterprise. In 2007, state-owned workers initiatives in Guangdong province were accompanied by spontaneous work stoppage and organised strike activities. These conflicts and social actions reflect the social zeitgeist of the time, combined with distrust in the ability of the state to take responsibility for the workers' interests. This triggers the question of whether the state is acting above party lines or is acting as a neoliberal state, as the owner of the state-owned sector. Wang Hui (2009) concludes that the recognition of workers' rights, most importantly freedom of association and the right to organise and bargain collectively, is an important starting point for more democracy in the country. The future development and change of the role of the labour unions in Chinese enterprises needs continuous observation.

In the Chinese context, little attention has been paid to the third group of stakeholders; the small investors. This is not only specific to China. Most countries in the world, including those in Europe, as well as in Latin America, East Asia, and Africa, show this feature. Corporations typically have controlling owners, who are often founders or their offspring (Schleifer/Vishny 1997:754). In Europe and Japan, banks and financial institutions exercise controlling ownership. In most East Asian countries, crony capitalism prevails with controlling families and controlling ownership, with two-thirds of listed firms controlled by a single shareholder or family relatives in those countries (Claessens et al. 2000). These countries can be characterised as being insider-dominated systems. Applying that to China, insider control is a well-known problem, as most of the industry and the financial system is dominated by the state.

Policymakers are aware that due to the omnipresence of the main shareholder, the interests of other important stakeholders are excluded and not taken into account. Due to the significant shortcomings of the system in protecting stakeholder interests (Zhu Yong et al. 2006:356), in December 2004 the China Securities Regulatory Commission (CSRC) promulgated the "Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders" (CSRC 2004). The aim of this was to implement a mechanism for preventing listed companies from control

abuse, and effectively protecting the legitimate rights and interests of small investors, especially the general public. Since the introduction of the Chinese corporate governance code, this circular is the first attempt towards improving the protection of small investor interests. This kind of agency problem can be mainly observed in East Asian countries where controlling shareholders are family holdings, bloc holdings or even the state itself. Claessens et al. (1999a) discusses the expropriation of minority shareholders' wealth by majority shareholders in East Asian countries. La Porta et al. (1998) examined weak legal protection of investors, which is associated with more concentrated ownership of shares. Chen Xiaohong, director of the Enterprise Research Institute in China, argues that interests of stakeholder groups have been ignored in the past and as a consequence rules and guidelines for state-related shareholders have to be improved and clarified (OECD 2007b).

2.3.3.6 Disclosure and Transparency

Chapter seven of the code of corporate governance deals with information disclosure and transparency in three areas: (1) listed companies ongoing information disclosure, (2) disclosure of information regarding corporate governance, and (3) disclosure of controlling shareholder's interest. Disclosure and transparency requirements in the light of the ongoing accounting reform in China are discussed in detail in chapter 5.

2.4 Legal Consequences of Non Compliance with Corporate Governance Regulations

The rudimentary legal framework and the essential absence of shareholder litigation do not provide a strong institutional foundation for legal consequences in the case of non compliance with CCGC regulations. China's corporate legal system (in particular the Company Law and the Security Law) does not have a long history and still needs revision in many aspects. Poor law enforcement is due to the insufficient evolution of institutional conditions. In 2002, the CSRC and the SASAC started to undertake joint inspections of all listed companies, to check whether listed companies abide by the guidelines or not (OECD 2005a:3). As this inspection was based on a self-check of the companies in question, the results were mainly positive.

Several scholars criticise existing public institutions for being weak in enforcement of laws and regulations. Tang (2008:147) argues that the Company Law does not

provide the CSRC with any specific power to curb illegalities, while the new Securities Law just ordered all listed companies to disclose their de facto controlling persons.²³ Clarke (2003:15) states that the CSRC as a quasi-government agency with the task of both enforcing the rules regarding disclosure and meeting the requirements of the investment quality of public issuers, the bureau is limited by its personnel scale to enforce the law²⁴.

In contrast to the OECD principles of corporate governance, Chinese corporate governance principles are not designed to be mandatory. It has to be questioned whether the CSRC has the tools to enforce compliance and the legal authority under Article §§167 of the Securities Law to regulate in this area (Clarke 2005:189). Mallin and Rong (1998) state that any system of corporate governance which develops in China is likely to embody the special role of the state and contain certain idiosyncratic aspects. Under a one-party system, a complete independent and uncorrupted judiciary is impossible.

Up until now, the three new corporate bodies created by the Company Law and the corporate governance code cannot function independently, and therefore the goals of the corporate governance reforms cannot be achieved. Although many SOEs have been transformed into business corporations, their management functions still tend to avoid the corporate governance requirements imposed by the Corporate Law and the corporate governance code and retain the traditional SOE governance model (Schipani/Liu 2001:14).

As mentioned above, the weak legal and institutional framework provided by the revised Company Law and revised Securities Law still shows limitations. In 2005, a revision of the Criminal Law was proposed, which would have made the directors, managers and the controlling shareholder of a listed company subject to criminal liabilities if they knowingly make the company: (1) provide commodities, services or

²³ §§71(1) Securities Law. Under the §§ 17(2) Company Law, the term controlling shareholder means a shareholder whose shares accounts for more than 50 per cent of total equity of a company limited by shares, or a shareholder whose shares account for less than 50 per cent but who holds the voting rights on the strength of its shares, which are enough to have an important influence on resolutions of shareholders general meeting.

²⁴ Bai/Xu/Ren (2005) undertook a survey with 607 samples of the administrative sanctions and disciplinary actions taken by CSRC, Shanghai and Shenzhen stock exchange up to the end of 2004. Estimating there are 600 – 2500 illegal cases which have not been detected and punished in the same period. The scarcity and inefficiency of the enforcement actions may be the result of: (1) deficiency of independence of the regulatory agencies; (2) deficiency of enforcement measures of the agencies; (3) complexity of the stock markets; (4) underdeveloped regulatory techniques and (5) flows in the regulatory institutions.

other assets to other units or persons while receiving no considerations; (2) purchase or sell commodities, service or other assets under manifestly unfair conditions; (3) sell commodities, provide services or transfer other assets to manifestly insolvent units or persons; (4) provide collateral for the debts of manifestly insolvent units or persons, provide collateral for the debts of units or persons without justified reasons; (5) disclaim a property right to bear a debt for others without justified reasons. The law revision is to strengthen the protection of minority shareholders and to improve corporate governance in China. In 2011, the National People's Congress Standing Committee has placed the revision of the law in its legislative agenda, and the revision of the Criminal Law eliminated the death penalty for thirteen economy-related crimes, as the government moved to restructure its penalty system and better protect human rights.

Clarke (2003:12) concludes that instead of the intended effect – more efficiency in state-owned enterprises due to the introduction of corporate governance – the opposite has been achieved: the entire corporate sector has come to be governed, to a significant degree, by principles that are needed and only applicable, if at all, to the state sector.

2.5 Relationship between laosanhui and xinsanhui

2.5.1 Institutional Change within Chinese State-Owned Enterprises

The transformation process from central planning to market economy requires the substitution of old institutions by new ones. Old institutions, which are characterised by rent-seeking and bureaucracy, need to be withdrawn in favour of new institutions characterised by performance and market orientation. New market institutions have been introduced to Chinese listed companies according to the needs of the capital markets, international standards and furthermore for the execution of corporate control. The new institutions consist of the shareholder's meeting, the board of directors, and the supervisory board. By introducing these new institutions, reformer failed to dismantle old structures. The coexistence of new and old corporate bodies is a distinctive feature of China's process of institutional transformation (Garnaut et al. 2005:128; Hua et al. 2006:405; Schipani/Liu 2001:18; Nee et al. 2007:28). The old corporate body is represented by the *old three committees* (老三会) including the

labour union, the employee representative committee and the Communist party committee. It now exists side by side with new corporate bodies. Central enterprise managers are deeply embedded in the overall system of patronage²⁵ that is the essence of Communist party rule in China (Naughton 2008). According to Chinese managers of SOEs, more than 50 per cent believe that the relationship between these two institutions is still characterised by contradictions (China Enterprise Federation 2001) which are not compatible (Renminribao 2003). Recently the SASAC (2008) even posed the question that under the assumption that most party committee members assume top management positions in large state-owned enterprises (thereby combining the position of a party member and a director in the company); would it not implicate insider control? The same ambiguity is observed for the recruitment of outside directors in state-owned enterprises, which should be independent by definition. As party committee members are still present in Chinese enterprises, their independence is questionable.

The relationship between the *old* and the *new three committees* in Chinese enterprises has been widely debated in Chinese literature (Liu Xiang-guo 2006; Tang You-Yuan 2006; Wang Tianyun 2007). One commentator argues that Chinese SOEs are covered on the outside with a new mantle, but from the inside the content remains the same (新瓶装旧酒) (Tang You-Yuan 2006). Going a step further, the Chinese debate is in fact concerned with the co-existence of state-socialist institutions with new market institutions. The legacy of the planned economy is characterised by an environment of weak economic institutions in which existing state-socialist institutions are still playing a significant role.

Under the old corporate bodies, SOEs were regarded as production centres of the government whose main task was to fulfil the production plans of the state bureaus. They were not compelled to focus on profit-maximisation. SOEs managers' performance was measured on the fulfilment of the production plans and not against resonance to the market situation. In actual fact, SOEs managers were more government cadres than professional managers. The introduction of new corporate bodies responds to the demand of the capital market and foreign investors. The goal,

²⁵ Informal institutions are heritage of Chinese culture that is based on traditional culture, personal networks, clientelism, patronage, corruption and clan organisation.

which is also heavily supported by the government, is to turn Chinese SOEs into more successful and more attractive companies. This can only be achieved if excessive governmental control is eliminated and if management is effectively held accountable for performance.

In economic terms, the institution of the *old three committees* can be translated into a state-oriented approach²⁶, whereas the new institution of the three corporate bodies refers to a shareholder-oriented approach. Liu Xiangguo (2006) states that in reformed state-owned enterprises the party committee still assumes a leadership role over the employee representative meeting and the labour union. Furthermore, since party committee members entered the board of directors, most of the time party committee members make company-related strategic decisions and exercise control over the company's management. This kind of disambiguity is a throw-back to the so-called *concurrent system* (兼任制) in state-owned enterprises, where top enterprise managers were required to act both as party secretaries and factory directors or chairs of the board of directors (You 1998). The overlap between the old and new corporate bodies provides a channel for political influence on corporate governance (Garnaut et al. 2005:128). On the one hand, there are the old values of tradition, conformity and collective spirit. On the other hand, there are the new values of transparency, openness, individuality and competition.

2.5.2 Empirical Evidence for Institutional Change in Chinese State-Owned Enterprises

In order to approach the debate in an empirical way, data for the Top 20 Chinese companies from the latest publication of the Fortune 2010 was used (Fortune 2010), which includes the annual reports and websites of the enterprises. Enterprises are chosen based on the ranking of the Top 20 Chinese companies according to Fortune 2010. For the following test, the following variables are relevant: dominant state-

²⁶ Party influence can be observed from the Communist Party Committee. Since the amendment of the Trade Union Law in 2001, trade unions are in charge of the core duties of a union, and are not protected by the state anymore. The state has withdrawn from management activities and rather supports management decisions. Anyway, unions have on the one hand to remain loyal to the Communist party and on the other hand respond to economic development (Heuer 2005). Additionally, they need to respond to the needs and requirements of their membership – especially in areas where the state has withdrawn its activities. Since the introduction of the contract responsibility system, the Employee Representative Meeting obtains a consultative role, and does not have much relevance. The influencing power remains with the Communist Party Committee, which holds control over the appointment and removal of relevant managers, the CEO of the board, and strategic decision-making (Liu Xiangguo 2006).

ownership, operating and cash flow result and corporatisation on the Chinese capital market. Taking the Top 20 Chinese companies from the latest publication of the Fortune 2010 listing of the World's largest 500 companies²⁷, the corporate structure and the relationship between the Top Management and the Chinese Communist Party and central government is analysed. Concerning the companies mentioned above, 19 out of 20 are clearly state-owned enterprises. Nearly 90 per cent out of the nineteen are based in Beijing, followed by Shanghai, Wuhan and Guangzhou. The results prove that 80 per cent of the board of director members are also party members. Furthermore 48 per cent of the board of director members, in particular the chief executive officer of state-owned companies, hold a post as a party secretary in the Communist Party. Their curriculum vitae show that most of the CEO's have spent their professional lives working in the private and public sectors. The survey also reveals that 53 per cent of the board of director members were working in public services before such as ministries, governmental departments and local bureaus. The typical professional career of a CEO of a state-owned enterprise involves party membership and work experience in the public sector. The combination of these two factors is the basis for networking which entails access to informal channels, information and resources.

The institutional shift has lead to the coexistence of two systems and proves to be much more complex than it was expected as the degree of duties, influence and decision-making power of each corporate body has not been clarified until now. The new corporate bodies are inhibited from carrying out their predetermined duties and therefore their efficiency has to be put into question. The co-existence of the *old three committees* (老三会) and the *new three committees* (新三会) in Chinese listed companies (Liu Xiang-guo 2006; Tang You-Yuan 2006; Wang Tianyun 2007) can be regarded as a unique feature of corporate governance in China and characterises the system of a hybrid economy. Thereby the Communist Party is creating an environment for its stakeholder position; they would not necessarily have in the role of the shareholder. The old corporate actors remain powerful in most of the SOEs and continue to play an influential role, which does not necessarily involve disadvantages for such a company. The informal, relation-based-structures (*guanxi* network) have a

²⁷ For a detailed analysis of China's Top 20 companies in 2010 see Chapter 3.

long tradition in China and have proven to be very efficient for certain interest groups. As far as it concerns the state-oriented approach, informal institutions are rather important. In contrast, the shareholder-oriented approach relies on the establishment of formal institutions. Certainly one may argue that informal networks are also omnipresent in Western enterprises outside of institutional systems. However, the significant difference to Western countries lies in the obstacles of enforcement of the rule by law in China. Clarke (2007) argues that despite the magnificent growth in the scale of economic activity since 1995, litigation comparatively falls behind and does not show any progress. Liebman (2007) states that the role of Chinese courts has reached a point where it is rather contested than trusted.

Due to well-working informal relationships and networks, newly introduced formal institutions within Chinese companies cannot become effective, and are restricted in their scope of activity, rather than being supported and protected. The thesis argues that because of well working informal networks, formal institutions have only limited impact on enterprises. These political and administrative networks inside companies are very complex and multilayered. In addition, regulatory frameworks are difficult to put into practice as the legal and judiciary framework in China is still weak and is lacking in assertiveness. In other words, the enactment of laws and regulations are insufficient as long as their enforcement mechanisms do not work.

Knowing these facts combined with historical and socio-political factors of Chinese circumstances of poor quality legal and regulatory institutions, it explains why people learned in the past to rely rather on interpersonal relationships than on formal institutions. Taking into account the low maturity of the rule of law, claims on the protection of the law are characterised by uncertainty with business people relying heavily on the social mechanism which is coordinating individual behaviour (Hendrischke 2007). *Guanxi* networks' crucial role is mostly caused by historical factors, as given the unstable environment in China enterprises were compelled to build up stable and reliant networks with all government levels. The role of *guanxi* networks changed over the time, since in the past traditional informal relations were rather describing personal and family-related networks, whereas today they are related to business. *Guanxi* networking is important to safeguard better access to scarce resources and an adequate supply of the necessary resources for the companies.

Furthermore networking is regarded as a guarantor of reliable firm performance because it allows firms to internalise market transactions and establish networks of value-creating relationships, including those with governments.

Additionally, in the course of the economic reforms, these administrative and political networks have not been eliminated. However, the new corporate governance bodies cannot act independently and the persistence of relation-based structures have to a certain degree had a negative effect on corporate governance reform in the long run. Assuming that members of these administrative-political networks are determined to protect their own interests, the resulting tension between shareholders and political elites creates a negative effect on the efficiency of the company. The *guanxi* (关系) network is present and will continue to be a distinguishing mark of Chinese business and economic environment in the near future. Informal institutions and *guanxi* networks are likely to reduce transaction costs and behavioural uncertainty during transactions. *Guanxi* network is regarded as a form of social network given that *guanxi* is a form of social capital and therefore *guanxi* practices are social exchanges (Peng/Luo 2000; Fu et al. 2006; Warren et al. 2004; Millington et al. 2005). As long as formal boundaries are not specified between old and new institutions, political influence and networking will prevail.

The conclusion is that internal corporate governance in Chinese corporations promotes and protects the economic position of the state and the Communist Party, which is regarded as the most sustainable form of corporate governance. The state and the Communist Party protect their interests by formal and informal means in order to influence and control corporate behaviour. The Communist Party does not only have economic interests in corporations, like shareholders do, but also political and social interests in addition to economic interests. By building-up a socialist harmonious society (和谐社会), the Chinese Communist Party is aware that the focus should be shifted from strong economic growth to promoting social security in the country. The Communist Party is aware of the need to respond to the social concerns from the general public, such as employment, healthcare reform, social security and affordable housing. On the other hand, the government is responding to the public through means of anti-corruption campaigns and by committing itself to be

more transparent in policymaking (Xinhuanet 2007). Chinese corporations are governed by the state to meet in first place the interests of the controlling shareholder state, and in second place the interests of international standards and international investors. Government bureaus usually primarily pursue the maximisation of a firm's value. The government being a shareholder, has a stake in the company, and wants its interests to be protected in a way that preserves resources. Despite ongoing efforts to strengthen new corporate institutions within Chinese state-owned enterprises by implementing international standards, deep rooted historical and institutional criteria continue to be active. The result is that old and new institutions coexist side by side, causing tension between the two. The survival of elements of the old institutions relies strongly on their flexibility to adapt to the demands of the dynamically changing environment. This standing is intended in order to maintain the traditional relationship and cooperation between the state, the Communist Party and enterprises. From the perspective of the ruling elite, these mutually supportive relations between the state and enterprises and between the Communist Party and enterprises respectively, based on an old institutional framework which functioned well to a certain degree during the Maoistic phase, requires a new organisational culture between state and economy. The view of the ruling elite whereupon the dysfunctions in the system have resulted in the decision of the economic reforms and opening up in 1978.

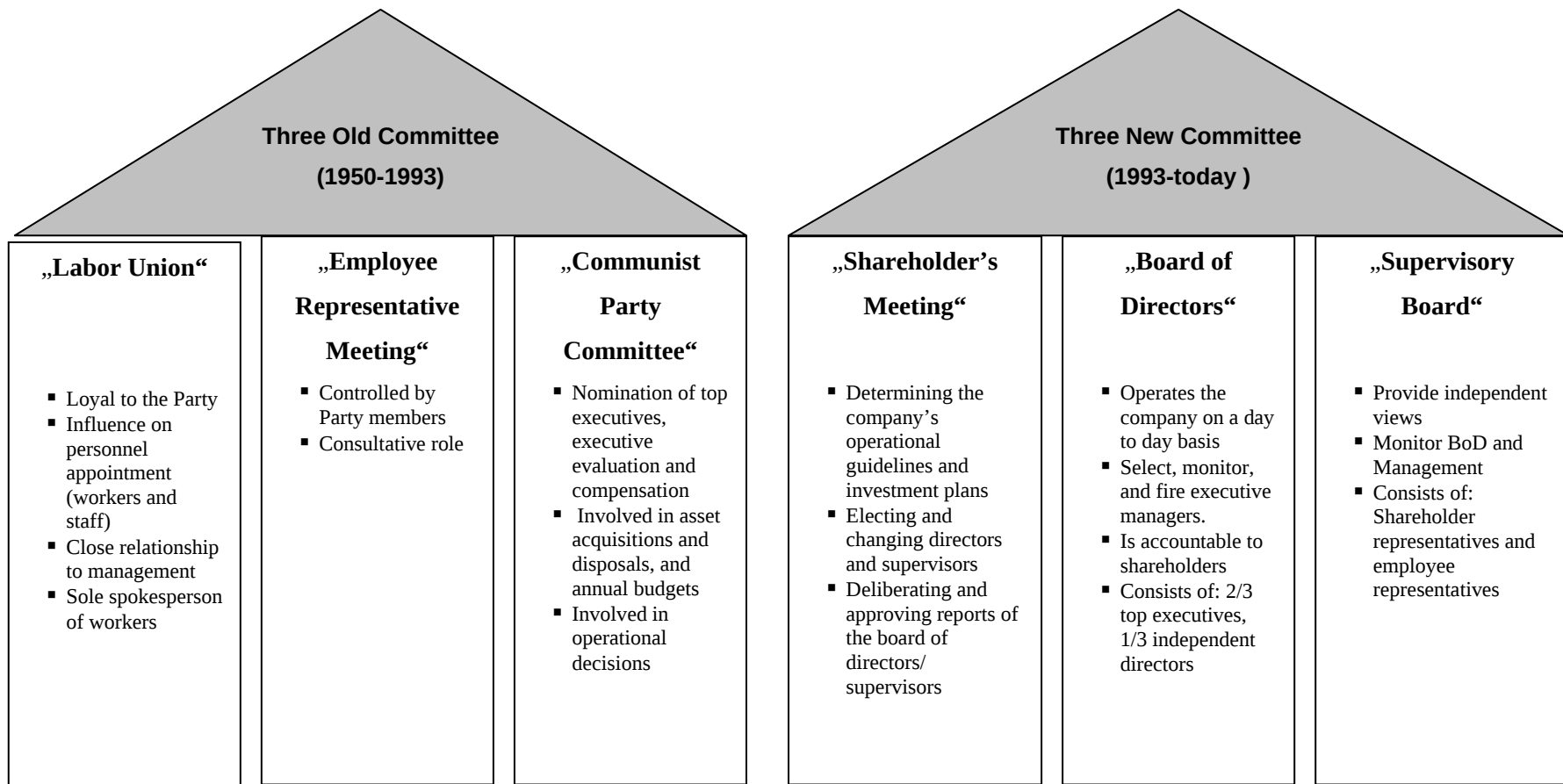


Figure 2: The three old committee and three new committee

2.6 Conclusion

The reorganisation of state-owned enterprises aims to separate enterprises from the government (政企分开). The government is tending towards withdrawing from the economy and allowing market forces to become more effective. Under the centrally planned system, the management of an enterprise possessed hardly any specific control rights, as branch ministries and bureaus of the government kept specific and residual control (Qian 1996:5). In the framework of the enterprise and corporate governance reform, control rights are shifted towards the management of the companies. Corporate governance elements have been implemented within enterprises, without dismantling traditional state institutions. With the Company Law (1994), new corporate bodies were introduced to Chinese enterprises, such as the board of directors, shareholders meeting and supervisory board. Now these new corporate bodies coexist next to socialist state institutions. From the internal corporate governance perspective, the relationship between the state and state-owned enterprises changed insofar as socialist state institutions do not possess monopoly control rights anymore. Socialist state institutions now have less scope left for direct interference and have to share control rights with the new corporate bodies. The coexistence is intended in order to maintain the traditional relationship and cooperation between the state and enterprises and between the Communist Party and enterprises respectively.

Nonetheless, state and Communist Party intervention still persists in Chinese listed enterprises. Therefore, the management does not only serve the shareholder's interest, which is the state, but also the Communist Party's interest. So, traditional supportive relations between enterprises and the Communist Party are preserved. The Communist Party maintains direct control and power through their participation in the new corporate bodies as members of the board of directors. This is possible as Communist Party members of the party committee now fill the positions of chief executive officer or director. The state maintains control over strategic decisions by being supplier of financial sources as the controlling shareholder. By approving or withholding funds, the state can directly interfere into the decision making process of the board of directors. Both the Communist Party as well as government influence

companies' decision in important areas such as the nomination of top management, executive assessment and compensation, asset acquisitions and divestments and annual budgets. They also possess a voice in the operation of the business.

This thesis shows that the CEO of a Chinese company fulfils three different roles, being the key representative of the corporation. Today the task of a Chinese CEO is to encompass differing interests which contains (1) the needs of the company and the employees, (2) political objectives and (3) the need to respond to shareholder and market requirements. By responding to the needs of the company and the employees, the CEO is taking over a *father* role. He is interested in transforming the company into a global player which can sustain its position in the national and international market. By responding to the needs of the Communist Party, being a party member, the CEO is charged with considering the social objectives of the Communist Party such as a low unemployment rate²⁸. Social objectives have been added to the economic reform process under Hu Jintao and Wen Jiabao. Under the leadership of Jiang Zemin and Zhu Rongji, the policy programme was a commitment towards encouraging economic progress only and neglecting social objectives. Given that China was officially at the primary stage of socialism, the view was held that economic progress would automatically contribute towards solving social problems. Therefore the Communist Party's prior objective was to adapt national policies in a way in which it could optimise market conditions. Under the leadership of Hu Jintao and Wen Jiabao, the attitude changed significantly, especially in the light of the increasing level of social tension and unrest in the country. With the introduction of the current official guiding socio-economic ideology of the *scientific development concept* (科学发展观), the Communist Party incorporates sustainable development, social welfare, a person-centred society and increased democracy with the aim of the creating a *harmonious society* (和谐社会). This approach responds to the country's increasing instability and social problems, such as employment, healthcare reform, social security and affordable housing. By building-up a *socialist harmonious society* (和谐社会), the Chinese Communist Party is aware that the focus should be shifted from strong economic growth to promoting social security in the country. Social

²⁸At the 17th National Congress of the Communist Party of China, Hu Jintao declared employment as one of the important measures to improve the people's livelihood. Other social objectives declared by the Communist Party of China are people's rights to education, medical and old-age care, and housing (Xinhuanet 2007).

issues have been brought to the attention of the Communist Party and have been discussed (Xinhuanet 2007). Thereby the Communist Party is taking on a mediator role between differing voices coming from the grassroots level, with the mutual aim of the realisation of a harmonious society. In actual fact, the Communist Party still articulates economic goals, such as the optimisation of economic structures and of economic returns.²⁹ Due to the two reasons mentioned above, the CEO is subject to major constraints that a CEO in a Western company does not have to deal with. By acting as a corporate manager, the CEO has to respond to the requirements of the shareholder and the market. The shareholder, which in the Chinese case is the state, demands high dividends, and high performance management, cash flow management and risk management, which involve cost reduction and restructuring programs. These profit-maximising targets are in contrast to the social objectives of the Communist Party. In the domestic market, state-owned enterprises still have a monopoly and therefore work in a protected market due to government regulations. In international markets, companies are exposed to market forces, global competition and dynamic environment changes.

Three roles of Chinese CEO in SOE			
<i>Role</i>	1. CEO/ Chairman	2. CPC member	3. Corporate Manager
<i>Task</i>	Respond to the needs of the company and the employees	Respond to the needs of the CPC	Respond to the demand of the → shareholder → domestic market → global market
<i>Requirement</i>	Transform company into a global player “Father” figure for the employees	Corporate decisions shall take into account national policies Low unemployment rate Optimization of economic structures Corporate social responsibility	Dividend High market share Cash Flow management Cost reduction programs Corporate governance Performance management Risk management Global market competition Chinese Companies Going Global
<i>Orientation</i>	Efficiency- and value orientation	Value orientation	Efficiency- and transparency orientation

Figure 3: Three roles of Chinese CEO in state-owned enterprises

²⁹ At the 17th National Congress of the Communist Party of China, Hu Jintao stated that China’s goal is to quadruple the per capita value of GDP by 2020 and complete the building of a *moderately prosperous society in all respects* (Xinhuanet 2007).

China's largest state-owned enterprises have shown strong efforts towards competing in the global market scene, with the aim of increasing market expansion, acquiring foreign technology and innovation and safeguarding resources. Recent examples of large-scale Chinese acquisitions abroad prove this tendency, e.g.; Lenovo's acquisition of IBM's PC business in 2004 and the takeover of the appliance manufacturer Maytag by China's largest home appliance maker Haier in 2005. The Chinese government encourages large enterprises in particular through the initiative *Chinese Companies Going Global* to expand overseas. Large state-owned enterprises are encouraged to acquire overseas companies, becoming multi-national companies by integrating them into a single corporate global brand name. Moreover, overseas acquisitions support the exigency of safeguarding natural resources in the long run.

For the CEO of a Chinese listed company it is quite challenging to align the Communist party's social objectives with the political objectives of the government and the economic objectives of the shareholders, whilst at the same time being responsible for the company and the employees. It is difficult for the board of directors to maintain managerial independence, while trying to respond to differing interest groups. On the one hand, business operations are supposed to be free from interference from any organisations and individuals. On the other hand, corporate management relies on guidance and direction from the party and the controlling shareholder. Due to this complexity and sensitivity the implementation of good corporate governance combined with transparency and efficiency is hard to achieve.

3 Restructuring of the Chinese State-Owned Sector

The modernisation of enterprises and associated market institutions started over a quarter of a century ago, with the aim of strengthening and increasing the growth and efficiency of the national economy. However, for reasons explained and outlined below, the enterprise reform cannot be seen as an isolated reform, but is instead directly associated with the reform of the banking sector, capital market and the implementation of a nationwide social security system³⁰.

3.1 External Corporate Governance and Institutional Change in State-Owned Enterprises

Since the early 1950's Chinese SOEs are an integral part of the Chinese economy. Under the command economy, their main function was to provide revenue as source of general funds to the Chinese government. Many Chinese SOEs, similar to their European state-owned counterparts in former communist countries were formerly private companies which were nationalised following the Communist revolution (World Bank 1997). Nowadays, it is not only the central government that has a stake in Chinese state-owned enterprises, but also provincial and local governments. Before the reforms, SOEs represented the dominant economic force in the country in terms of their contribution to industrial output.

³⁰ Related concerns also include the establishment of an appropriate judiciary system, encouraging a competitive environment and training of managers.

Year	Number of industrial enterprises (unit)	Number of state-owned and state-holding industrial enterprises (unit)	Share of state-owned and state-holding industrial enterprises in total industry in %	Share of industry output of state-owned and state-holding industrial enterprises in total industry in %
1998	165.080	64.737	39%	50%
1999	162.033	61.301	38%	49%
2000	162.885	53.489	33%	47%
2001	171.256	46.767	27%	44%
2002	181.557	41.125	23%	41%
2003	196.222	34.280	17%	38%
2004	276.474	35.597	13%	35%
2005	271.835	27.477	10%	33%
2006	301.961	24.961	8%	31%
2007	336.768	20.680	6%	30%

Table 1: State-owned industrial enterprises (1998-2007)

Source: Calculated from China Statistical Yearbook 2008

In the recent years the number of state-owned industrial units decreased substantially (see table 1). The total number of SOEs has been reduced by means of change in ownership, bankruptcies and divesting. Additionally, two reasons can be identified for this trend since 1998. First, the number of firms classified as *SOE* decreased in the last years. According to Chinese statistical classification an enterprise is categorised as a *SOE* if the state ownership share is more than 51 per cent and annual sales are more than RMB 5 million³¹. Secondly, changes in ownership forms transformed SOEs into corporations.

In China, enterprise classification involves four main types of ownership and can be distinguished as followed: state-owned enterprises (SOE), collectively-owned enterprises (COE), privately-owned enterprises (POE) (including former township and village enterprise; TVE), and foreign-owned enterprises (FOE) (units with funds from Hong Kong, Macao and Taiwan, and other foreign funded units). All enterprises are required to register their ownership type with the State Administration of Industry and Commerce (SAIC 1998).

³¹ Data for Chinese state-owned industrial enterprises, available in China Statistical Yearbook, includes only those with state ownership share more than 51 per cent and annual sales income of over five million RMB. Small state-owned industrial enterprises are excluded.

The size of the state sector is different in terms of asset-ownership, which has settled at approximately 45 per cent (see table 2), whereas investment in fixed assets has remained the same for twenty years (see table 3).

Year (in RMB 100 million)	Total assets of industrial enterprises	Total assets of state-owned and state shareholding industrial enterprises	Total assets of private industrial enterprises	Total assets of industrial enterprises with Hong Kong, Macao and Taiwan and foreign funds	Total assets of other *) industrial enterprises		Share of state-owned and shareholding industrial enterprises in total assets in %	Share of private industrial enterprises in total assets in %	Share of industrial enterprises with Hong Kong, Macao and Taiwan and foreign funds in total assets in %	Share of other*) industrial enterprises in total assets in %
1998	108.822	74.916	1.487	21.327	11.092		69	1	20	10
1999	116.969	80.472	2.289	23.019	11.189		69	2	20	10
2000	126.211	84.015	3.874	25.714	12.608		67	3	20	10
2001	135.402	87.902	5.902	28.354	13.245		65	4	21	10
2002	146.218	89.095	8.760	31.514	16.850		61	6	22	12
2003	168.808	94.520	14.525	39.260	20.502		56	9	23	12
2004	215.358	109.708	23.725	55.602	26.323		51	11	26	12
2005	244.784	117.630	30.325	64.308	32.521		48	12	26	13
2006	291.215	135.153	40.515	77.109	38.438		46	14	26	13
2007	353.037	158.188	53.305	96.367	45.178		45	15	27	13
*) Collective-owned Enterprises, Cooperative Enterprises, Joint Ownership Enterprises										

Table 2: Total assets of industrial enterprises (1998-2007)

Source: Calculated from China Statistical Yearbook 2008

Economic Unit	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
State-owned units	63%	61%	61%	65%	66%	67%	61%	56%	54%	52%	52%
Collective-owned units	15%	16%	14%	12%	13%	17%	18%	16%	16%	16%	15%
Private-owned units	22%	23%	25%	23%	21%	16%	12%	12%	13%	14%	14%
Joint Ownership units								1%	1%	1%	0%
Share Holding units							2%	4%	4%	5%	6%
Foreign Funded units							4%	8%	8%	8%	8%
Units with Funds from Hong Kong, Macao and Taiwan							2%	3%	3%	4%	4%
Other							1%	0%	0%	1%	1%
Economic Unit	1998	1999	2000	2001	2002	2003	2004	2005	2005	2006	2007
State-owned units	54%	53%	50%	47%	43%	39%	36%	33%	33%	30%	28%
Collective-owned units	15%	15%	15%	14%	14%	14%	14%	13%	13%	4%	4%
Private-owned units	13%	14%	14%	15%	15%	14%	14%	16%	16%	22%	24%
Joint Ownership units	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Share Holding units	7%	8%	12%	15%	19%	23%	25%	27%	27%	31%	31%
Foreign Funded units	6%	5%	4%	4%	4%	5%	5%	5%	5%	6%	5%
Units with Funds from Hong Kong, Macao and Taiwan	5%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
Other	0%	0%	0%	0%	0%	1%	1%	1%	1%	2%	2%

Table 3: Percentage of investment in fixed assets by different economic units (1987-2007)

Source: Calculated from China Statistical Yearbook 2008

According to theory, in a perfectly competitive market, capital is allocated with the aim of maximising returns within a limited timeframe. In China the capital allocation mechanism is not necessarily subject to profit maximisation. Table 3 illustrates that the proportion of investment in fixed assets remained more or less the same from 1987-2007. In 1987, for the non-state sector, investment in fixed assets accounted for 37 per cent of total investment, in 2007 it was 40 per cent. The investment share of the non-state sector was always above one-third of total investment during this period. In 1987 state sector investment in fixed assets accounted for 63 per cent of total investment, in 2007 it was 60 per cent. The state-sector has a continuing investment share of two-thirds in fixed assets over time. The state sector is comprised of state-owned units and share-holding units, since former state-owned enterprises have been turned into share-holding enterprises over the last number years. This process allowed the companies to get listed on the stock market, without running the risk that the state might lose control over assets. The sudden increase of the proportion of capital investment to state-owned units by 10 per cent to 54 per cent in 1995 can be explained by an incremental shift of capital investment to share-holding units. Therefore the increase of the proportion of investment in fixed assets of share-holding units from 0 in 1992 to 31 per cent in 2007 is the logical consequence of the ongoing corporatisation process. Hence, the state remains as the main contributor of investment in fixed assets with a dominant portion of 60 per cent in 2007. According to this development, the capital allocation mechanism is not assumed to be employed according to efficiency reasoning. Under the assumption that the non state-sector is much more driven to maximise profit and investment decisions are related to return on investment; the non state-sector does not have any impact on the allocation mechanism.

SOE share of industry output in the total industry has shrunk significantly, reform of Chinese SOE plays an integral role in Chinese economy. Former president Jiang Zemin (People's Daily 2002) said that "the reform of state-owned enterprises in China will remain the central task of the economic restructuring." The State-owned Assets Supervision and Administration Commission (SASAC), the supervisory body of state assets (China Daily 2004a), confirms that state-owned enterprise reform is at the core of the entire economic reform in China. Justin Yifu Lin (2005), chief economist at the World Bank, addresses that "China's transition towards a market

economy depends on a final solution to the viability problem of firms in the traditional sectors. Since the viability problem is not yet solved, the Chinese government has been required to continue its interventions in markets in order to protect/subsidize the nonviable firms and the interventions come with consequences.” The IMF (2003) critically notes that “recent reforms have resulted in some efficiency gains but have been unable to substantially improve corporate governance and impose financial discipline, especially in the large SOEs.” SOEs still maintain a dominant position in China’s key industrial economy. In March 1989 the State Council implemented the first industrial policy guideline. The reform of state-owned enterprises in China was introduced during the 4th plenary session of the 15th Congress of the Communist Party of China by the passing of the “Decision of the Central Committee of the Communist Party of China on Some Major Questions of the State-owned Enterprise Reform and Development” (People’s Daily 1999).

China’s policy makers are determined to preserve important national assets and not to lose them to foreign investors, especially when it comes to the highly political question of the future of state-owned enterprises. Defined state enterprises represent the mainstay of China’s economy and the central government retains control of key industries. In 2006, the State Council released an explicit policy paper in which it outlined the strategically important sectors over which the state must maintain absolute control. The definition of what exactly these strategically important sectors were had been vague before. The chair of the SASAC, Li Rongrong, said that “the state should solely own, or have a majority share in, enterprises engaged in power generation and distribution, oil, petrochemicals and natural gas, telecommunications and armaments. The State must also have a controlling stake in the coal, aviation and shipping industries. Furthermore, reform and restructuring should be accelerated in SOEs engaged in the downstream petrochemical sector and in value-added telecom services, to allow injection of private or foreign capital. Central SOEs³² should also become heavyweights in sectors including machinery, automobiles, IT, construction, iron and steel and non-ferrous metals” (China Daily 2006).

³² Since the founding of the SASAC (State Assets Supervision and Administration Commission of the State Council) in 2003, a classification of central enterprises (中央企业) has been undertaken. Central enterprises are by definition, those enterprises regarded as key SOEs by the government. Key SOEs are main contributors to SOE profits and obtain about 25 per cent of SOE corporate investment. Key SOEs represent the foundation of China’s modern economy, nationally, as well as internationally.

By strategically formalising the key economic sectors, the government is committed to allocating capital to priority industries and to retreating from non-essential areas. Enterprises operating in these key sectors already rank among the most profitable in earnings and are the largest in size; i.e. tobacco, petroleum and natural gas, electric power and coal mining (see table 4). Key sectors in manufacturing include steel, chemicals and machinery. Key infrastructure sectors are banking, telecommunication and distribution. These industries are not only highly protected by the central government and party officials, but are also containing the vested interests of local institutions and officials. It is worth mentioning that the state is the main provider of infrastructure in China. These companies produce products and services which are necessary for further infrastructure development in backward regions of China. Due to the global economic crisis and the impact it is having on the Chinese economy, and since GDP growth is not double-digit anymore, the Chinese government issued a number of measures to boost industry's and the public's confidence in the Chinese economy. The most significant of these was a USD 586 billion (RMB 4 trillion) stimulus package and subsequent revitalisation plans for key industries (Businessweek 2009). Further government infrastructure spending reduces the dependence on external global markets and on export.

	Value added			Fixed capital and inventory	Employment	Number of companies
	1998	2003	2007			
Manufacture of tobacco	98.9	99.3	99.8	99.2	95.5	78.6
Extraction of petroleum and natural gas	99.9	99.9	97.2	97.0	97.7	90.6
Production and supply of electric power and heat power	87.5	94.0	88.6	87.9	87.6	62.4
Production and supply of water	95.4	96.1	68.2	92.1	96.2	70.4
Mining and washing of coal	83.3	80.8	66.5	80.8	70.0	11.2
Processing of petroleum, coking, etc.	87.5	81.0	62.3	68.5	50.0	10.3
Manufacture of transport equipment	69.3	64.6	48.9	55.3	37.1	9.5
Production and supply of gas	82.7	74.9	46.2	61.0	65.8	36.8
Smelting and pressing of ferrous metals	78.7	66.0	45.4	61.2	43.9	4.6
Mining and processing of non-ferrous metal ores	57.1	44.5	34.6	45.4	41.9	14.1
Smelting and pressing of non-ferrous metals	58.5	48.1	34.1	47.2	36.3	6.5

Table 4: Industries with the highest degree of state-control
Source: OECD (2010:114)

By defining the area of state ownership in such a precise way, the government has openly declared which key sectors will be excluded, or severely limited to, foreign investors, in their allowable percentage of share acquisition. Key industries are also protected against hostile takeovers. Protection of key industries is also observed in Western countries. Measures taken to protect domestic enterprises from being

acquired by undesirable foreign investors have been observed in Germany (Businessweek 2007), as well as Russia (BBC News 2006) and France (Spiegel 2008). In Germany, policy makers have chosen not to define which industries are regarded as being strategically important, instead, the economics minister decides on a case-by-case basis (Businessweek 2007). The Chinese government also defined the automotive and IT sector as key sectors in which it is trying to obtain a controlling stake. The same is observed in France where the state plays a strong role in car manufacturer Renault and France Telecom.

The ongoing classification of several key industries in the national economy has already proven to be successful. For empirical relevance the data for the Top 20 Chinese companies from the latest publication of the Fortune 2010 (table 5) was used, which proves that in an international environment Chinese restructured enterprises are competitive. According to the latest Fortune 2010 publication which lists the world's largest 500 corporations, five Chinese companies rank among the world's largest 100 enterprises. The five companies are *Sinopec* (petroleum refining) with revenue of USD 187.5 billion, *State Grid* (utilities) with USD 184.5 billion, *China National Petroleum* (petroleum refining) with revenue of USD 165.5 billion, *China Mobile Communications* (telecommunication) with revenue of USD 71.7 billion and *Industrial & Commercial Bank of China* (banking) with revenue of USD 69.3 billion. According to the ranking, state-owned companies dominate the list, occupying nineteen enterprises out of twenty. The largest private company on the list, the Hong Kong trading company Noble Group, came in nineteenth, though its revenues rose to USD 31.2 billion (Fortune 2010). The Industrial & Commercial Bank of China, which is the largest of China's *Big Four* state-owned commercial banks, provided the largest initial public offering worldwide³³, raising a record breaking USD 21.9 billion in October 2006. As China's biggest bank by revenue and Asia's most profitable bank, with profits of USD 18.8 billion in 2009, it came in fifth on the 2010 Fortune list (Fortune 2010). In the following section the reform of state-owned enterprises will be analysed.

³³ The IPO of ICBC exceeded the current record holder, a USD 18.4 billion initial public offering by NTT DoCoMo of Japan in 1998.

2009 National Rank	2009 Global Rank	Company	Revenues (\$ millions) ¹	Profits (\$ millions) ¹	Number of Employees	Location	Industry
1	7	Sinpoec - China Petroleum & Chemical	187,518	5,756	633.383	Beijing	Petroleum Refining
2	8	State Grid	184,496	-343	1.533.800	Beijing	Utilities
3	10	China National Petroleum	165,496	10,273	1.649.992	Beijing	Petroleum Refining
4	77	China Mobile Communications	71,749	11,656	228.437	Beijing	Telecommunications
5	87	Industrial & Commercial Bank of China	69,295	18,832	389.827	Beijing	Banking
6	116	China Construction Bank	58,361	15,628	301.537	Beijing	Banking
7	118	China Life Insurance	57,019	3,125	119.332	Beijing	Insurance
8	133	China Railway Construction	52,044	960	235.387	Beijing	Engineering, Construction
9	137	China Railway Group	50,704	1,008	276.150	Beijing	Engineering, Construction
10	141	Agricultural Bank of China	49,742	9,514	441.144	Beijing	Banking
11	143	Bank of China	49,682	11,868	262.566	Beijing	Banking
12	156	China Southern Power Grid	45,735	251	303.184	Guanzhou	Utilities
13	182	Dongfeng Motors	39,402	720	143.792	Wuhan	Automotives
14	187	China State Construction Engineering	38,117	839	111.587	Beijing	Engineering, Construction
15	203	Sinochem	35,577	659	44.256	Beijing	Trading
16	204	China Telecommunications	35,557	581	495.239	Beijing	Telecommunications
17	223	Shanghai Automotives	33,629	1,070	69.931	Shanghai	Automotives
18	224	China Communications Construction	33,465	704	106.150	Beijing	Engineering, Construction
19	242	Noble Group (Hong Kong)	31,183	556	4.900	Honkong	Trading
20	252	China National Offshore Oil	30,680	3,634	65.800	Beijing	Mining, Crude-oil production
Notes: ¹ All dollar values were converted using the 31.12.2009 exchange rate of RMB 6,828 per US dollar. ² Market value is based on all shares outstanding, including those held by the government.							

Table 5: China's Top 20 companies 2010 (ranked by 2009 revenues)

Source: Fortune (2010)

3.1.1 Institutional Change despite Path Dependence

This thesis applies new institutional economics, as principal agent theory, transaction costs theory and property rights theory represent the supporting theoretical pillars of a corporate governance system. All three elements refer to the discipline of new institutional economics, and are leading approaches in respect to the analysis of organisations in economics. For China, the concept of new institutional economics is applied in regard to institutional system change under economic transformation. Economic reforms in China are characterised by path dependence (North 1990). The legacy old institutions from the centrally planned economy, results in the coexistence of old and new institutions in the transformation economy. Due to path dependency, this situation leads to an inconsistency within the institutional framework and hampers the transition process to a market economy. Institutional reforms in China are delayed and are to a certain degree suboptimal due to informal institutional arrangements, which have an active interest in the preservation of restrictions and are characterised as being reform-reluctant. These institutional arrangements can influence institutional change to a certain extent by influencing the degree of change of rules within transformation. The exertion on influence against widespread reforms is possible as the Communist Party holds its position in the long term and policies can be designed, independent from democratic elections. As already outlined above, the reform process in the state-owned sector led to substantial gains in the economic sector, and not to losses. Macroeconomic expenses of the transformation process arise from vested interests, which want to safeguard their position by means of reform blockades. Economic reforms have not been carried out with a political reform, but the political system changed to being characterised as federalism, *Chinese style* (Montinola/Qian/Weingast 1995; Krug et al. 2005; Krug/Hendrichske 2008; Hauff 2002). Regarding federalism as an institution, power devolves from the central to the local levels, which leads to interjurisdictional competition and authority decentralisation over public goods with varying levels of government. In general, federalism theory assumes benevolent governments at all levels (Qian/Weingast 2005).³⁴ Further research focuses on fiscal federalism in China (Qian/Weingast 1997, 2005). Krug and Hendrichske (2008) argue that new institutional structures in China

³⁴ The opposite approach from the benevolent government is the Leviathan government (Buchanan 1975).

are emerging due to entrepreneurship and networks, which are choosing organisational forms and investing in organisational capabilities.

The new institutional economics approach is applied as an analysis tool in order to find an explanation for the ongoing transformation process in China, combined with the restructuring of the state-owned sector. The following chapters attempt to align the economic analysis of the external corporate governance framework with the examination of Chinese cultural specific features. Generally speaking, a transformation process in an economic system allows the substitution of certain arrangements such as hierarchy versus market. The old system has been replaced by a new system. Finally, the transformation process should end in a functioning market economy (Bohnet 2006). By changing the coordination mechanism in the economy, differing influencing factors have to be adjusted such as the property rights regime, institutional rules and the principal-agent relationship. In addition hard budget constraints need to be introduced, and transaction costs have to be reduced. Finally, the system of governance has to be rearranged in the economy. According to the theory, all these adjustments lead to lower transaction costs (North 1997). A fundamental change in the governance system implies a change of the rules and institutions initiated by economic and political forces. Previously existing institutions will be removed to the advantage of new ones. The exchange of old institutions by new institutions for the coordination of market activities always generates transaction costs. Ideally, the new institutions should cause lower transactions costs than the old ones. Institutions evolve and shape arrangements in a dynamic and competitive environment, being divided into formal and informal institutions. North (1990) states “how and why institutions change incrementally and why even discontinuous changes are never completely discontinuous are the result of imbeddedness of informal constraints in societies”. Formal institutions involve institution creation, contracting, laws and regulations. Informal institutions involve behaviour, habits, unwritten customs and beliefs. Whereas formal institutions are codified rules and codes which are put down on paper, informal institutions base upon unwritten beliefs, customs, conventions and norms of behaviour. Consequently, imbedded informal institutions are much more reform-resistant than formal institutions. Institutions have several characteristics that influence behaviour; they (1) create incentives, (2) coordinate behaviour, (3) guide self-selection, (4) provide information on procedures, (5) allow

for causal attributions and (6) influence preferences related to intrinsic and extrinsic motivation (Bohnet 2006). Knowing an economy's culture and history helps in understanding the objectives and preferences of the agents which are part of networks. In fact, wealth distribution arises from the rules which are defined by these institutions. Therefore, institutional change is always subject to lock-in effects and path dependence (North 1990). China's economic reforms are path dependent, and decision makers are locked into this certain path, even though past circumstances may no longer be relevant or another alternative would have been better. History and tradition plays an important role in path dependence, as historical preconditions have an impact on the path chosen. North (1990) argues that a change in the path is possible but entails high transaction costs. Therefore the coexistence of institutional systems with differing efficiency levels is the norm. In the Chinese case, the coexistence of socialistic and market-based institutions indicates that gradual reform efforts mostly result in partial reforms. North (1990) further argues that gradual reforms are mainly triggered by individuals and organisations, which are determined by vested interests. Hereby institutional change is a product of vested interests and competition among the organisations. These partial reforms do not necessarily produce more economic efficiency and transparency. Partial reforms are expected to generate rent-seeking opportunities arising from price differentials between the liberalised sectors of the economy and those still coordinated by nonmarket mechanisms (Murphy/Shleifer/Vishny 1992).

In order to understand China's reform of state-owned companies one must analyse China's industrialisation process within a wider historical context. The industrialisation process was characterised by major national experiments to reconcile socialist revolutionary principles with industrial development to achieve organisation without bureaucracy. Under the leadership of Mao, the objective was to elaborate an industrialisation process. In China, already in the Maoist phase, reforms being in line with party policies are always carried out through the trial-and-error method; this is referred to by the Chinese as *crossing the river by stepping on each of the stones*. Major reform endeavours follow a three-step process. Starting on an experimental basis, pilot projects are conducted on local levels. Positive results are analysed and the lessons learned are further implemented in several provinces. The last step of the process includes identifying successful pilot projects and proposing them to the

central government with a catalogue of measures for nationwide implementation. Famous example are the TVEs (township and village enterprises), which were originally initiated by local governments. The special feature about TVEs is that they never operated in urban areas, and were never part of central planning (Walder/Oi 1999). Other former communist countries like Poland, Czechoslovakia and Russia announced the *big bang policy* to transform the country rapidly into capitalism. Chinese reformers tended instead to embrace an evolutionary and gradual reform process, which saw measures for transition being carried out step by step, without consulting a grand plan for reform³⁵.

Chinese policymakers tackled the reform with remarkable determination by founding the State Assets Supervision and Administration Commission of the State Council (SASAC) in 2003. The SASAC is authorised by the State Council. Its defined task is to supervise and manage, on behalf of the state, state-owned assets and to advance the reform and restructuring of state-owned enterprises³⁶. Aside from its central bureau, regional branches have been established to govern local enterprises. Furthermore the SASAC provides administrative support to domestic and foreign private investors purchasing these businesses. Following theoretical reasoning, SASAC has been established to function as an intermediary between the state and state-owned enterprises, according to the principle that the function of public administration shall be separated from the function of the owner. So far 128 central enterprises are under supervision of the central SASAC (SASAC 2010a), with the goal to cut the number of SOEs under its supervision to less than 100. At the same time, SASAC's head Li Rongrong states that another objective of the streamlining process is to get 30 central enterprises ranked among the world's top 500 companies by 2015 at the latest (Xinhuanet 2007).

3.1.2 Transformation related Agency Problems

With the introduction of SOE reform, there was no intention to abolish state ownership, but rather to increase efficiency within state ownership (Zhang Weiying

³⁵ Qian (1999b:44) argues that that kind of comparison is inappropriate. Hungry, Poland and Soviet Union, as well as China went through a two-stage process: First reforming the planned system and then building the market system.

³⁶ Classification of Chinese SOEs into *Central enterprises* (中央企业) by name, and *Key enterprises* (国有重点企业) by region and name are listed on the homepage of SASAC (SASAC 2010ab).

1999:15). The reform path chosen was *through corporatisation*, and definitely *not through privatisation* (Lin 2001; Walder 1995; Rawski 1994, 1999; Zhu 1999)³⁷. The goal was that through corporatisation, SOEs management would be finally separated from the government. However, the government also apparently wants to retain a dominant shareholder position in large SOEs. There are three reasons that corroborate why China's state-owned enterprise reform never pursued the privatisation policy as the primarily objective (Chunman 2000):

- One is the functional reason. The state-owned enterprises are the material foundation of Chinese socialism. They play a dominant and crucial role in the national economy and do not only appear in situations where *the market does not work*.
- The second is the number. The number of state-owned enterprises, the fields they cover, the capital scale they occupy and their proportion of the whole national economy is big in China compared to other countries.
- Thirdly, because of the previous two reasons, the operation and development of China's national economy largely depend on the vitality, adaptability and efficient development of the state-owned enterprises in the market economy.

Measures taken towards corporatising the state sector mainly targeted the large-scale state-owned enterprises which the state declared as the backbone of the China's national economy. Concerning this strategically important target group, the central state explicitly articulated strong and substantial interest in keeping state ownership. Corporatisation and restructuring are much more in line with China's socialist legacy and therefore are more common than privatisation (Oi 2003:2). During the Ninth Five-Year Plan (1996-2000) the program of *grasping the big and letting go of the small* (抓大放小) was introduced, with the aim of retaining ownership of strategic control over large SOEs in key industries and infrastructure sectors and letting go small and medium SOEs by means of ownership change. Whereas large SOEs were transformed into corporations, a huge number of small and medium SOEs were privatised during that period. Oi (2003) argues that political constraints in China have resulted in significant corporatisation and restructuring but relatively little

³⁷ Privatization of SOEs was the prevailing pattern for the Soviet Union and Eastern European countries in the reform process.

privatisation. Furthermore she observes that privatisation has taken place primarily within medium and small enterprises, while corporatisation and restructuring has taken place in large enterprises. The diversification of the ownership of small and medium SOEs has been driven by local governments, largely in response to the poor financial performance of firms under their control.

In the context of SOEs reform, public ownership of state-owned companies was transferred from central government to local governments and from government to enterprises, families and private persons (Oi/Walder 1999). In other words, the decentralisation of public ownership was a top-down process, whereby the management of public assets is a bottom-up process. This path was chosen intentionally, with the aim of reducing inefficient bureaucracy by putting the responsibility over the success or failure of state-owned companies into local authorities' hands, and withdrawing the central government's responsibility. .

The central government realised that inefficiency of state-owned companies derived primarily from the problem that ownership was carried out and controlled by bureaucrats working for government organisations. SOE reform was not aimed at triggering a privatisation process in the country, but at the restructuring of the SOEs through corporatisation and by separating enterprise management from government bureaus and political influence. Furthermore, it was necessary to turn SOEs into efficient and self-reliant enterprises. SOEs reform proceeded under the principle of *decentralisation*. From a managerial control perspective, SOEs were managed and organized like cost centres³⁸, profit centres³⁹ or investment centres⁴⁰ after 1978

³⁸ The Standard Cost Centre: A standard cost centre is a production or operating unit in which someone other than the local manager determines the outputs that will be produced as well as the expected inputs required to produce each unit of output. Industrial engineers and cost accountants specify the quantity and price standards for the materials, labour, energy, and machine time required to produce each widget, the generic term for a manufactured good. The cost centre manager's job is to produce the demanded quantity and mix of widgets in an efficient manner, as determined by the standard cost system. The performance of a cost centre manager is evaluated by a complex system of cost variances that compare actual to budgeted cost performance (Anthony/Govindarajan 2004).

³⁹ Profit Centre: Many operating unit managers have responsibility and authority for both production and sales. They make decisions about what products and services to produce, how to produce them, their quality level, price, sales and distribution systems. But these managers may not have the authority to determine the level of capital investment in their facilities. In these cases, operating profit may be the single best (short-term) performance measure for how well the managers are creating value from the resources the company has put at their disposal. Such a unit, in which the manager has almost complete operational decision-making responsibility and is evaluated by a straightforward profit measure, is called a profit centre (Anthony/Govindarajan 2004).

⁴⁰ Investment center: When a local manager has all the responsibilities described above as well as the responsibility and authority for his center's working capital and physical assets. The performance of such a unit is best measured with a metric that relates profits earned to the level of physical and financial assets employed in the center (Anthony/Govindarajan 2004).

(Xiang 1998:111; Huang 2003:140; Qian 1996; Zhu 1999). This transformation was gradual, characterised by a higher degree of managerial autonomy and a separation of ownership and control. Thus, SOEs are working as decentralised organisation units and no longer as centrally administrated production units. The conversion of SOEs into profitable corporate entities took place predominantly in the form of limited liability companies and joint stock companies (Lin 2001; Zhang 2001:3).

There are several reasons, why Chinese government designated corporatisation as the preferred path for further SOE reform:

- Listing on stock market which allowed them to generate new capital sources for investment, e.g. initial public offering at the stock market, without losing majority share.
- Access to external finance, SOEs are actively seeking investment and capital injection from outside investors.
- SOEs can be bought or sold, or even leased out (not possible under a strictly socialist system).
- Efficiency increase within state ownership, by separating ownership from control. In the Chinese case, it is regarded instead as a separation of enterprise management from government offices and political influence.

The State-Owned Assets Supervision and Administration Commission of the State Council implemented corporate social responsibility guidelines for state-owned enterprises in December 2007 and the Chinese Academy of International Trade & Economic Cooperation, a subsidiary of the Ministry of Commerce, drafted corporate social responsibility guidelines for foreign invested enterprises in August 2008. The intention is that enterprises do not only fulfil performance targets but also assume social responsibility (SASAC 2008). By undertaking such a commitment, the Communist Party is showing its strong commitment for interest intermediation for differing stakeholders that have voiced their expectations. With the implementation of the guidelines on corporate governance and corporate social responsibility, the balance of social, economic and environmental aspects are emphasised in business enterprises. At the moment, SOE are facing a dilemma: how to cope with social, political and economic objectives which are not necessarily consistent. On one hand,

Chinese SOEs are charged with performance requirements like Western profit-seeking companies, maximising revenue and reducing costs. On the other hand, the company has to fulfil national policy requirements. Chinese reformers became aware of the huge financial burden resulting from the preponderance of labour and social welfare costs in Chinese SOEs. The necessary measure taken was the successive downsizing of employees in SOEs and the welfare system. Nonetheless, the state still faces the financial burden of the income related pension provision for the huge number of aging former employees. The privatisation process is a necessary by-product of SOE reform. The importance of privatisation starts to play a significant role, especially when it comes to the question of taking responsibility for millions of redundant workers⁴¹ that became dispensable in the course of the reform. Furthermore, it has to be taken into account that the reform process also involves the change from a labour-intensive to a capital-intensive industry. The Chinese situation differs profoundly from the Western situation within the corporate governance framework, as the protection of interests of the state and the party has priority. The situation becomes even more complex as the state does not involve the central government itself by definition, but also local governments. The same is applicable for the party system. State offices and state institutions possess a dominant shareholder role, whose strategic goals involving the profit maximisation goal in almost the same manner as outside investors. Party organisations possess a dominant political role, whose strategic social goals diverge from the profit maximisation goal.

In brief, in an economy where market forces dominate, companies incurring losses would go bankrupt or be restructured. Due to soft budget constraints, which allow uncontrolled loan lending and missing credit ratings, these companies still exist. Even though, China's Bankruptcy Law (Article 8) clearly defines that insolvent firms are to file for bankruptcy, the law gives ample leeway for negotiation and political intervention. In China, the adoption of firm liquidation as a sanctioning mechanism is subjected to particularly close scrutiny, as policy makers at the central and local level are afraid of social instability and social unrest. Therefore, they prefer reorganisation rather than liquidation; and do not dispose bankruptcy and liquidation decisions to economic mechanisms.

⁴¹ Overstaffing is generally thought to be at least thirty per cent (Broadman 2001:854).

China's market like other emerging countries is characterised by profound information asymmetry in the capital market, an underdeveloped corporate governance system, unbalanced legal enforcement and weak enforcement capability (Xu/Wang 1999; Peng 2004). Changes in the corporate system in China can be regarded as changes in the institution building process, mainly influenced by the central government, local governments and enterprises.

3.1.3 Transformation related Property Rights

Following the works of Grossman and Hart (1986) and Hart and Moore (1990), *property rights theory* and asset ownership has gained a lot of attention. Earlier classical works on property rights has been published by Coase (1960), Alchian and Demsetz (1972, 1973), and Furubotn and Pejovich (1970, 1972, 1974). Whereas classical works on property rights place more attention on the historical and institutional framework that shapes and changes property rights, earlier works place more emphasis on the ownership models and incentive structures. All economic activities, including trade and production, are the exchange of bundles of property rights (Furubotn/Pejovich 1972). Property rights involve all rights to use, to generate income from and to transfer and or exchange assets and resources (Libecap 1989). Alchian/Demsetz (1973) specifies that capitalism heavily relies on markets and private property rights to resolve conflicts over scarce resources.

Property rights are constituted by law and by the state in terms of articles and laws covering title. Ownership forms that govern rights are communal ownership, private ownership and state ownership (Demsetz 1967:453). Property rights arrangements subsequently improve efficiency in the allocation of resources. Under the condition of the existence of rules for the exchange of property rights, both trading parties will experience benefits. Property rights are an instrument that helps individuals to set the latitude and the usage of a resource, by applying laws, customs and mores of a society (Demsetz 1967:347). As an individual or legal person has defined rights in any resource, the person will therefore solely define how the resource will be deployed. In reality, property rights are a resource in the hands of several interest groups, and have to be apportioned among them.

Demsetz (1967:348) defines that the primary function of property rights is that of guiding incentives to achieve a greater internalisation⁴² of externalities. According to the new institutional economics approach, clearly defined private property rights are the precondition for the realisation of a market economy, and are a core tenet of a functioning capitalist economy. Poorly defined property rights give rise to agency problems and moral hazard (Alchian/Demsetz 1973). Three features characterise clearly defined property rights (Demsetz 1967; Furubotn/Pejovich 1974):

- *Property rights are attributed to a certain owner/ owners, with exclusive rights of ownership.*
- *The owner/ owners of the property rights obtain a residual income arising from the asset.*
- *The owner/ owners possess the right to control, or determine the use of the asset, to restructure, to sell or lease it.*

In addition, identified ownership confers residual rights of control over enterprise assets (Grossman/Hart 1986). Under the property rights theory, the enterprise has to face incomplete contracts, and property rights have to determine who is the repository of the residual control rights, in the case that transactions costs cannot be arranged by contractual arrangements (Grossman/Hart 1986).

In emerging countries like China, legal institutions, like property rights, are defined in order to support the state in being effective in protecting state-ownership. By definition, in centrally planned economies – such as the former Eastern European countries - state-owned enterprises belong to everyone and to no one (Kornai 1980:51). This definition means the subject is open to a lot of interpretation. In China, until the 90's, per definition state-owned enterprises were formally owned by *all people* (全民所有制企业). Today, the constitution stipulates that “*socialist public ownership is the basis of the socialist economic system of the People's Republic of China. State economy is the sector of socialist economy under ownership by the whole people and that the state ensures the consolidation and growth of the state economy* (集体所有制, 国有制). In reality, Chinese people did not possess the right

⁴² Ronald H. Coase (1960) first introduced the term *internalization*, in his paper *The problem of social cost*. In theory, the term is also known as the Coase-Theorem.

to monitor Chinese state-owned enterprises. In reality under this system, governments at different administrative levels are the sole owner of state-owned enterprises and control them on behalf of the public. Property rights regimes in central planned economies determine that resources and assets are owned by the state only. In China, allocation of inputs was according to plan (through administrative rather than market channels), but the planning and allocation were often done on provincial and county levels rather than by Beijing (Yusuf et al. 2006:50). In the Chinese case, several government agencies used to administer state assets on behalf of the public, and exercised both a partial shareholder role and a regulator role. The critical point is that planning offices redistributed earnings among enterprises in their jurisdiction because firms in planned economies did not possess clear and enforceable rights to retain profits and allocate them at their discretion (Walder 1992:525). Therefore unproductive state-owned enterprises normally benefit from subsidisation and tax advantages. This leads to the *soft budget constraint* described by Kornai (1980). Decision-makers in centrally planned economies are in the position to adapt property rights and institutions on their behalf. As a consequence investors are faced with a profound information asymmetry problem (La Porta et al. 2000). According to contracting theory, information asymmetry combined with underdeveloped property rights results in high risk premiums or market failure in investment assets (Fama 1991). Institutional change targets the creation of property rights laws and privatisation in order to define how resources and assets can be used and transferred. The reform of legal institutions is necessary to define the rules in a new way in the market.

From the viewpoint of corporate governance, shareholders have a claim on a residual income. That means shareholders have an entitlement to profits gained by the corporation. Shareholders are not entitled to manage the corporation; instead a board of directors is installed, which acts on behalf of the corporation. It is up to the board of directors to nominate qualified managers who act as agents for the board. This structure actually leads to separation of ownership from control. In China, as a result of complex ownership structure – where multiple differing government agents are involved - the assignment of property rights is not clarified, and control over residual income remains vague.

Theory assumes that investment increases when property rights are protected, having a positive influence on economic growth⁴³. China's experience proves by means of empirical and positive evidence that the country has maintained robust and growing markets (Walder/Oi 1999). The People's Republic of China has experienced strong growth with gross domestic product averaging 8.9 per cent between 1988-1993; 9.8 per cent between 1993-1998; and 8.0 per cent between 1998-2003 (OECD 2005b:32). So far, China's experience has not proven that maintaining state ownership holds back economic growth. As far as the ownership reform of state-owned enterprises in China is concerned, evidence suggests that central government is determined to preserve public ownership in the economy, especially in key industries. More precisely, the state is promoting ownership diversification and the approach of a shareholding system, without neglecting the security of control rights of enterprises under public ownership. This shows that new institutional economies also have their limitations, as it assumes that institutional efficiency can only be realised under the assumption of a free market economy, decentralised decision making and competition (North 1990). The Chinese case proves that rapid economic growth can be realised even where inefficient institutions and non-productive resource allocation still exists.

In general, assets are publicly owned, attributed to the central, provincial or local governments or to villages as collectives. Regardless, "China's reform has witnessed a gradual reform through the gradual reassignment of specific property rights from higher government agencies to lower government agencies, or from government agencies to enterprises, managers, families, or individuals" (Walder/Oi 1999:6). Walder/Oi (1999) approach of ownership and fiscal decentralisation mainly focused on explaining the economic success of TVE (Township Village enterprises) in rural areas of China. Giving lower level local authorities, managers, families, or individuals appropriate incentives and the right to monitor the enterprise; they will act as shareholders, having an interest in acting economically advantageously and improving performance. In contrast, multiple government departments lack the appropriate incentives. Without a functioning system of checks and balances, bureaucrats acting as decision-maker may unconditionally seek their own self-

⁴³ See North/Thomas (1973), North (1981, 1990, 1994), and Hayek (1989:66).

interests, with resulting opportunistic behaviour, according to Williamson (1975:26; 1985). Opportunistic behaviour results in high transaction costs. The emergence of high transaction costs can be avoided through vertical integration. Government agencies exercise the shareholder role. Apart from reassignment of specific property rights, there has been attempted to provide the central feature of private markets, a system of private property rights. Nor has an attempt been made to develop commercial law or an independent court system for adjudication (Weingast 1995:1). Walder/Oi (1999:11) and co-authors describe patterns of change which substantiate the shift away from traditional state ownership. Walder/Oi identify five processes of change; the contracting and leasing of public firms; the outright sale of government assets to private individuals and families (transfer of ownership to elites); private gains for officials controlling public firms; state agencies or enterprises invest private funds (government budget) in new enterprises that operate independently as private firms; and private start-ups. As mentioned previously, by traditional property rights theory, China's economic growth should be less efficient than under private ownership due to the vagueness in property rights. Walder and Oi conclude that "the utility of solutions that are suboptimal in theory", seem to work and can be explained by means of empirical, positive evidence. Consequently, investors must have found a way to overcome the information asymmetry problem and the vagueness in property rights. Wank (1999:269-272) argues that China's successful economic growth and advance arises from the advantages of partial reassignment of property rights that are absent when rapid privatisation has occurred. He explains that informal social ties that bind officials and entrepreneurs as co-owners provides a means of specifying and enforcing property rights in ways that would not otherwise be possible in the absence of an effective system of government regulation and civil law.

The implementation of corporate governance structures in China is a step forward defining ownership, as corporatisation helps to clarify property rights in SOEs. The introduction of the Company Law in 1994 determined the first step for separating government from management functions. The separation was aimed at reducing bureaucratic intervention and conflicting influence from several state agencies. Furthermore, the change of corporate form of SOEs into joint stock companies allowed the access of a limited number of shareholders by listing on the stock market. This means that former SOEs were able to raise necessary external capital, without

losing strategic majority. Under the Company Law, external investors must be listed in the articles of association. Furthermore the value of assets needed to be assessed and owners needed to be defined by name. As a result ownership rights could be transferred according to title. As mentioned earlier, before this time China lacked accurate determination of the owners of SOEs. Government agencies occupied two opponent roles, the role of the shareholder and the role of the regulator, without being responsible for performance targets. The establishment of SASAC was another step towards pushing forward the effective separation of management from government. In effect, the establishment of SASAC was also based on rationalisation considerations, as previously several bureaucratic government agencies managed and supervised state assets. Since 2003 only one government body has been in charge of that function. State assets which are under SASAC's supervision are directly under the control of the State Council. Consequently, observers note that reform did not dramatically affect bureaucratic organisations; instead they actually introduced new government bodies making bureaucracy even more unwieldy (Fernandez-Stembridge/Huchet 2006:34; Naughton 2006). Naughton (2006:2) notes that a fundamental feature of Wen Jiabao's administration of the State Council is the high degree of support he gives to bureaucratic agencies and legitimate decision-making processes. As a result, Wen tends to support SASAC's agenda. On behalf of the State Council, SASAC acts as an investor without participating directly in the operational business of enterprises. SASAC's task is to hold control over state ownership, and to push forward value maximisation in defined state sectors in combination with the realisation of strategic government objectives. Currently, SASAC has taken measures toward establishing a claim on state-owned enterprise profits. SASAC, which exercises property rights on SOEs, pursues the aim of deriving income from them. According to SASAC, China's state-owned enterprises realised record profits of RMB 1.6 trillion (USD 222 billion) in 2008, a 32 per cent increase compared to 2007 (China Daily 2008). As profits have remained solely in the hands of SOEs since the taxation reform in 1994, a fundamental debate has arisen. At the moment, the government is working on a new accounting system which will allow the state to share the profits of the SOEs. By defining ownership, crucial questions such as who should monitor and control managers in SOEs, how capital should be raised and how should SOEs be reorganised could be answered. In the specific case of China, it has also been taken into account that state-owned assets are burdened with debts. This

leads to the consequence that ownership also involves the assumption of accumulated debt.

The development of ownership definition and a property right system has led to the adoption of the Property Rights Law of the People's Republic of China, at the 5th Session of the 10th National People's Congress of the People's Republic of China on March 16, 2007, is hereby promulgated and came into effect on October 1, 2007. On March 8, 2007, the Property Law was formally introduced at the National People's Congress (China Daily 2007). Before the change of the constitution in 2002, the Communist Party invited private entrepreneurs to join the Communist Party (China Daily 2007). With the change of the constitution, the Communist Party tackled two problems. Firstly, former cadres who became shareholders in the past were legitimised in the Communist Party. Secondly, private entrepreneurs were accepted into the Communist Party. With this both groups, which belong mainly to the subversive middle class, have been integrated in the Communist Party, and have become a support pillar for the Communist Party. In 2004, China changed the country's constitution to preserve private-property rights by granting equal protection of property to the state, the collective and individuals (People's Daily 2007a). Despite announcing the new Property Law, which symbolises a significant turning point in Chinese policy, all land in China is, in any case, owned by the state. Concerning real estate, individuals can only claim right to a 70-year lease on buildings. By designing the new Property Law, the state responded to the need of securing assets of its growing middle class, and putting investors, both foreign as well as domestic, at ease. In other words, the state responded in a symbolic way to the necessity of promoting economic growth.

The adoption of the new Property Law has been fiercely debated in China (Yu Ge 2006; Yin Tian 2001). The lack of consensus on this issue and also about the direction of China's economic reforms contributed to the delay of the enactment of the Property Rights Law. The debate was deepened when a law professor at Peking University's Faculty of Law, Gong Xiantian, called the proposed bill unconstitutional and said that the setting up of a new property rights system was unacceptable. Despite the public opposition of the draft in form of an open letter to the Standing Committee of the National People's Congress (Gong Xiantian 2005), the Property Rights Law

was finally passed. The law covers the creation, transfer and ownership of property; companies (but not individuals) can file for bankruptcy and rights of creditors are better protected.

3.1.4 Transformation related Soft Budget Constraints

The term soft budget constraint was first introduced by Kornai (1980), explaining incentive problems and inefficiency of SOEs in socialist economies and transitional economies. Soft budget constraint arise mainly due to the state being unable to make a credible commitment not to refinance bad projects once some investment costs turn into sunk costs (Qian 1994:2). In contrast, the state provides financial support in the forms of subsidies, credits and tax concessions. Consequently, a budget constraint can be only hardened under the condition in which the state can credibly commit not to refinance an inefficient project. The hardness of the budget constraint is not a matter of direct policy choice, but rather the indirect result of putting institutions in place that discourage or interfere with refinancing (Kornai/Maskin/Roland 2002:21). Therefore soft budget constraints can be only mitigated in combination with institutional change. From the Western point of view improvement of the corporate governance system in transitional countries can be achieved through the privatisation of state-owned enterprises (Boycko/Schleifer/Vishny 1996). Private enterprises are obliged to work under hard budget constraints. Hard budget constraints require enterprises to work efficient and to disclose their financial situation. In the Chinese context, before reforms, soft budget constraints hinder state-owned enterprises in efficiency and transparency efforts as they are protected by means of government subsidies and regulation. State-owned enterprises' corporate disclosure remains poor.

Kornai (1980) argues that soft budget constraints can be put down to the fact that political constraints persist in socialist countries due to bureaucratic paternalism. The degree of paternalism in the relation between the state and micro-organisation is an important characteristic of the nature of a system.⁴⁴ In contrary, Dewatripoint/Maskin (1995) illustrate that paternalism is not necessarily a condition for soft budget constraints. From their point of view, the primary cause for soft budget constraints are

⁴⁴ Kornai (1980:562-569) distinguishes four degrees of paternalism in socialist countries. He takes paternalism as the direct explanation of the softening of the budget constraint. According to Kornai, the relationship between the state and the firm is equivalent to a parent-child relationship, in which the state/ parent allots goods e.g. materials, labor, and the firm/ child tries to pump out as much as possible.

highly centralised systems in socialist countries, as in market economies decentralised systems are dominant. Therefore the transaction costs of refinancing will be so high, that refinancing *ex post* will be inefficient. Qian (1994) argues against this by explaining that the devolution of China's fiscal system enhanced the competition among different local regions, and therefore reduced the possibility to refinance bad projects. Schleifer and Vishny (1994) argue that soft budget constraints arise when politicians and bureaucrats obtain control rights over enterprises, as they do not pursue profit-oriented targets. Li/Liang (1997) identified three causes of the soft budget constraint, applicable for China. According to them the main causes are political influence, creditor's lack of information and commitment and insider control. In the case of insider control, the central government takes the individual benefits of firm insiders into account in their decision to liquidate or to refinance. In the analysis, however, Kornai (1980), as well as Li/Liang (1997) publication on soft budget constraints, both support the idea that informal relationships are also an integrated part of the whole problem. The literature shows, that the decision-making process on budgets in socialist countries are much more the result of a bargaining and negotiating process, rather than the result of hard facts. Therefore the thesis wants to prove in the following that soft budget constraints in China are hard to eliminate as informal relationships prevail, and the state does not possess effective tools to harden the budget constraints of the enterprises.

In Chinese state-owned enterprises four major means of the problem of soft budget constraints can be identified (Garnaut et al. 2005:147):

- Overdue loans
Government directed bank support is a simple way to subsidise SOEs through bank lending and to maintain cover for social expenditures, transferred from the government to the SOEs (such as housing, education, healthcare and pensions).
- Overdue interest payments
High overdue amount of interest payments for bank loans.
- Overdue taxes - central, local
High overdue amount of tax payments to national as well as local tax offices.
- Overdue social security payments – local
High overdue amount of social security payments to local administrative offices.
- Informal financial markets for financing and refinancing.

In the recent past, Chinese banks started to work according to Basel II Capital Accord rating arrangements; consequently the informal financial sector is incrementally increasing. Small and private companies which have limited access to bank credit, rely heavily on informal finance. Where the private economy is less developed, the most common form is re-lending by SOEs to members of firms associations (对方). According to the OECD, (2005b:144) the member pays 10 per cent interest on the amount borrowed and pledges inventories as a way to address the risk of non-payment. Members can borrow only once or twice a year, the maximum amount is RMB 1-2 million and most loans are for 3 months or 6 months.

According to Kornai (1998) soft budget constraint arise in vertical relationships where there exists a degree of dependency; i.e. a relationship of superiority and subordination between two organisations. In the case of a state-owned enterprises, this vertical relationship occurs because the owner; i.e. the state, is superior to the subordinate agent; i.e. the manager.

In the case of China several vertical relationships can be identified, which are all characterised by a strong relationship to the central government or local governments respectively. In the following section the soft budget constraint will be analysed in the context of two three-tier hierarchies of central government – local government – enterprises, and central government – banks – enterprises (see chapter 3.1.5.1 and chapter 3.1.5.2).

The term *local government* refers to all relevant levels of government, under the central government. This term includes the provincial (省), city (市), county (县) and township (镇) levels. In almost the same manner enterprises can be classified according to their level of administration. The term *local enterprise* (本地企业) refers to provincial enterprises (省级企业), city enterprises (市级企业), county enterprises (县级企业) and township (镇级企业) enterprises.

3.1.4.1 Motives for Soft Budget Constraints

Both two three-tier hierarchies have in common that the basic source of soft budget constraints is that the ex post benefits of bailing out are higher than the benefits of liquidation. Soft budget constraints are possible even though they involve inefficiency because the initial investment is sunk (Kornai/Maskin/Roland 2002). Soft budget constraints in China are the result of several reasons which also complement each other to a certain degree and cannot be regarded in an isolated manner.

Massive concern about employment

Economic reforms in China were introduced and realised, chargeable to the environment and the society. Redundancy of state-owned workers increased and affected millions of individuals. Chinese policymakers are aware of this problem and focus on maintaining social stability as well as political legitimacy in the country. The problem of social unrest is becoming an urgent question in China's policy.⁴⁵ Even at the expense of massive long-term problems of capital misallocation, the state shielded SOEs and banks from market forces so as to avoid near-term problems of social unrest. When push comes to shove, the government tempers the kind of market forces that would shut down major firms, drive up urban unemployment and possibly ignite social upheaval. Worth mentioning is the fact that on the one hand the state supports the reduction in the number of the civil service workers in state-owned companies as a result of efficiency improvement within state ownership, and on the other hand is concerned about the emergence of social unrest. Inefficiency of SOEs results mainly from the soft budget constraints, which derives from the long term priority to support employment growth and stability (Chiu/Lewis 2006:198).

⁴⁵ It is necessary to mention, that in the past the government only felt responsible for the urban population, and not for the rural population. In 2004, the Chinese government issued the document Nr. 1, which addresses for the first time the question how to increase the income of the rural peasants. With this document, the central government declares its readiness, to make political decisions in favor of certain social groups and maintain social stability. This signifies a new legitimacy strategy of the Chinese government, which tries to respond to the claim of social justice in the country (Weigelin-Schwiedrzik 2008).

Crony relationships are still prevailing in Chinese economy, and support the interests of the organisation to be rescued

The reforms undertaken do not necessarily focus on the immediate realisation of efficiency in the heavy industry and the banking sector. Rather, the protection of interests of politically powerful social groups, like loyal party insiders (managers, state bureaucrats, etc) proves to have top priority. In general, in China's state sector the hierarchy of control runs from the state to the industrial agencies at different levels of the government and then to the state-owned enterprises. Bai/Wang (1998) explain that soft budget constraints in the Chinese state sector persist alongside the agency problems of the bureaucracy. According to their model, the root of soft budget constraints is in the hierarchically managed system itself, the problem will persist under the current ownership and control arrangements in China's state sector. Additionally, the banking sector serves as a useful financing tool where credit culture still remains to be weak. What ostensibly results is a patronage system bearing tremendous long-term costs to the nation's macro-economy, but great short-term benefit to political authorities and their loyal supporters (Steinfeld 2004:649).

Avoidance of economic spill over effects

As already mentioned Chinese industrial companies and the banking sector are all dominated by state ownership. Assuming the case that a large enterprise would not be bailed out by the state and goes bankrupt, other stakeholder groups like suppliers and banks would go bankrupt too. This could trigger a chain reaction of bankruptcies, with catastrophic results for the economy. Other state-owned companies might be affected and the danger of mass redundancy would emerge. Therefore the state, as well as local governments, are interested in supporting the organisation in question by all means necessary to guarantee its survival on the market by bailing it out. Furthermore, the bailing out of an organisation has to be regarded as an effective tool of prevention against social unrest in both urban and rural areas.

Social function of state-owned enterprises

In a centrally planned economy, state-owned enterprises provided a full package of social services to state-employees and their families, a concept

which is alien to Western companies. So far state-owned enterprises are engaged in providing subsistence allowances for laid off workers (下岗). Unemployed workers have to sign up with labour agencies and will receive a subsidy from the government. The state has not established a social-welfare system in China which would relieve state-owned enterprises from their responsibility. State-owned enterprises employ millions of workers knowing that overstaff and related costs hinder performance objectives. High labour costs work against flexibility in production costs and cash flow management. Soft budget constraints are possible as state-owned enterprises do not only matter from an economic point of view but also from a social and political viewpoint. The threat of a high unemployment rate, social unrest and political instability concerns both the state and the Communist Party (Weigelin-Schwiedrzik 2008).

State-sector where the market does not work

Due to the huge size of the country, many regions in China are still underdeveloped and backward. Infrastructure development is important in China's Western regions.⁴⁶ In 2006, the Chinese government announced *the construction of a socialist new countryside* (社会主义新农村).⁴⁷ Infrastructure projects in terms of road construction, railways, water supply, power generation and oil pipelines, are not necessarily profitable from an economic point of view, but are of strategic relevance to the Chinese government. State-owned industrial enterprises cover all strategically important segments. They provide products and services to customers in undeveloped regions. The provision of public infrastructure development ensures in China the utilisation of resources (especially human resources), stimulates sustainable economic growth in the domestic economy and guarantees social as well as political stability in local communities.

⁴⁶ The definition of China's Western region incorporates the provinces of Sichuan, Gansu, Guizhou, Yunnan, Qinghai, Chongqing municipality and the two largest and most remote regions of Xinjiang and Tibet (Annual Report BOC 2008:379).

⁴⁷ The 11th five-year program for 2006-2010 periods was approved by the executive meeting of the State Council presided over by Premier Wen Jiabao. Zhongfa (2006), No. 1. 中国中央，国务院关于推进社会主义新农村建设的若干意见 (Several opinions of the Central Committee of the Chinese Communist Party and the State Council regarding the pushing ahead of the construction of a new socialist countryside).

3.1.5 The Role of the State in the Enterprise Reform

The transformation from a planned economy to market-based economy requires a fundamental change in the relationship between the state and the state-owned enterprises. The vertical, reciprocal relationship which existed in socialism, changed to a horizontal one. The corporatisation process of state-owned enterprises intends to implement market-based coordination mechanisms in the state sector through the transfer of property and control rights. Thereby owners of assets are identified more easily. In the Chinese case, branches took over ownership, accompanied with rights and responsibilities. Corporatisation was initiated with the aim that the state's strategic interests and objectives are still backed up in the enterprises. On the other hand, the state recognised the necessity of retreating to a certain degree from its dominant position, in order to assure that the market mechanisms worked. Corporate governance stands for market liberalisation and the retreat of the state from an overall control function to a sole regulatory function. In fact, corporate governance asks for a new definition of the role of the state in the economy, which is the responsibility for the provision of a market-based institutional framework. As a result of the immense social costs occurring during the transformation process, it is an important task of the state to establish a social welfare system, where income and social policy plays a fundamental role. In order to align economic and social questions, corporate social responsibility was added to the Chinese corporate governance discourse. Since the introduction of the construction of a *harmonious society* (和谐社会) in 2005 and the *scientific concept on development* (科学发展观) in 2007 by Hu Jintao, an approach that encourages enterprises to emphasise sustainable development, the Communist Party has put social responsibility on its agenda. Formal guidelines have been implemented by state agencies. Thereby, common social objectives have been addressed in order to balance economic, social and environmental factors in business organisations in the transformation economy. The introduction of social sustainability has to be also seen in the light of painful social reforms, where the state withdrew from a multitude of its previous social functions.

Before reforms, the state-subsidised enterprise sector was characterised by a distortion of competition as enterprises were not treated equal. The social-political considerations of the state also contributed to inefficient production results in the

state-sector. By changing the function of the state – through the separation of corporate economic activity from state control – corporate governance standards should improve the efficient deployment of production factors in enterprises and resource allocation. Furthermore, soft budget constraints, which are relevant contributors to inefficiency, should be eliminated. When analysing corporate governance in China, it is helpful not to analyse the relationship between the shareholders and corporate management alone, but also to describe the relations between the enterprises and banks and local governments respectively. In the following section the thesis describes how the role of the state and its relationship to state-owned enterprises has changed over time.

3.1.5.1 Central Government versus Banks versus Enterprises

Chinese banks are still dominated to a large extent by state ownership, as the government controls and subsidises the banking system. In turn, Chinese banks finance state-owned enterprises. The high degree of state ownership of financial institutions is accompanied by a dominant emphasis on lending to state-owned and state controlled enterprises, while non-state enterprises have poorer but growing access to external credit (OECD 2005b:140).

Government revenue and expenses 1949-93

Historically Chinese SOEs provided an important source of revenue for the Chinese government. SOEs were primarily concerned with providing financial support to government bureaucracy and were not concerned with earning an economic surplus to satisfy shareholders. In the pre-reform era, the two most important income sources were tax incomes and monopoly profits generated by the SOEs (China Statistical Yearbook 2006). Starting from 1958, enterprise profits represented the main income source for the government. In 1958, enterprise profits represented 52.7 per cent of the total income of the Chinese government; in 1959 it stood at 61.6 per cent and in 1970 at 57.2 per cent (Donnithorne 1967:369; OECD 2004a:2). In 1978, revenue from enterprises accounted for 50.5 per cent of total government budget revenue and hence represented the largest source of revenue whereas in 1993 it only accounted for 1.1 per cent of total government budget revenue (China Statistical Yearbook 2006). The sharp decline in government revenue provided by SOEs can be explained by the fact

that SOEs were allowed to retain realised profit for their own purposes. In the late 1980's, the contract responsibility system was introduced, as the central government was facing difficulties concerning the division of profits between the state and SOEs. The profit retention policy, as well as the contract responsibility system, resulted in a yearly bargaining and negotiation process between state officials and SOEs representatives over profit division.

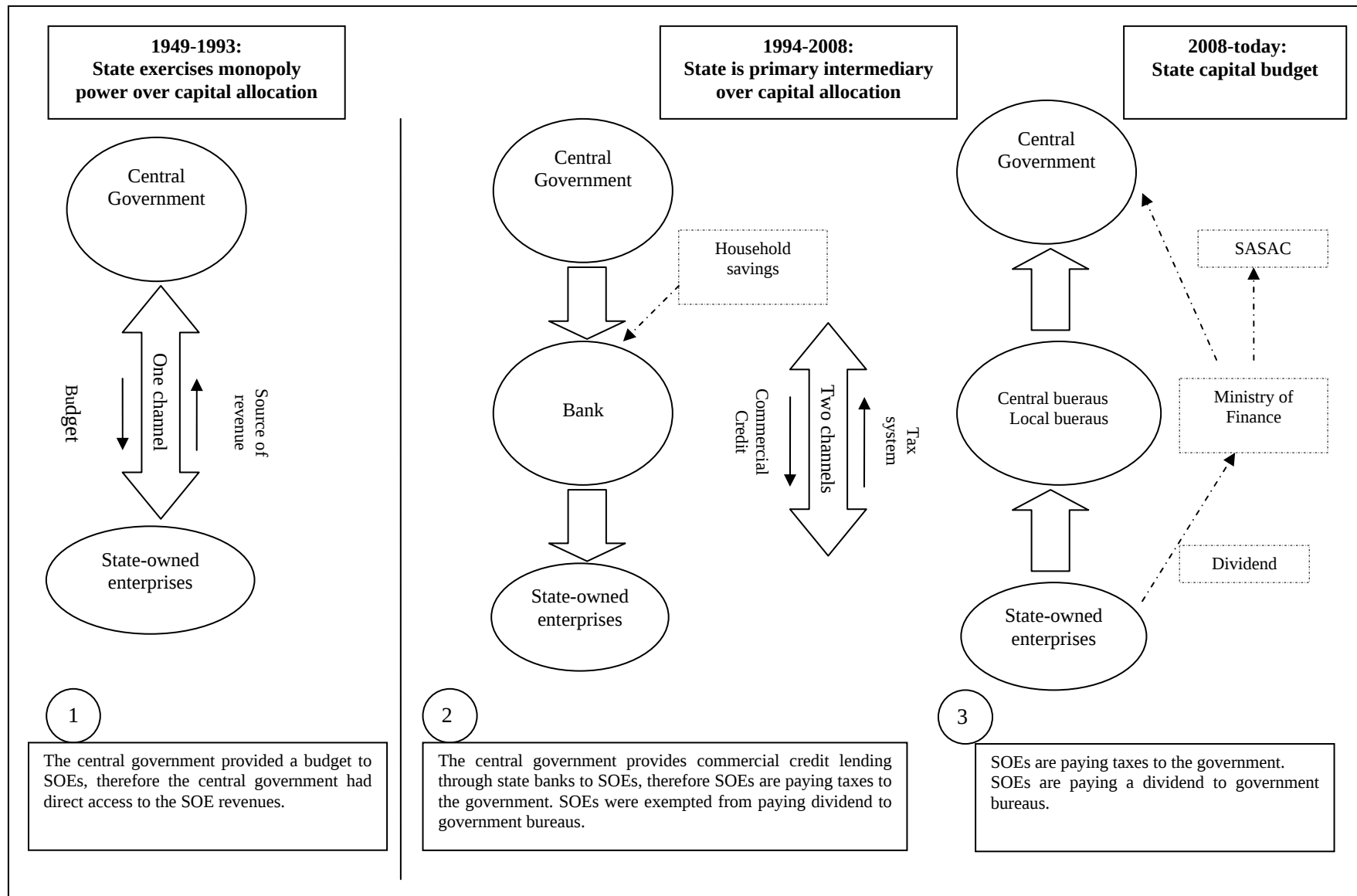


Figure 4: State capital allocation to state-owned enterprises

In the period between 1949-1993 the central government directed state budgets to the SOEs, therefore the central government had direct access to the SOE, by receiving all of its earnings (no distinction between profits and taxes). Government savings were not generated through taxation, as there was practically no tax imposed on households. The household system was based on the Soviet model.⁴⁸ Zhang (2002) argues that the agricultural products were the primary channel of transferring savings from the rural household sector to the state-owned industrial sector. As Lardy noted (1983), in the pre-reform era, prices were set by the government “largely to generate industrial profit, and thus government revenue”. Furthermore, the low-wage policy applied on workers in the state sector also contributed to an increase in state budget and savings. This was despite social services provided and financed by the state sector (Zhang 2002). The point is that at that time the government exclusively disposed over monopoly power of capital allocation and control over the balance of revenue and expenses.

Through the establishment of the mono-banking system in 1980, resource and capital allocation were transferred by banks operating as de facto lending arms under continuing state control. The government budget allocation was carried out through the central bank to designated sectors of the command economy. Long term investment was channelled through the budget and working capital to enterprises was determined administratively (Chiu/Lewis 2006:186). At that time, SOE investment⁴⁹ was primary financed from interest-free budgetary grants, retained profits were barely used (Cull/Xu 2003:535). Consequently the banking sector did not obtain a dominant position in the role of a financial source. In the pre-reform era, SOEs tried to maximise government budget and grants by applying for as much as possible. Self-financing through equity finance did not represent a viable alternative and SOEs tried to minimise this form of financing. This behaviour resulted in soft budget constraints for state-owned enterprises and state-owned banks, and was the main reason for the negative financial development.

⁴⁸ Alternatively, the state can generate public savings by retaining part of the national income that could otherwise be saved by households and distribute only the remainder to private households. This is better known as the “deduction” approach in China, following the Karl Marx design of an ideal socialist economy, which was one of the theoretical blueprints of the central planning economy (Zhang 2002:3).

⁴⁹ Cull/Xu (2003) find that aside from government grants and bank loans, funds for investment come from six other sources – foreign investment, issuing of domestic stock or domestic debt, borrowing from enterprises, investment by other enterprises, and the enterprise’s retained funds. Retained funds came from three sources: retained profits, depreciation and major repair funds, and other enterprise retained funds.

Consequently in 1994, within the framework of the tax reform, the government changed its policy regarding public support of the state sector. The government delegated the task of SOE financing to the state banks, which provided bank loans to the SOE sector. State-owned enterprises no longer rely on fund appropriation, and the role of the state as the primary source of funds has been reduced. Since the 1980's, household savings have poured into these banks, but the funds have been directed toward activities – loans to large-scale state industries – that have yielded decidedly low returns (Steinfeld 2004:646; He/Cao 2007). A specific characteristic of the corporate sector reform in China is that the state did not retreat from the allocation of capital, but still controls it. In addition to direct investment in fixed assets, government capital transfer to state-owned enterprises was about 63 per cent of government savings in 1992, and accounted for 83 per cent in 2001 (He/Cao 2007:10f.).

Several channels have been identified which are a source of financing for state-owned enterprises and investment in enterprises. In general, five channels have been identified, including an external channel, which is foreign direct investment. The other financing channels are household savings, government savings and enterprise savings.

- *Household saving*

Traditionally China has a relatively steady high household saving rate⁵⁰ compared to other countries. Actually the state is the primary intermediary of capital transfer between household savings and state-owned enterprises in the financial system (Zhang Chunlin 2002). Zhang Chunlin (2002:8) identified three sub-channels through which financial resources are transferred from the household sector directly to the enterprise sector:

Sub-channel (a): Households deposit part of their savings with state banks and thus become holders of debt claims against the state banks.

Sub-channel (b): Households invest part of their savings in equities of enterprises that are transformed from wholly-state owned enterprises into joint-stock companies.

⁵⁰ He and Cao (2007) argue that the stable high national saving rate in China is due to fast growth of non-financial corporations and government savings, and not to the high household saving rate.

Sub-channel (c): Households invest their savings in private firms, TVEs, acquire small SOEs and turn them into joint stock cooperatives in which all employees hold shares of their firm. These investments are recorded as equity on the balance sheets of those non-state enterprises.

Sub-channel (a) and (b) are explicitly monopolised by the state and have been main sources of finance for the enterprise sector. Sub-channel (c) is also characterized by heavy government intervention.

- *Government saving*

Until a short time ago, the high government saving rate was due to low government consumption and high rate of retained revenues. Chinese government savings have been invested into two main channels, first into US Treasury bonds and second into Chinese domestic economy, primarily into state-owned companies. A part of the national income that could have been distributed among households was retained by the state with the help of administratively determined prices and wage rates and became budget revenue. It was then invested in enterprises and resulted in state owned equity. Recently, the Chinese government started activities to increase public spending and public expenditure policies which are undergoing a transformation to meet the changing requirements of the market economy. Although official government spending overall has grown rapidly in China – from 17.7 per cent of GDP in 1995 to 27.4 per cent of GDP in 2003 – it is still well below the OECD average of 44.5 per cent (OECD 2006). The rise in Chinese public spending has been most observed in infrastructure investment and in public administration; other areas still to be reformed are health and education, clean technology and agricultural production.

- *Enterprise saving*

High enterprise savings are due to a high rate of retained revenues. Retained revenues in addition to credit loans and subsidies represent the key financial sources for allowing employee levels to be maintained, especially in the light of the unexpected economic downturn. State-owned enterprises' integral role is to provide employment and goods and services in the economy. Chinese

SOEs employ a large workforce. According to Fortune 2010, the workforce of the State Grid and China National Petroleum is over one million (see chapter 3.1). China already faces an unemployment problem, especially in the rural areas of the country, which results in society discontent and social unrest. By retaining revenues corporate managers are responding to the national policy of the Communist party, which declared employment as an important factor of a harmonious society.

- *Foreign direct investment (FDI)*

Foreign direct investment also plays an important role concerning the financing of Chinese state-owned enterprises. Overseas investors poured financial resources into former SOEs by acquiring shares and by forming joint ventures. Huang (2003) argues that foreign direct investment has less to do with financing state-owned enterprises, but is instead more of a supporting pillar for the ongoing privatisation process. As an explicit privatisation program is missing and credit constraints on the private sector exist, foreign investors provide venture capital to private entrepreneurs. Foreign investment boosts interregional capital mobility in a highly fragmented economy.

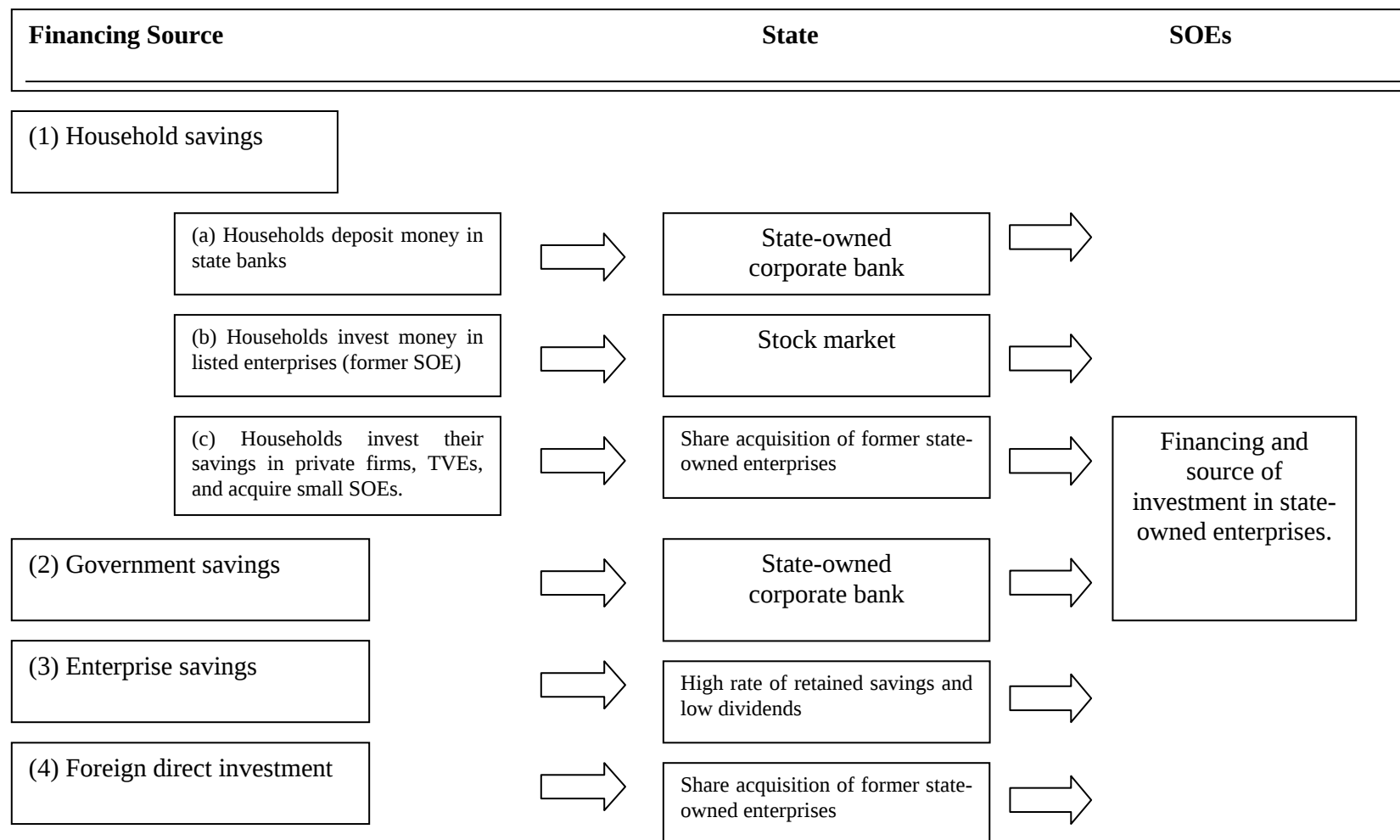


Figure 5: Financing of state-owned enterprises
Source: Compiled by the author (Zhang Chunlin 2002, He/Cao 2007)

Households are the net creditors and the government and enterprises are the net debtors. The majority of household savings flow into state banks. The most important internal financing channel of state-owned enterprises is bank loans (He/Cao 2007:11). The central government's shift from budgetary to bank financing of SOEs involves switching from financing SOEs with direct taxes to financing them with implicit taxes (quasi-fiscal revenue) collected from bank deposits (Gordon/Li 2003). By 1994, direct government transfers had nearly disappeared. Poorly performing SOEs started to rely on commercial credits, in other words they had to be bailed out by banks. In truth, commercial credits provided by state banks present a mixture of policy loans, stabilisation loans and commercial lending. State-owned banks face the dilemma of identifying good credit risks⁵¹ and granting loans only under the condition of commercially oriented objectives. On the other hand banks realised that extending new loans to SOEs was throwing good money after bad (Cull/Xu 2003:540). The shift also signifies an end to the unbounded funding, by imposing a ceiling on grants, and requires SOEs to enhance at least a minimum profitability.

In 1994, instead of the direct provision of SOEs revenue, the central government implemented tax reform so that state-owned enterprises would no longer remit after-tax profits to government agencies. Consequently, the central government has changed to a system where fixed income is guaranteed, and the state is not the primary claimant of earnings after taxes. In contrast with a shareholder in Western companies, who is entitled to receive a dividend when the enterprise is profitable, China traditionally pursued a low or no dividend policy. A World Bank survey in 2005 revealed that in China, no government entity – neither the Ministry of Finance (MOF) nor SASAC – received any dividends, despite net profits being earned from centrally-administrated SOEs. Commentators note that state-owned enterprises did not turn over profits to their administrative superiors. Instead those superiors were transformed into holding companies of various kinds, and these holding companies were not required to – and did not – remit the profits further up to government itself (Naughton 2008). The same situation has been observed for local governments in relation with locally-administrated SOEs (Worldbank 2005). The World Bank study

⁵¹ By analyzing product portfolio of an enterprise, profitability, credibility and signed contracts with customers.

(2005) identified four reasons why the government would not collect profit from SOEs:

- Firstly, this decision seemed a natural extension of the logic prevailing in SOE reform in 1980s, which emphasised the independence of SOEs from the government.
- Secondly, the central theme of SOE reform during 1992-1994 was the increase of managerial autonomy and the reduction of government intervention, as was evident in the State Council *Regulation on Transformation of Management Mechanisms of SOEs* in 1992. The collection of dividends from SOEs shows that the government is now moving in the opposite direction.
- Thirdly, without corporatisation and some minimum progress in corporate governance, it would be difficult for the government to determine an acceptable rate of dividend without reopening the negotiation with management of each SOE on profit division.
- Fourthly, SOEs as a whole were in poor financial situation in the early 1990s. What the government could collect did not amount to much, while the need for new capital injection was perceived as urgent and large. In 1994, the total profit of industrial SOEs was only 1.8 percent of GDP, which compared with 3.3 percent of GDP in 2003.⁵²

⁵² China Statistical Yearbook (1995)

As a consequence, in 2004 the SASAC reached an agreement in principle with the Ministry of Finance for the setting up of a state capital management budget for central state enterprises, the principal component of which is that a percentage of after-tax profits have to be turned over to the government. In May 2007 during a State Council meeting, Premier Wen Jiabao debated the plan of state-owned enterprises paying dividends to the government (MOFCOM 2007), and in September 2007 the State Council approved detailed regulations concerning the remittance of profit to the government.⁵³ The approval of the establishment of a national budgetary system for state assets affects the 120,000 plus state enterprises nationwide and the 128 central enterprises, both of which will start paying dividends to the state. The MOF will be responsible for creating the national budget while the SASAC will have the power to decide on the budgets of the central enterprises (China Daily 2007). Starting in 2008, nationwide after-tax profits have been given to the Ministry of Finance first, after which a portion is transferred to the SASAC. In the first draft, central enterprises had to pay twenty per cent of their profits, although the final decision constituted that enterprises were to be divided into three groups, with remittance rates for after-tax profits set at zero, five, and ten per cent. Seventeen SASAC firms plus the State Tobacco Monopoly remit 10 per cent of their profits, 32 SASAC firms, mostly military industrial firms and research institutes, are exempted from paying for three years, and the remaining SASAC firms remit 5 per cent of their profits (Naughton 2008).⁵⁴ Profit remittance for local governments is still not regulated, but it is estimated that detailed regulations will be promulgated by local SASAC offices in accordance with the central SASAC. It is expected that local state-owned enterprises are subject to a 5 or 10 per cent rate. Profit remittance is allocated through three defined channels: investment in assets e.g. company purchases, investment in restructuring and compensation for social benefits.⁵⁵

This development underscores that as a result of corporate restructuring, state-owned enterprises have been transformed into profitable enterprises, and that control over profit is a crucial criterion in the light of corporate governance reform, social security

⁵³ State Council, September 13, 2007: 国务院关于实行国有资本经营预算的意见 (State Council views on the State Capital Management Budget);

SASAC/MOF, December 12, 2007: 财政部出台国有资本经营预算有关配套管理办法 (Management methods for receiving the state capital income of central enterprises).

⁵⁴ Entire name list: Caijing (2007): 央企“国有资本收益”收取出新规 (New regulations appear for central enterprise *State capital income* receipts and outlays).

⁵⁵ See article: Zhongguo xinwenwang (2008): 国资委公布央企上缴红利支配方式 将用于三领域 (SASAC promulgated the methodology for allocating remitted dividends, which will be used in three areas).

reform and fiscal reform. The introduction of state capital management budgets is necessary to enable the state, in particular the SASAC, to gain access over a significant portion of state-owned profits.

Traditionally, Chinese banks have played a crucial role in the realisation of the government's economic and social objectives. In recent years, since Chinese banks were transformed into financial institutions, local governments in particular have gained powerful influence over bank lending through the appointment of regional bank leaders (Jin/Zhou 2000:21). As already mentioned above, the majority of state-owned companies actually belong to local governments, which are consequently highly interested in the survival of these firms under their jurisdiction. Moreover, the traditionally close ties between government and bank officials on the local level have created a culture that has given local government officials substantial influence over bank lending decisions⁵⁶ (OECD 2005b:141). The high level of non-performing loans proves that in reality neither credit standards, nor effective credit classifications, exist (see chapter 4.3). This has resulted in a major problem of capital misallocation. Consequently, soft budget constraints arise due to the endogenous lack of credible commitment to liquidate an inefficient project instead of refinancing it.

The point is that so far, Chinese state banks have been the main provider of external finance to enterprises, instead of the capital market. In China, the state actively promotes an industrial policy which results in a specific relationship between the state and the enterprises. Although corporate governance reforms have been undertaken, the concentrated ownership structure has been maintained. External finance provided by the stock market through individual households plays only a minor role in SOEs financing (see chapter 4.1.4, table 9). The concentrated ownership structure is also based on the dominant role of insiders in the enterprises. As the state is the main provider of external finance, it requires a return on its investment by asking for dividend payments. This move shows that the state is officially acting as a shareholder who is demanding profit maximisation within state ownership. Since

⁵⁶ Local government officials have traditionally had an important role in evaluating the performances of senior officials of state owned commercial banks branches and in determining their future career path within the broader government service. While these practices are changing and bank management becoming much more professionalized, local officials still having strong incentives to stay in good standing with local governments (OECD 2005b:170). SOE managers are in the same situation as government bureaucrats also appoint them.

economic reforms have started, the state has been ready to support financially state-owned enterprises during their period of transformation. The state acknowledged that transformation requires investments which are sunk, and will not be paid back. As state-owned enterprises have now turned into profitable enterprises, the state is now asking for a piece of the cake. Dividend payments curtail enterprise savings by managers, which remained so far as retained revenues in the enterprises. Management generally tends to retain revenues in order to keep employee levels up, but also to build up a financial cushion in the case of downturn in their enterprise. Furthermore, dividend payments have positive impact on capital market discipline by forcing state-owned enterprises to rely on external financial sources to obtain necessary funds. Changes in dividend distribution will work as a signal to the government of poor performance and is therefore a tool which allows corrective action to be taken by applying differing corporate governance mechanisms. This is especially valuable under asymmetric information which exists between the central state and the enterprises, and managers and the dominant shareholder respectively.

An influencing corporate governance measure concerning the dividend policy in the state-owned sector is the Chinese corporate governance code. According to §87 “Chinese listed enterprises shall truthfully, accurately, completely and timely disclose information” by means of quarterly and annual reports. Taking the China’s Top 20 companies ranked by Fortune 2010 into account, annual reports of these enterprises include financial data on such as earnings per share, cash flows from operating activities and dividends payable to equity shareholders of the company. Corporate governance systems and measures are substantial as public financial statements can produce meaningful information to the state.

Functioning dividend payment is only guaranteed as long as financial statements and cash flow statements are disclosed and are reliable. Therefore the state in particular is highly interested in corporate governance reform which requires transparency and financial disclosure. By requiring the fulfilment of disclosure requirements within state ownership, the state is able to exercise ownership rights on an informed basis. Dividend payment will have a positive impact on corporate governance in China. The demand for corporate governance institutions will increase, which will contribute positively to higher transparency in the enterprises.

3.1.5.2 Central Government versus Local Government versus Enterprises

As mentioned previously, through SOE reform the central government intended to enhance efficiency within state ownership. The reform path chosen to improve state-owned enterprise performance was *through corporatisation*, and through *decentralisation*. Several scholars characterise the Chinese economy as fragmented, federalistic and as being federalistic “Chinese style” (Huang 1996; Qian/Cao/Weingast 1999c; Qian/Roland 1998; Qian/Weingast 1996, 1997). Huang (2003:144ff.) goes even further, by explaining the transformation from administrative to economic decentralisation, whereupon privatisation is a form of it (see also Zhang Weiying 1999).

The decentralised economic structure in China is identified by the transfer of *fiscal authority* and *ownership to local governments*. Fiscal authority classifies the tax base between the central and local governments corresponding to administrative levels. Ownership is categorised through control and revenue rights, whereupon central enterprises belong to the central government, and regional enterprises belong to local governments (Huang 2003:143). Qian and Roland (1998) argue that the devolution of the central government to local government, in particular the decentralisation of fiscal authority since 1994, is the key method towards hardening budget constraints in China. The reason behind this lays in the fact that competition among the local governments serve as commitment device to harden budget constraints.

Huang (2003:144) argues two reasons exist for administrative decentralisation between central and local government:

- *“Firstly, decentralisation has long tradition in China, going back to 1951. Administrative decentralisation is a policy instrument available to the government to improve the efficiency of firms within a framework of state ownership.*
- *Secondly, knowing the dimension and complexity of Chinese socialist economy, the central government found a way to reduce monitoring and supervision, by allowing local governments to participate as financial stakeholders in the operations of SOEs.”*

Weigelin-Schwiedrzik (2004) explains that

“Decentralization is a heritage of the Chinese model, explaining the relationship between the centre and the periphery.”

Zhang Weiying (1999) argues that the decentralisation policy has contributed significantly to privatisation, as a consequence of cross-regional competition. This explanation comes from the fact that local governments are concerned with total revenue of location, which includes tax revenues and profits⁵⁷ generated by the enterprise⁵⁸. In general, enterprises are the major tax payer at the local level. The increase in discretionary power over the decision making jurisdiction of local governments and the emergence of local autonomy resulted in intense research by scholars (Oi 2003; Yep 2004; Wedeman 2003; Walder 1995). Wedeman (2003) calls this newly acquired authority *local protectionism*, and explores strategies and methods of local protectionism applied by local governments.

Decentralisation also involved the transfer of state-owned assets to local governments. As a result of the 16th Communist Party congress, Jiang Zemin once again placed emphasis on the transfer of SOE ownership to local governments, including the transfer of authority. In the 1990's, as a result of the increasing number of loss-making SOEs, the government started to transfer small-size SOEs to lower-level governments, namely to the provincial, town and county level in order to avoid the growing fiscal burdens (Yao 2003). Guthrie (1997) shows that the controlled transfer of the majority of enterprises to local authorities represents an important trigger for harder budget constraints and increased autonomy under the enterprise reform. As local authorities possess only limited financial resources, SOEs have had harder budget constraints imposed on them, which has lead to more efficiency.

⁵⁷ Generally, profits are depended on market share and profit margin.

⁵⁸ As product markets become more competitive, local governments only incentive to motivate managers, is through privatization. Effectively, this is also a method to harden budget constraints.

Local governments now administer about 90 per cent of China's SOEs (OECD 2004b:18)⁵⁹. In literature there is often the misconception that state ownership reflects solely central state ownership. Indeed, the term is often associated with sub-national jurisdictions, and not with the central government. Putterman (1995:1052) argues that the state does not represent a relevant actor on any level; instead state control means control by specific persons and groups of persons whose actions are constrained by particular organisational structures and rules. In contrast to theoretical reasoning, government agencies at local levels are not homogenous units, which are acting in the outright interest of the central government. Much more central-local fiscal relations are a matter of the principal-agent problem, where local levels obtain an information lead over the central government, and possess discretionary power. The problem is due to missing institutions that combine the interests of national legislation with the interests of local agencies acting on behalf of local governments (Krug et al. 2005). Therefore they pursue their own economic goals and make arrangements with local enterprises - on the one hand to minimise tax payments to national tax collecting agencies (Wong 2002; Bernstein/Lü 2003), and on the other hand to maximise levies to their own local administration (Weigelin-Schwiedrzik 1999; Bai et al. 2003; Wedeman 2003; Krug/Hendrischke 2003; Walder 1995).

Before 1994, under negotiated revenue-sharing contracts, provinces were obliged to transfer a certain amount of locally collected revenues to the central government, and in return received a certain amount of subsidies from them. The fiscal contract system did not represent the rule-based governance that is necessary for a market environment, as it led to bargaining over intergovernmental transfers between central and provincial governments (Shirk 2007). As Wang (1997) points out, provinces had to hand over remittances to, or receive subsidies from, the central government according to the old revenue-sharing contracts. In the end, no one knew what constituted real central revenue and local revenue. Therefore the central government's aim of successfully hardening the budget constraint has failed. In her article on the relationship between fiscal reform and local industrialization Christine Wong (1992) describes the shift of control over total revenues in favour of the

⁵⁹ Chinese sources claim that in 2003, 56.7 per cent of the state-owned assets of industrial and commercial enterprises were under the control of the central government, and 43.3 per cent enterprises under the control of local governments (People Daily 2004).

provinces and localities as a “problem of sequencing the reform” in the wake of the tax reform.

In 1994, the central government promulgated China’s Enterprise Income Tax Law. By introducing two models of tax administration the government was aiming to increase the central portion of tax revenues and at the same time to take over the role of appropriating funds to the provincial and township level. The government changed from the former budget-system that was primarily dependent on state-owned enterprises to the tax-collection system. In the course of reform, the government relinquished financial management of public services to a local level. Kornai/Maskin/Roland (2002:30) argue that decentralisation of the government does not necessarily harden the budget constraints of regional governments. On the contrary, they argue that giving regional governments’ discretion over expenditure allows them to distort the composition of this expenditure in the hope of attracting funding from the central government, again to subsidise loss-making enterprises. The decentralised economic structure empowered local governments concerning budget, investment decisions and the distribution of land family planning and taxation. Along with the decentralisation of fiscal authority, local governments have also acquired authority over their own local economies. However, decentralisation has also imposed a multitude of obligations on local governments such as the provision of public goods and services like education, social insurance, infrastructure and health. Consequently it was up to the provinces and townships to define by themselves additional sources of income to be able to finance public services in their community. Wong (2005) argues that fiscal decentralisation in the form of the introduction of the tax sharing system was rather a strategy of *muddling through* – by transferring responsibilities to lower levels, defaults on government obligations can be hidden and blamed on local conditions.

In fact in China a dual track tax system exists, where taxes are divided into central government taxes, local government taxes and taxes shared between the central and local governments. Central taxes are those needed for protecting national interests and undertaking macroeconomic regulation. Shared taxes are those directly related to economic development. Local taxes are those that are suitable for collection by local governments. A detailed analysis and compilation of the different tax forms and the

reform of the fiscal equalisation scheme at the central and local level is provided by Hauff (2002:200). The dual track tax system combines two tax systems in the country. The first is authorised by national legislation, which defines the tax rate and tax base. Taxes are levied by national tax agencies as well as by local tax offices. The second is not authorised by national legislation, but defined by local governments only. Provincial governments, city governments, county governments and township governments levy fees, surcharges and taxes which are not submitted to the central government and which are not registered as local taxes. This kind of source of income is also called extra budgetary revenue (预算外资金) and is used by local jurisdictions only. Therefore local governments are residual claimants of local taxes and fees. A second revenue source for local governments are off-budget revenues (Wong 2002; Eckhaus 2003), which refer to the revenue local governments realise by selling land or by receiving dividends from half-privatised incorporated companies (Krug et al. 2005). Both categories, extra budgetary revenue and off-budget revenue, cannot be found in official statistical data⁶⁰. The attempt of the central state to harden the budget constraint, by fiscal devolution, actually resulted in the situation that local levels turned entrepreneurial, by embarking on business activities outside the reach of bureaucratic control (Krug et al. 2005).

Administration Level	National Tax System	Local Tax System
Central	State Administration of Taxation (SAT)	
Province	Provincial State Tax Bureau	Provincial Local Tax Bureau
City	City State Tax Bureau	City Local Tax Bureau
County	County State Tax Bureau	County Local Tax Bureau
Township		Township Local Tax Bureau

Figure 6: State administration of taxation, PRC
Source: www.chinatax.gov.cn

The disequilibrium in the allocation of financial resources and expenses for public services increased as the central government curtailed allocated financial resources to local levels, although they had taken over additional financial burdens at the same

⁶⁰ Since 1997, the extra-budgetary revenue of local governments does not include the intra-budgetary government funds (Chinese Statistical Yearbook 2008).

time. As a consequence, the local population was faced with a non-transparent tax system, where local government offices acted arbitrarily. The central government then introduced the Tax-for-fee reform, which has the goal of relieving the rural population from taxes (Oi 2003:5-6; Yep 2004; Li 2005; Li Changping 2003). In the course of reform a high number of local taxes and fees have been prohibited and there now exist just two taxes, namely the Agricultural Tax and the surcharge of 20 per cent based on the Agricultural Tax.

Krug et al. (2005:23) argues that

“The devolution of power is subsequently less an attempt to introduce (fiscal) federalism than a political expedient measure that enables aligning the interests of the legitimate local political agents with the reform policy as defined by the political centre.”

As regards tax policy for enterprises in China, regardless of a company’s legal form, the 10th National People’s Congress enacted the new Enterprise Income Tax Law (EIT), which unifies the income tax levied on domestic and foreign enterprises, which has been effective since January 1, 2008. The unified tax structure will introduce a single tax rate of 25 per cent, replacing the existing two-system tax, which allowed foreign investment enterprises to receive significant tax preferences principally due to lower tax rates, tax holidays and other provisions. The new tax rate is lower in comparison to the average tax rates of neighbouring countries in an effort to push the competitiveness of enterprises and to boost China's attraction of foreign investors.

Enterprise form	SOEs	Domestic Chinese Enterprises	FIEs
Former tax rate	33 %	33 %	15% to 24%*)
Former provisions			Tax holidays with full tax exemption of two years, 50% exemption for the next three years, and other tax reductions. In local regions: exemption of local surcharges, 3% tax exemption of taxable income.
Tax rate, since Jan. 2008	25%	25%	25% The tax rates will gradually increase: a. 18% b. 20% c. 22% d. 24% e. 25%
Note: *) Enterprise tax of 15 per cent in special economic development zones, 24 per cent in coastal regions and all provincial capitals.			

Figure 7: Unified tax structure for enterprises in China

Source: Peoples's Daily 2007, State Council Circular 39

With the new Enterprise Income Tax Law, the central government has changed its incentive policy from supporting investments in specific geographical regions in the past, to industry- and sector-specific investments, like infrastructure, environmental protection, research and development, energy and agriculture. On December 26, 2007, the State Council released a *Circular on the Transitional Preferential EIT Rate*⁶¹, Circular 39 for short, and its *Circular on the Transitional Preferential Tax Treatment for the Newly Established High- and New-Tech Enterprises in the Special Economic Zones and Shanghai Pudong New District*⁶², also known as Circular 40 (PWC 2008). Established enterprises that obtain the title of being high- and new-tech enterprises⁶³ will benefit from a preferential tax rate of 15 per cent. The unified corporate income tax legislation has been installed to support the government's financial revenue needs and with the aim of keeping China's tax environment internationally competitive. According to the Ministry of Finance, dual income tax rates have incurred growing

⁶¹ The first circular is Circular 39 which mainly addresses the grandfathering treatments available to Old FIEs. It provides the detailed rules on the phasing-in of the CIT rate of Old FIEs which are currently enjoying an income tax rate of lower than 25 per cent under the Foreign Enterprise Income Tax (FEIT) regime to the statutory rate of 25 per cent within the five-year period as stipulated in Article 57 of the CIT Law.

⁶² Circular 40 clarifies that the specific regions refer to the five special economic zones (namely, Shenzhen, Zhuhai, Shantou, Xiamen and Hainan) and the New Area of Pudong ("5+1 Zones") and the tax incentive applies to HTNEs established in the 5+1 Zones on or after January 1, 2008.

⁶³ High- and new-tech enterprises must possess their own core proprietary intellectual property rights, engage in high- and new-tech sectors encouraged by the state, and fulfill the criteria of high- and new-tech products service income, research and development (R&D) expenditure, R&D personnel, and others.

complaints from domestic enterprises, some of which even disguised themselves as overseas-funded ones to receive tax preferences (People's Daily 2007b), consequently the State lost substantial sources of tax income. The new Enterprise Income Tax Law also highlights the implementation of anti-tax avoidance rules, with a detailed focus on transfer pricing documentation requirements, cost-sharing arrangements, thin capitalisation rules, controlled foreign corporation rules and general anti-avoidance rules. Furthermore, the state lost overview over the differing tax bases in regions and bills receivable. The tax restructuring is consciously designed to meet domestic balance requirements thereby concentrating on actual economic, social and environmental needs, such as expenditure on ongoing SOE reform, recapitalisation of the banking sector, establishment of a social safety net and pension reform. The growth potential in China's tax revenues is jeopardised by tax evasion activities. The tax reform aims to close the tax gap in China, the difference between taxes owed and taxes paid.

The actual tax reform is highly linked with corporate governance efforts, as legislation attempts to encourage business investment via tax reforms, in particular by decreasing the tax burden of selected enterprises. Investment decisions in China are primarily taken by the state, which is the main provider of infrastructure projects in the country. According to the new law, tax incentives are provided to enterprises involved in investment and the operation of certain public infrastructure facilities. Enterprises involved in environmental protection and energy and water saving projects are exempted from EIT for a three year period, followed by a 50 per cent reduction on unified EIT rate for a period of three years. The shareholder, which is the state, determines these enterprises objectives, and because of this the tax burden of the shareholders, which again is the state, will be relevant for investment decisions as well. Therefore tax reform includes investment decisions of the state, which is highly linked with the current corporate governance structure in the country. As previously discussed, investment decisions of state-owned enterprises are determined by the shareholder rather than the management. So the state as the controlling shareholder considers upcoming investment decisions in the framework of tax reform.

Corporate tax reform in China is significant, especially in the light of concentrated ownership. Weak institutional arrangements and weak corporate governance

mechanisms are an incentive to avoid tax payments. In China, the state is not only tax collector but also the dominant shareholder in the state-owned sector. As a shareholder, the state has to bear the burden of taxes, as they reduce the companies' profits and also the shareholders' returns. As a tax collector, the state is interested in high tax revenues. However, it is in fact the corporate management that controls financial results and therefore influence the tax liability of a company. This situation presents a classical principal-agent problem, where the interests of the corporate management are not necessarily the same as the interests of the state tax agencies. The new tax policy tries to go against tax avoidance where managers capture enterprise cash flows. International evidence shows that revenues decline with higher tax rates in countries with weak corporate governance (Desai/Dharmapala 2007). The new tax policy in China makes allowances for that tendency, by having decreased corporate tax from 33 per cent to 25 per cent for state-owned enterprises and domestic private enterprises. By imposing tax penalties, the state as a tax authority is influencing taxpayer behaviour and is enforcing tax compliance.

Noteworthy of mention is the fact that according to the new Enterprise Income Tax Law §46, interest payments on debt are not deductible anymore. According to the *Interim Regulations of the People's Republic of China on Enterprise Income Tax* as promulgated by the State Council in 1993, debt was favoured by the tax system before due to the deductibility of interest payments. This signifies a shift from monitoring of managers by lenders (state-owned banks) to monitoring of managers by equity-holders (state). This shift will have significant implications on corporate governance, as the state-owned banks will not anymore act as an intermediary between the enterprises and the state, but the state will directly monitor the amount of debts by means of published debt-equity ratios. This move reduces agency problems caused by the use of debt between state-owned enterprises in the role of lenders and the state in the role of the shareholder.

An influencing corporate governance measure accessible to tax departments is the Chinese corporate governance code. According to §87 "Chinese listed enterprises shall truthfully, accurately, completely and timely disclose information" by means of quarterly and annual reports. Under the condition that financial information is reliable, tax departments can work with the annual reports, where tax information is published.

In general, tax authorities require in the course of tax audits an incremental amount of documentation on internal processes and business activities. Taking China's Top 20 companies ranked by Fortune 2010 into account, annual reports of these enterprises include financial data such as profit before taxation, tax payable and the debt-equity ratio. Corporate governance systems and measures are substantial as public financial statements can produce meaningful information on tax payments. According to the new Enterprise Income Tax Law §54, enterprises are required to enclose financial statements and other relevant information in accordance with the relevant regulations, when they are filing their annual income tax returns with the tax authority. Functioning corporate governance regulation and information systems have a positive impact on tax behaviour by enterprises, as transparency and control is automatically improved.

The state is challenged to fight tax evasion, which would eventually hinder the official national policy of expanding health and social programs. Expansion and development of social programs represent an integral part in the concept of a harmonious society, according to the Communist Party. Therefore, the tax behaviour of Chinese state-owned enterprises is also highly linked with corporate social responsibility. Therefore, for a harmonious society to exist, requires that enterprises pay taxes to ensure public financing. Consequently, the state and the Communist Party are aiming towards the same objectives within the framework of tax reform; the fair tax payment of by the enterprises. Competition among jurisdiction to attract industries will be limited in the future, due to the introduction of the unified enterprise tax structure with similar tax treatment. According to the Tieboutian paradigm (1956) of tax competition in the state and local context, mobility among individuals and enterprises to other regions occurs because of an excessive tax burden. Therefore relocating is an attractive alternative as it enables high tax burdens to be avoided. The focus of tax incentives has shifted from special economic regions to the entire country and from a regional development orientation to an industry orientation. Furthermore, the new Enterprise Income Tax Law indicates a move away from an export-oriented to a domestically driven economy. In addition, with the new compliance requirements under the Enterprise Income Tax Law, taxpayers also have to face new accounting, tax adjustment and reporting requirements, taking into account the new anti-tax avoidance measures. The actual tax change has to be seen

among other reasons as a commitment to the WTO for equal tax treatment of enterprises.

Tax incentives will be bestowed to critical sectors such as environmental protection, agricultural development, water conservation, production safety, high-tech development and public welfare undertakings. Therefore, benefits for traditional industries, such as manufacturing, will be shifted to new industries with a focus on environment, innovation, research and development.

3.2 Conclusion

The reform of the state-owned sector represents to be a crucial element in corporate governance in China. Other elements are the reform of the banking system, the capital market and the accounting reform. The introduction of corporate governance in the state-owned sector involves corporatisation and decentralisation. Decentralisation in China took place in two areas, with the aim of increasing efficiency. Firstly, in the 1990s small and medium-sized SOEs were transferred to local governments, including the transfer of authority. Whereas the central government concentrates on the restructuring of strategically important large state-owned enterprises, the restructuring of small and medium-sized SOEs has been turned over to local governments. Secondly, in 1994 fiscal decentralisation was realised through the tax sharing system⁶⁴.

The relationship between state-owned enterprises and the government changed significantly in the framework of reform. Until 1985 the state imposed direct influence on state-owned enterprises, having a vertical relationship. From the external corporate governance perspective, the relationship between the state and state-owned enterprises changed from a vertical relationship to a horizontal relationship (see figure 8 and 9). The government and the Communist Party do possess less power now for direct interference, and have to share control rights with external players. State-owned enterprises no longer serve the state alone, but have to fulfil the expectations of several interest groups.

⁶⁴ Before 1994, decentralization efforts have been already undertaken in the form of the tax-for-profit reform (1983-84), and the fiscal contracting system (1985-93). Hauff (2002) argues that the tax reform was not initiated for decentralization reasons, but rather to strengthen the Chinese political centre.

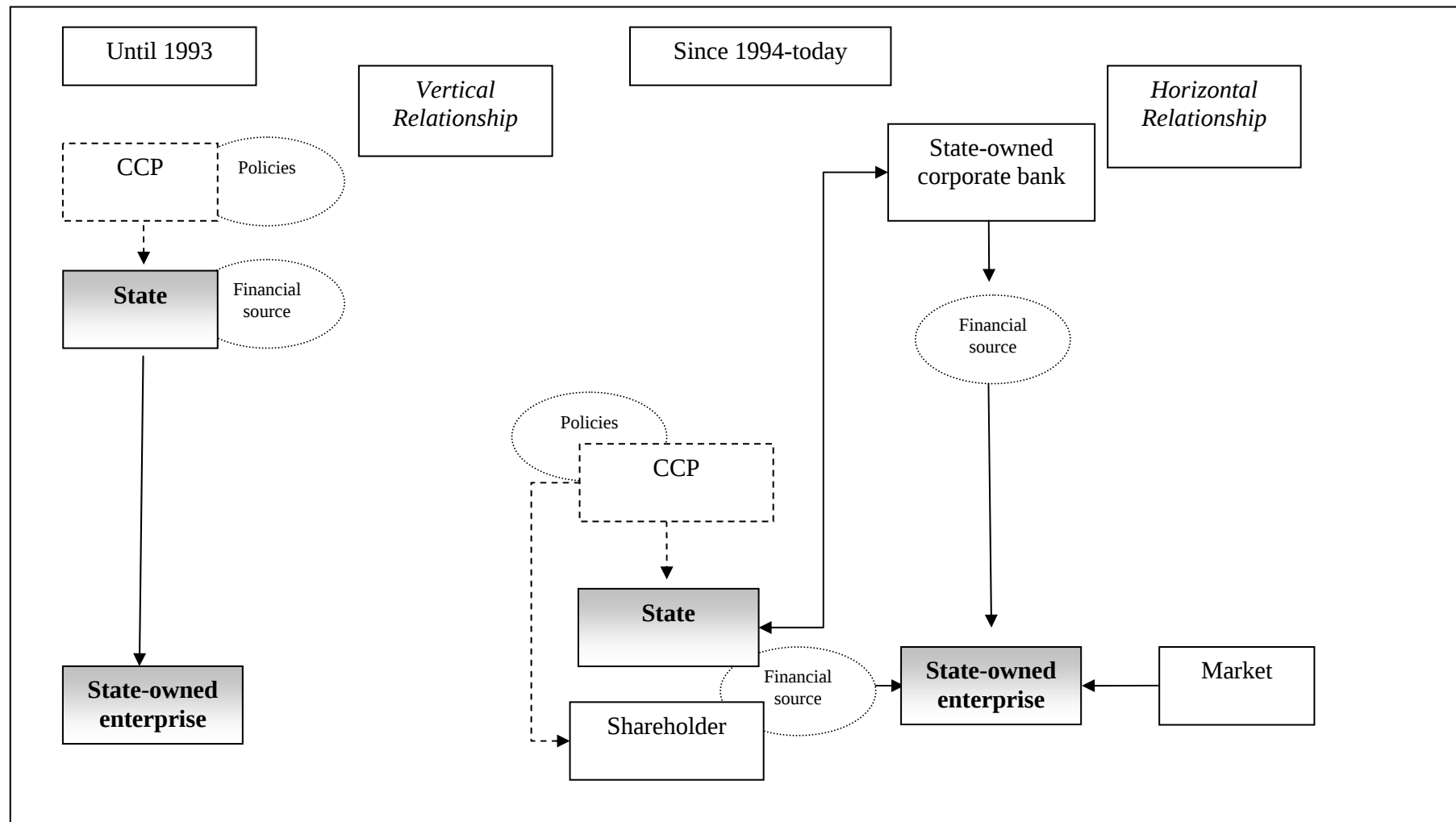


Figure 8: Vertical and horizontal relationship between the state and state-owned enterprises

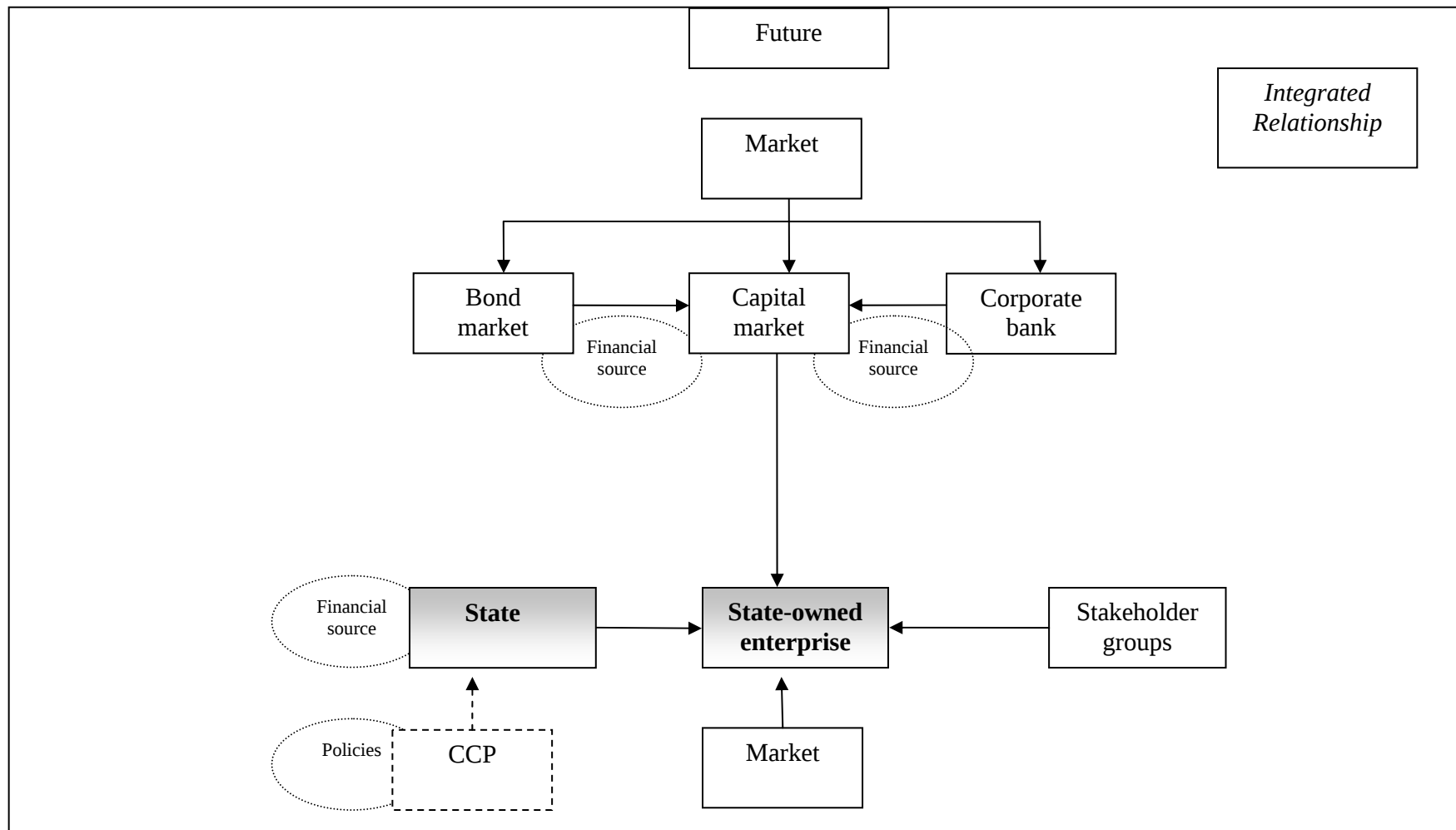


Figure 9: Integrated relationship between the state and state-owned enterprises

Each interest group, the central government, the shareholders and the Communist Party, pursue particular interests, which are subject to social, political as well economic constraints. Under the leadership of Deng Xiaoping, Zhao Ziyang and Jiang Zemin, the central policy approach emphasised high GDP growth of the Chinese economy. Only shareholder interests and performance targets were of ultimate importance, other stakeholder interests were neglected. Certain stakeholder groups, involving state departments and Communist Party members, were not integrated into the implementation of corporate governance, or if so only to a very small degree. The corporate governance concept responds to the reform requirements of the government, thereby concentrating on actual economic and political objectives, such as the ongoing enterprise reform, recapitalisation of the banking sector, reform of capital market, establishment of a social safety net and pension reform. With this approach the central government wants to push reforms within state ownership. As far as it concerns state-owned enterprises, corporate governance standards help to turn these enterprises into much more efficient ones by improving processes and streamlining administration. Furthermore these standards are implemented to help to improve supervision and transparency within the enterprises. The government adopts a strong position for efficiency-orientation. Since the tax reform in 1994, enterprises have been required to work under hard budget constraints. Subsidies and subsidised debt hinder companies from facing market forces and competition. As soft budget constraints conceal the real financial situation of companies, they are contributing to poor transparency in the companies. Changes in the corporate system in China can be regarded as changes to the institution building process, mainly influenced by the central government and local governments.

Since Hu Jintao changed the central policy approach from *high GDP growth of the Chinese economy* to *scientific concept of development*, policy efforts place stress on people-centred development that is comprehensive, coordinated and sustainable. The *scientific concept of development* responds to domestic requirements thereby concentrating on actual social and environmental needs. With this concept, the Chinese Communist Party has taken over a mediator role for differing social interests and it shows strong commitment to social corporate responsibility. Thereby it has adopted a strong position for value-orientation such as social stability, harmonious society, xiao kang (small fortune) and political stability. In actual fact the concept is a

trust strengthening tool. With this approach the Communist Party wants to legitimise its ruling status. Since the Communist Party's claim to power is not legitimated by democratic elections, the Chinese Communist Party is weighing measures and strategies of how to tackle the problem of imminent legitimacy loss (Weigelin-Schwiedrzik 2007). It is necessary to integrate differing social and economic groups by making them understand the political values, culture and economic interests of the Communist Party. The actual Chinese debate of social responsibility linked with the corporate governance efforts indicates that Chinese policymakers did not simply adopt a Western model of corporate governance, but instead consolidated the already existing Western models to their country-specific needs. Concluding, with broader stakeholder participation, corporate governance standards and regulations can be implemented more effective and sustainable. Considering the interests of all stakeholder groups leads to consensus over the reform process and the introduction of co-ordinated market mechanisms, including employee participation and state intervention.

Differing objectives in the course of economic reforms			
<i>Actor</i>	State	Shareholder	CPC
<i>Goals</i>	Reform of SOE Reform of banking system Reform of stock market Reform of accounting system Tax reform Reform of pension system Social safety net Market-based legal system Market –based institutions Reform of public administration system ↓ Efficiency improvement more transparency within state ownership	High dividend Return on investment ↓ Cost reduction Increase of market share Cash flow management Risk management Performance management Low number of staff	Social justice Harmonious society Xiao Kang Political stability Low unemployment rate ↓ Legitimate one-party claim Survival of one-party system
<i>Role</i>	Reformer	Investor, Money source	Mediator and spokesperson of differing social interest groups
<i>Orientat ion</i>	Efficiency- and transparency-orientation	Efficiency- and transparency-orientation	Value-orientation in form of social corporate responsibility.

Figure 10: Objectives in the reform of the state-owned sector

China's one-party regime needs to respond to major interest groups, such as the urban working class, if political stability and the immediate survival of the political leadership are to be secured (Hu/Opper/Wong 2006:85). For that purpose, the Communist Party needs to involve several interests groups, which on one hand share overall goals and on the other hand pursue their own interests. The government is aiming to increase efficiency and transparency in state-owned enterprises and banks, and at the same time the Communist Party is taking over responsibility for social objectives (Xinhuanet 2007), which would otherwise lead to social-political destabilisation. The controlling shareholder wants profitable companies which are competitive in the domestic and international market. As the main investor, it requires that companies undertake cost reduction programs which have a positive effect on cash flow and performance. The challenge regarding the implementation of corporate governance in China is to align and to consolidate all of these differing objectives.

4 Financial Market Reform

Financial markets work under a mechanism which allows economic actors to trade, normally governed by the theory of supply and demand. Thereby scarce resources are allocated through a price mechanism. The financial market plays a key role in pushing forward a market-based allocation mechanism instead of state-regulated resource allocation. The control function of financial markets is crucial, as investment decisions are based on published quarterly and annual company information. In general, a healthy financial sector makes a significant contribution to macroeconomic stability, economic development and growth.

Different institutional arrangements in Western developed countries lead to different roles of the banking sector and the capital market in corporate governance. So far scholars did not find a consensus concerning related advantages and disadvantages of each corporate governance regime (Classens 2006; La Porta 1997, 1998, 2002; Fama 1991) in financial markets. In the United States and Anglo-Saxon countries, corporations rely primarily on equity financing on the capital markets, based on liquid capital markets, dispersed ownership and large stock exchange. In Continental Europe and Japan, corporations rely primarily on debt financing from bank institutions. Banks are holding voting rights in trust of smaller shareholders and bank-enterprise

relations are traditionally strong, where banks are an important source for financing. Roe (1997) states that banking and tax laws in the Anglo-Saxon countries discourage relational investments by banks in industrial enterprises, and encourage them in Germany and Japan. Thus, in Germany and Japan, banks and other corporate investors share a degree of control over enterprise decisions.

This chapter does not attempt to analyse the specific features of Western models of corporate governance in financial markets, but will pay attention to the role of corporate governance in the banking sector and the capital market in China. In China, the financial market is undergoing a transition from socialism, so the underlying conditions for the system will be analysed, by looking at the internal and external corporate governance framework in Chinese banking sector and the capital market.

Corporate financing in China is driven by the loan policy based on the macro policy of the state. Today, Chinese corporations rely rather on long-term credit financing and retained revenues (see chapter 4.1.4, table 10)⁶⁵, where financing from the capital market plays a subordinated role only. So far, the capital market does not possess such a strong role compared to the banking sector in China (see chapter 4.1.4). Large commercial banks primary favour in their lending decisions enterprises where the state owns a large portion of shares, or where they own shareholder rights. In the following the role of differing interest groups in the financial market reform, namely the state, the Communist Party, state-owned enterprises and banks and national and international investors will be examined. Financial market reform is accompanied by the implementation of corporate governance standards, as the controlling shareholder as well as international investors' demands efficiency and transparency in the banking sector as well as in the capital market.

4.1 Banking System

The Chinese banking system is in a situation of transition as it has emerged from a central planning economy to operate in a socialist market economy. Among all other industries in the domestic economy, the banking sector in China is characterized by the highest level of state regulation and supervision. State intervention in the form of

⁶⁵ In the framework of corporate reforms (starting 1994), the capital market played an important role for refinancing, by turning state-owned enterprises into corporations.

public ownership or the lender of last resort in the banking sector is not a unique phenomenon, but is also observed in other countries such as France, Germany, Italy and Japan (La Porta et al. 2002). Bank nationalisation is regarded from two perspectives. In some countries bank nationalisation is regarded as control tool with the aim to monitor the business landscape such as in China, Russia and South America. In other countries, bank nationalisation is regarded as temporary support program during severe economic crises, where banks are saved from insolvency, such as in France, UK, Sweden, Germany and USA⁶⁶. Within the shocks of the financial crises, governments take measures by taking control over banking institutions. Government bailout's in the banking sector aim to stabilize the health of banks, public confidence and trust, and expansion of lending.

La Porta et al. (2002) tries to explain the role of governments in the financial sector, where it is distinguished between two prevailing views. The first view is the *development* view associated with Alexander Gerschenkron (1962), who focuses on the necessity of financial development for economic growth. According to this approach, the state can develop and support strategic industries through both direct ownership of industries and ownership of banks, by channeling savings into specific industries. The second view is the *political* view, where the state and politicians pursue control over investment by firms, but emphasizes political rather than social objectives. This view is associated with Kornai (1979), and Shleifer and Vishny (1994), where governments acquire control of enterprises and banks in order to provide employment, subsidies and other benefits to supporters, who return the favor in the form of votes, political contributions, and bribes. La Porta (2002) concludes that the attraction of such political control over banks is presumably the greatest in countries with underdeveloped financial systems and poorly protected property rights, because the government does not need to compete with the private sector as a source of funds. In fact, in the Chinese case, state interference arises from a mixture of both implications, and allows the state and Communist Party to have control over the selection of project finance and resource allocation. In contrast to the enterprise sector where competition through the private sector has been introduced during the reforms, the banking sector

⁶⁶ Since the world financial crises in 2008, several commercial banks have been nationalized or partly nationalized through government bail-outs, such as the 25 per cent stake in Germany's Commerzbank, nationalization of Hypo Real Estate, partly nationalization of Citigroup and Royal bank of Scotland (Source: publicly available information).

in China is subject to limited and constrained competition and liberalisation regulations, with the objective to maintain stability in the country.

According to the Oxford Handbook of Banking (2010), banks perform several roles in the economy:

“First, they ameliorate the information problems between investors and borrowers by monitoring the latter and ensuring a proper use of the depositors’ funds.

Second, they provide intertemporal smoothing of risk that cannot be diversified at a given point in time as well as insurance to depositors against unexpected consumption shocks. Because of the maturity mismatch between their assets and liabilities, however, banks are subject to the possibility of runs and systemic risk.

Third, banks contribute to the growth of the economy.

Fourth, they perform an important role in corporate governance. The relative importance of the different roles of banks varies substantially across countries and times but, banks are always critical to the financial system.”

Understanding the many roles that banks play in the Chinese financial system, might be helpful to get a picture of the current situation of the Chinese banking sector. In the following section, the historical background and the current situation of the banking reform will be elaborated upon and an overview of actual corporate governance efforts in the banking sector will be provided.

4.1.1 Historical Background of the Banking System Reform

In a centrally planned economy, the banking sector’s main role is to work on behalf of the centrally organised administration. Banks play a rather passive role, which is integrated into the system in order to control the fulfilment of predetermined plans and market constraints are nearly not known. In China, the banking system was consciously adapted to the needs of the socialist framework of the economy. Under the leadership of Mao Zedong, China’s economy can be described as a non-monetary economy, where the currency was a tool for measuring the planning agencies in order to control the effectiveness of the working units, especially the state-owned enterprises (Zhu Jia Ming 2010). In a monetary economy the price is determined by demand and supply and therefore is the dominant mechanism for distribution. Further,

money is not only a means of exchange on markets, but also, and primarily, a means of payment between creditors and debtors. In a non-monetary economy, price is not the mechanism for distribution. In the allocation of resources, interest rates play no role, as funds are allocated following the central plan of lending. As state-owned enterprises benefit from government guarantees, creditworthiness is neglected. When a command economy is prevailing, like it was in China until 1978, the economy is closed; the planning board fixes wages and prices and sets production and employment targets. Firms do not compete for resources but fulfil the predetermined plan targets. The centrally planned economy was characterised by egalitarianism, a lack of interest in economic results and a low sense of economic and legal responsibility. Each financial institution, like the banking system, the stock market and the value of the currency (and prices) are under the control of the government (Zhu Jia Ming 2010).

Following the idea of Lenin and the Soviet model, China established a mono bank system. According to Lenin, the banking system should represent the core of the administrative apparatus of the socialist state.

Lenin noted:

“Without big banks, socialism would be impossible. The big banks are the “state apparatus” which we need to bring about socialism, and which we take ready-made from capitalism...A single state bank, the biggest of the big, with branches in every rural district, in every factory, will constitute as much as nine-tenths of the socialist apparatus. There will be country-wide bookkeeping and country –wide accounting of the production and distribution of goods”. (Lenin 1961)

In all socialist countries, both in Eastern Europe as well as in Asia, banks were integrated into a mono bank system. The mono bank’s role was (People’s Bank of China) to implement the central credit plan that was made up by the State Council and the Ministry of Finance. State-owned banks in socialist countries were in charge of credit allocation and coordination of investment finance on every level in the state-owned sector. In China, state banks transferred household deposits by means of credit allocation to state-owned enterprises. A high rate of household savings was resulting from low household consumption activities. So households’ deposits served in first

place as a financial provision for the industrialisation process in the country (Zhu Jia Ming 2010). In general state-owned banks were characterised by directed credit lending, minimum banking supervision and poor accounting regulation.

4.1.2 Reform of the Banking System

Since 2003, policymakers were successful in their effort to restructure the banking sector from the bad debt problem in the system, but with the constraint, that further market reforms are not implemented and financial discipline is not enforced. Reform efforts are limited where Party and state related important interest groups support partial reform activities, which preserve the traditional soft lending policy in the country. The banking system remains the most unreformed and troubled economic sector in China (Pei 2006; Shih 2009). Nevertheless, even with almost no structural change in the banking system the Chinese economy realized durable high growth rates since 1994. Bank executives are challenged by adhering to government directions in continuous lending policies and at the same time working profitable.

The Chinese state-owned banking sector's core activity is still to provide financial resources to state-owned enterprises and private consumption; financing of the private business and entrepreneurs for growth is nearly non-existent. According to the evaluation of reform measures undertaken by Pei (2006), reforms in the banking sector have failed. Neither the state's nor the Party's control and intervention has been reduced, nor has competition improved in the sector. Competition has not been introduced as the structure of the banking sector still shows the dominant monopoly position on financial intermediation of the state-owned banks. Since state-owned enterprises started to obtain credit from the banks in 1994, and do not receive any more budgetary disbursements, the banking system is an integral part in realising policy and political purposes on behalf of the Communist Party and the state. State regulation is actually the root problem of the creation of the huge amount of non-performing loans and the ongoing recapitalisation activities. By decentralising credit allocation decisions to banks, policymakers had initially aimed to discipline the financial activities of the state-owned enterprises. Reform efforts in the banking sector mainly focus on moving closer to international best practices within the framework of economic liberalisation by maintaining the state's control. Until 1984, the People's Bank of China served both as central bank and commercial bank. In

1984, the Chinese government transferred some commercial operations to four former branches of the central bank: the Agricultural Bank of China for the rural sector, the Industrial and Commercial Bank of China for the industrial sector, the Construction Bank of China for long-term investment and the Bank of China for foreign exchange business (Annual Report, BOC 2008). These four banks compete for financial resources, therefore enterprises and private individuals are allowed to open accounts with more than one bank. Additionally, regulations impose restrictions on state-owned banks concerning their scope of activities and monitoring capability in which different industry they can engage. Although the market share of the four commercial banks has slightly declined over the years, the structure of the Chinese corporate banking sector has remained unchanged to this day. These four banks continue to keep their leading market share in terms of assets (see table 6) as well as profitability. Although in 2003 these four banks were unprofitable, in 2007 they accounted for 55 per cent of profit after tax of all banking institutions and in 2008 for 61 per cent of profit after tax of all banking institutions (Annual report CBRC 2008).

in %	2003	2004	2005	2006	2007	2008
Large commercial banks	58	57	56	55	53	52
Other bank institutions	42	43	44	45	47	48

Note:
Other banking institutions include policy banks, joint-stock commercial banks, city commercial banks, rural commercial banks, rural cooperative banks, urban credit cooperatives, rural credit cooperatives, postal savings banks, foreign banks, non-bank financial institutions.

Table 6: Market share of the four state-owned commercial banks in total assets.
Source: Annual report CBRC 2008

All four state-owned commercial banks (Industrial and Commercial Bank of China, Construction Bank of China, Bank of China, and Agricultural Bank of China) have changed from a wholly-owned state bank structure to a shareholding state bank structure. Other shareholders besides the Chinese government are now allowed to hold shares in these banks, thus the state remains their largest shareholder.

Today the Peoples' Bank of China, which works under the guidance of the State Council, supervises and regulates the banking institutions in the financial market amongst other responsibilities. By 2008, there existed 5,634 legal banking entities,

including 4 state-owned commercial banks⁶⁷, 3 policy banks⁶⁸, 12 joint-stock commercial banks⁶⁹, 4 financial asset management companies, 136 city commercial banks, 22 urban credit cooperatives, 4,965 rural credit cooperatives, 22 rural commercial banks, 163 rural cooperative banks, 91 village and township banks, 6 lending banks, 10 mutual credit companies, 84 finance cooperatives of enterprise groups, 32 foreign banks, 57 trust and investment companies, 75 finance companies, 12 financial leasing companies, 9 auto finance companies and 1 postal savings banks (Annual report CBRC 2008). The introduction of these differing small and medium sized banking entities resulted from the *Decision on Financial System Reform* promulgated by the State Council in 1993. The objective of this reform step was to create a competitive commercial banking sector where state banks co-existed along side with other forms of banking entities.

The State Council stated:

“...The goals of the financial structure reform are:...to set up the financial organisation system that separates policy finance from the commercial finance, makes the state-commercial banks principal part and different financial institutions coexist...” (State Council 1993)

The decision on the separation of policy financing from commercial financing promoted competition within the Chinese banking sector under state ownership. Through a new and diversified ownership structure, banking institutions offer banking services to households and firms, mainly in urban areas. In 1996, the first non-state bank, China Minsheng Bank⁷⁰, was founded, with stock mainly being held by non-state investors. In 2001, in accordance with WTO's accession that the banking sector should be liberalised, entry barriers for foreign banks were relaxed. Since 2003, foreign banks have been allowed to give loans to Chinese companies in selected cities, by 2006 all regional and other restrictions ceased to exist and foreign banks were able to offer their product portfolio without limitations (Mahlich/Zhu 2005:78).

⁶⁷ Industrial and Commercial Bank of China (中国工商银行), Agricultural Bank of China (中国农业银行), Bank of China (中国银行), and Construction Bank of China (中国建设银行).

⁶⁸ China Development Bank, Agricultural Development Bank of China, Export and Import Bank of China.

⁶⁹ Among others: Bank of Communications (交通银行), China International Trust and Investment Corporation Industrial Bank (中国中信集团公司), China Everbright Bank (中国光大银行), and Hua Xia Bank (华夏银行).

⁷⁰ In 2000, China Minsheng Bank(中国民生银行) listed its shares at the Shanghai Stock Exchange, with 70 per cent private shares (<http://www.cmbc.com.cn>, 2008).

Regulations in the scope of foreign bank competition are regarded as control mechanism to prevent undesirable behaviour which would lead to a conflict of interest. The potential presence of foreign banks might decrease the state's control over the economy. It is estimated that multinational foreign banks will mainly penetrate urban areas with high growth expectations, whereas rural areas will remain unattractive for market penetration. Regardless of this, foreign banks have opened branches or representative offices, but their activities can be regarded as limited. The financial system reform introduced diversified ownership in the banking landscape. All these banking institutions compete for household and enterprise deposits and savings in the Chinese banking sector. Policymakers recognised the need to separate policy financing from commercial financing in order to allow reform efforts to become successful. In the following, the progress of reform efforts with regard to the internal and external corporate governance framework in state-owned banks will be examined.

4.1.3 Internal Corporate Governance and Institutional Change in State-owned banks

In 2004, the CBRC (Chinese Banking Regulatory Commission) promulgated ten guidelines for corporate governance in a pilot programme for two Chinese state-owned banks, the Bank of China and the China Construction Bank. State-owned banks reform is based on three cornerstones: the recapitalisation of banks, the establishment of corporate governance principles, and the public listing on the stock market. In the following, the internal corporate governance framework of Chinese state-owned banks is examined, with regard to the question to which degree the guidelines and recommendations of the corporate governance code are applied and where they meet limitations in the Chinese context. The code consists of ten parts, and is written down in the *Guidelines on Corporate Governance Reforms and Supervision of Bank of China and Construction Bank of China*. In the meantime, the Industrial and Commercial Bank of China as well as the Agricultural Bank of China have also participated in the pilot programme. Beside the implementation of the corporate governance guidelines, all four banks were recapitalised.

Changes in the regulatory environment involved the development of the nation's financial regulatory system, strong focus on risk management, enactment of new rules and regulations as well as the introduction of stricter auditing and accounting standards which are in line with the states approach of efficiency and transparency improvement within the state sector. In 2009 the China Banking Association (CBA) introduced guidelines on corporate social responsibility for the banking sector in China. Its objective is to promote comprehensive corporate social responsibility programs within Chinese financial institutions (China Banking Association 2009). The guidelines are in line with the Communist Party's national policy of promoting a harmonious society and sustainable development in the state-owned sector. The corporate social responsibility guidelines address the active protection of stakeholder's interests such as consumers, employees and the community and mention the economic responsibility of corporate governance compliance within the corporate banking sector.

4.1.3.1 Corporate Governance Structure

Article §§ 4 requires a clear corporate governance structure comprising the general shareholders meeting, a board of directors, a board of supervisors and an executive management, with all the necessary checks and balances. The two state-owned banks undertaking the pilot reform are required to establish standard corporate governance structures, so as to ensure scientific decision-making and efficient enforcement and supervision in line with the principle of segregation of responsibilities combined with effective cross-supervision.

Taking China's top banks ranked among the China's Top 20 companies by Fortune 2010 into account, the corporate structure and the relationship between the executive board and the Chinese Communist Party and the central government is analysed. The board of the large commercial banks is composed beside of directors and executive directors, also of nonexecutive and independent directors. The results prove that in all four state-owned banks (Bank of China, Construction Bank of China, Industrial and Commercial Bank of China, Agricultural Bank of China) a general shareholders meeting, a board of directors, a board of supervisors and an executive management is

installed, and that Communist Party members assume top management positions. Consequently, Communist Party members in the corporate board directly influence corporate decision making in credit lending and capital allocation. Priority in funding projects is given to recommendations of the State Council and the Central Committee. Senior officials and board members benefit from the alignment with the Party, as in the long run they will be considered in promotion decisions (Pei 2006; Shih 2009). The corporate structure in these state-owned banks, whose headquarters are all based in Beijing, shows the same unique feature of corporate governance as in state-owned enterprises. New corporate bodies exist next to old corporate bodies, which remain powerful in most of the Chinese banks and continue to play an influential role. Although formal corporate governance standards have been introduced, old business practices may not have changed. This model of corporate structure is mostly challenged by balancing the interests of differing networks of trust relationships. In almost the same manner as in state-owned enterprises, the new corporate bodies cannot act independently, which has to a certain degree a negative effect on corporate governance. The old corporate bodies promote and protect the position of the state and the Communist Party. Through these corporate bodies, the state as well as the Communist Party can directly influence investment decisions of the board by approving or withholding funds and credit allocation. Consequently political intervention in the banking sector is still maintained and with the objective of financing the industrialisation process in the country. The anticipated commercialisation of Chinese banks is line with the reform activities by the state to turn Chinese banks into healthy and efficient enterprises. The Communist Party is supporting the state in maintaining control over finance, since deliberated resource allocation for the industrialisation process is crucial to the stability of the country.

4.1.3.2 Involvement of Strategic Investors

Article §§ 5 encourages the selection of domestic and foreign strategic investors to form synergy. Strategic investors from China and foreign countries with solid financial strength and superb management skills will be invited, based on fairness and equity, to take stakes in the two banks as an effort to improve their equity structure, capital base and management.

In accordance with the WTO accession in 2001, authorities allow more foreign participation in the existing banks. Beijing agreed to open gradually up its banking system to foreign investors by the end of 2006, over a five-year period. Opening up its banking system to foreign investors also demands for more commercial orientation and elementary reform of Chinese state-owned banking institutions. Up until now, foreign banks have had limited access to China's domestic banking business. If multinational banks become shareholders of Chinese state-owned banks, then according to international regulations for corporations, shareholders can have a strong influence on the system although they are not in the majority. Although the state does show sympathy for the idea of foreign participation in existing Chinese banks, this only extends to a certain degree. From the point of view of the Chinese government, the function of the foreign bank should be primarily concerned in mobilising of capital but not in obtaining of a strategic majority. In 2004, foreign equity stakes in Chinese banking institutions were approximately 2 per cent of total banking capital. In an international perspective, China is in last place, and more in line with other Asian emerging countries, where the share of foreign banks is usually 10 per cent or less. On the contrary, the foreign banks' share of Hong Kong banks is 33 per cent, and in Malaysia is 24.4 per cent. In Eastern Europe, foreign banks' had a 48.3 percent share of the Czech Republic's banks in 2001. In Poland this was 68.8 per cent in 2001 and in Russia 8.1 per cent in 2003 (OECD 2005b:151).

Chinese Bank	Year since	Foreign investor	Price in USD	Stake in %
China Everbright Bank	1996	Asian Development Bank	20 million	2
Bank of Nanjing	2001	International Finance Corporation	27 million	5
		BNP Paribas	87 million	12.6
Bank of Shanghai	2002	British HSBC	133 million	8
		Shanghai Commercial Bank (HK)	n/a	3
		International Finance Corporation		7
Shanghai Pudong Development Bank	2003	Citigroup	72 million	5 (option of increasing its stake)
China Bank of Communication	2004	British HSBC	2.25 billion	20
China Construction Bank	2005	Bank of America	3 billion	9 (option of increase stake)
		Temasek	2.4 billion	5.9
		Reca Investment Limited	n/a	0.34
		Fullerton Financial Holdings	n/a	5.65
China Industrial Bank	2005	Hang Seng Bank	208 million	12.78
		International Finance Corporation	52 million	3.2
		GIC Special Investment of Singapore	65 million	4
China Minsheng Banking	2005	Temasek	n/a	5
		International Finance Corporation	23 million	0.93
Bank of China	2005	Royal Bank of Scotland	3.1 billion	10
		Temasek ^a	3.1 billion	10
Industrial & Commercial Bank of China	2005	Goldman Sachs	3 billion	10
		American Express	n/a	0.4
		Allianz Investments	n/a	1.9
Hangzhou City Commercial Bank	2005	Commonwealth Bank of Australia	78 million	19.9
		Asian Development Bank	30 million	4.9
Bank of Beijing	2005	ING Group	215 million	16.7
		International Finance Corporation	54 million	4.04
Chinese Guangdong Development Bank	2006	Citigroup	n/a	20
		IBM	n/a	4.74
Xi'an City Commercial Bank	2009	Scotiabank (Canada)	155 million	20
Qilu Bank	2009	Commonwealth Bank of Australia	n/a	20
Hua Xia Bank	2010	Deutsche Bank	2.3 billion	19.9
Xi'an City Commercial Bank	2009	Scotiabank (Canada)	155 million	20
Note:				
^a Currently, the biggest foreign player in China's banking sector				

Table 7: Foreign stake in Chinese banks

Source: Compiled by the author (Publicly available information at Citigroup, Bank of America, HSBC, IFC, Bank of China, and other sources)

Although, the Chinese government does not want to give up ownership, as they do not want to lose control over banks, in 2003, the CBRC raised the limit from 15 per cent to 20 per cent for the stake a single foreign investor can hold in a domestic bank. It increased the limit further to 25 per cent for two foreign shareholders (China Daily 2005), and foreign involvement in domestic institutions is under government control and ownership limits for foreign investors have been installed in Chinese banks, at the moment capped at 20 per cent per investor and 25 per cent combined foreign ownership (China Daily 2005). Stringent ownership regulations are regarded as control mechanism to prevent undesirable behaviour in financial institutions which would lead to a conflict of interest. High presence of foreign investors might decrease the state's control over the state-owned banks. The opportunities implied by China's continued economic growth, combined with China's vast population and high national saving rate, provide an intriguing market for foreign financial institutions. For both sides there is a win-win situation, as China benefits from having foreign investors buy in and foreign investors benefit from being there.

Acquiring equity stakes in big state-owned commercial banks has its strategic advantages (Hui 2006): Firstly, there is an opportunity to operate a huge distribution network in China. For example, Bank of America's business partner China Construction Bank has 14,500 bank branches and 12,500 ATMs across the country, and has 136 million retail accounts – a number close to half the size of the population in the United States. Secondly, there is a vision of serving a growing group of multinational clients who do business in China. For instance, Bank of America and China Construction Bank co-introduced a free wire transfer service between the Bay area on the U.S. west coast and several big cities in China including Beijing and Shanghai. Thirdly, foreign banks can conduct certain business practises through their Chinese partners, which they are not allowed to do under Chinese law. Recently, Bank of America entered the Chinese credit card market by working with its partner China Construction Bank, even though foreign banks are banned from issuing bank cards independently in China. The anticipated outcome promises to improve the governance of the banking landscape and its operational efficiency. According to Anderson (2005:12) the purpose of selling to foreigners is never to get money only. Instead, the government found that overseas investors provided a *one-stop shop* for enterprise reforms. Global management consultants, human resources and investment

banking firms take the reins of the restructuring process, identifying and stripping off unproductive assets, clarifying pension liabilities, carrying out audits and redefining governance responsibilities.

The result by selling off stakes in large banks is more profitability and transparency within the state-owned banking sector, which is in line with the state's approach of efficiency orientation. Allowing foreign banks to acquire shares in Chinese banks has undoubtedly had its advantages. But from the point of view of the Chinese government, the function of the foreign bank should be primarily in bringing fresh investment capital into the banking sector and helping to undertake necessary reforms, but again not in obtaining a strategic majority. In December 2006, the CBRC has approved regulations which allow wholly-owned foreign banks to obtain a licence for offering banking services and retail business (CBRC 2006). Since 2003, the foreign banks' total assets grew steadily, and overall market share accounts for 1.83 per cent in 2010 versus 1.7 per cent in 2009 (PWC 2011:4). Summarising, the Chinese banking sector is characterised by a highly monopolistic structure and ownership is more or less restricted in the national banking landscape.

4.1.3.3 Performance-Based Strategy

Article §§ 6 demands the setting out of clear-cut strategies. The two banks must develop a market-oriented perception to identify development strategy based on comprehensive analysis of each bank's core business competence and market competition advantage. The two banks need to produce their core business development plan compatible with their operational performance targets and will at the same time set a detailed enforcement timeframe for such a plan.

The Chinese Banking Regulatory Commission (CBRC 2004) determined seven benchmarks to develop a performance based culture for state-owned banks. Key performance indicators support the definition and help measure the progress towards organisational targets. Key performance indicators assess the actual situation of activities and prescribe milestones for operational target achievement. Reform progress will be reviewed on a quarterly and annual basis, based on key performance

indicators such as net return on assets (ROA), net return on equity (ROE), cost/revenue ratio, non-performing asset ratio, capital adequacy ratio (CAR), large exposure and loss provisioning coverage ratio. Performance indicators are successfully implemented in the state-owned commercial banks and are reported on a regular basis in quarterly and annual reports. Performance figures prove that commercial banks have been transformed into profitable enterprises, which is in line with the state's strong position for efficiency-orientation within the state-owned sector.

Indicator	KPI	ICBC	BOC	CCB	ABC
Profitability	Return on average assets (%)	1.21	1.02	1.31	0.84
	Return on average equity (%)	19.43	14.55	20.68	--
	Cost to income ratio (%)	29.84	37.59	36.77	44.71
Asset quality	Nonperforming loan ratio (%)	2.29	2.65	2.21	4.32
Capital adequacy	Capital adequacy ratio (%)	13.06	13.43	12.16	9.41

Table 8: Key performance indicators 2008 for Chinese state-owned commercial banks
Source: Compiled by the author (Annual reports 2008 ICBC, BOC, CCB and ABC)

All four banks are ranked among the Fortune's 2010 Top 20 enterprises in China. According to the global ranking of the world's largest 500 corporations, Industrial & Commercial Bank of China with revenue of USD 69.3 billion is placed on 82 (Previous rank 2008: 92), the China Construction Bank with revenue of USD 58.4 billion is placed at 116 (Previous rank 2008: 125), the Agricultural Bank of China with a revenue of USD 49.7 billion is ranked at 141 (Previous rank 2008: 155), and the Bank of China with a revenue of USD 49.7 billion is placed at 143 (Previous rank 2008: 145). In this regard, the state-owned commercial banks do not follow only internal performance requirements of their controlling shareholder but also follow latest developments in the global market which has enhanced their international competitiveness and presence. At the moment the large commercial banks are targeting a broader global presence. At the end of 2008, the 5 large commercial banks set up 78 tier-one overseas operating entities located across Asia, Europe, America, Africa and Oceania. Furthermore, acquisition and investments in 5 foreign banks involving investment capital of approximately USD 7.13 billion have been realised (Annual report CBRC 2008). Overseas activities are in line with governments

anticipated strategy to encourage Chinese companies to expand globally. Thus, reform efforts in the banking sector have successfully resulted in moving towards international best practices.

4.1.3.4 Risk Management and Information Technology

Article §§ 7 requires the establishment of sound decision-making process, internal controls and risk management system. The two banks are required to put in place relevant systems to assess and control credit risks, market risks and operational risks. Moreover, concrete measures will be taken to effectively identify measure, monitor, control and defuse risks, and establish clear accountability arrangement.

Article §§ 11 requires the building of an up-to-date management information system. The two banks must speed up construction of their information and technology supporting systems to improve business management, risk control and financial services.

Both articles aim to improve transparency and information disclosure in state-owned banks. Against the background of change in the corporate credit culture in state-owned banks, appropriate systems to monitor risk elements have been implemented, including the 10-plus loan classification system. Further plans have been set up to implement the internal rating-based loan systems in order to comply with Basle II and Basel III regulations. The Chinese government shares the vision of the good governance represented by the Basel Committee, as it is regarded as a commitment to stability in the banking sector and in the economy. Risk management and the implementation of Basel II and Basel III requirements are discussed in detail in Chapter 4.3.

4.1.3.5 Organizational Structure

Article §§ 8 encourages the adoption of reduced layers of hierarchy and a streamlined business structure. In 2004, the two banks will strive to reform the existing decision-making and information management system and start to introduce a sound, independent and highly efficient business operation system

and institutional framework. Institutional layouts will be rationalised and business lines will be vertically organised to improve resource allocation and business efficiency.

In 2003, the government amended the Law on the People's Bank of China and the Commercial Banking Law, resulting in the foundation of the Chinese Banking Regulatory Commission (CBRC). The commission is charged with the objective of strengthening financial regulations and monitoring the non performing-loan ratio. Before this, the banking sector was solely overseen by the central bank, and no independent regulatory agency existed. This initiative signified a first attempt to establish a property rights system within the banking landscape by indicating which state department holds ownership over Chinese banks accompanied with rights and responsibilities. Initially, the central bank reluctantly accepted the idea of the creation of an independent regulatory agency, with some components even opposing it. At that time the central bank shifted the debate to a wide range of alternative proposals in the other direction, ranging from the consolidation of all financial regulations under the People's Bank of China to the establishment of an independent regulatory agency under the leadership of the People's Bank of China (Shih 2005:38). Further, in 2003, Central Huijin⁷¹ Investment was established which operates as an investment company owned by the Chinese state. The company is a wholly-owned subsidiary of China Investment Corporation with a corporate board of directors and board of supervisors. The members of the board of directors and board of supervisors are appointed by and are accountable to the State Council (Central Huijin Investment 2010). The principal shareholder rights of Central Huijin Investment are exercised by the State Council. The purpose of Central Huijin is to create an organizational structure by which the state can operate as a shareholder for the large big four commercial state-owned banks and other financial institutions. Through the board of directors, the state can directly influence investment decisions and allocation of financial funds, as well as strategic decision-making in financial institutions. Therefore the state possesses clear control over capital allocation, corporate governance activities and initiation of reforms in the banking sector. By 2009, Central Huijin is holding a 67.5 per cent stake in Bank of China, 48.2 per cent in China

⁷¹ Central Huijin Investment 中央汇金投资有限责任公司 also possesses shares in insurance and security companies.

Construction Bank, 35.4 per cent in Industrial and Commercial Bank of China, and 50 per cent in Agricultural Bank of China. Further, Central Huijin is holding a 49 per cent stake in China Development Bank and 71 per cent in China Everbright Bank (Central Huijin Investment 2010).

4.1.3.6 Human Resource Management and Personal Training

Article §§ 9 deals with the introduction of accountability and motivation. The two banks are required to create a market-based human resources management system as adopted in modern financial institutions, which is characterised by effective incentives and disciplines. Under such a system, employees will be recruited based on the agreed contract and no lifetime employment is guaranteed. An employee will also be rewarded or punished based on performance.

Article §§ 12 states the importance of underpinning staff training plus talents recruiting. Competent people hold the key to the success of modern financial institutions. The two banks should make comprehensive plans to strengthen staff training and recruit competent people to fill the key posts.

Initiatives in human resource management focus on the standardisation of processes and refinement of the organisational structure for regulatory purposes in state-owned banks. More focus is put on staff training, by means of career design and training programs. It is anticipated that the change will result in the selection and appointment of executive members according to performance assessment criterion, which should see a reduction in the appointments made directly by government authorities. Further, training programs focus on the improvement of the professional ability of bank employees and supervisors in risk management and credit appraisals which includes the assessment of the various risks that can impact on the repayment of loans. As outlined above, this shift in culture will be hard to achieve as cadres and directors working for state-owned banks are still selected according to their loyalty to the Communist Party, therefore not only their professional ability but also their political will is necessary in this process of change management.

4.1.3.7 Accounting and Transparency

Article §§ 10 deals with accounting practices and transparency. The two banks must start with the process of gradually adopting international accounting practices now as they are required for a modern financial institution or a share-holding company. Additionally they must establish a prudent accounting system and transparent information disclosure arrangement. The annual reports of the two banks must be subject to auditing by an internationally accepted intermediary institution and proper information disclosure arrangement must be established.

Disclosure and transparency requirements in the light of the ongoing accounting reform are discussed in detail in Chapter 5.

4.1.3.8 Restructuring

Article §§ 13 Giving a full play to the professional consulting services. The two banks need to take advantage of the professional services offered by the intermediary institutions in the market through commissioning the internationally accepted accounting (auditing) firms, financial or legal advisory agencies to conduct external auditing, assessment and due diligence investigation so as to steadily push ahead the share-holding transformation process. Based on progress made in this area, the two banks will be allowed to use supplementary capital to boost their capital base following international practice.

Restructuring efforts aim to transform the state-owned banks into commercial operating banks. Reforms steps taken include recapitalisation of commercial banks; internal restructuring and stock listing. Besides structural restructuring, policymakers are also taking measures for the financial restructuring of the banks. Financial restructuring aims to solve the non-performing loan issue in the country, but the introduction of further restructuring programs are delayed or hardly existing, which include efficient financial intermediation, establishment of supporting institutions following the principles of private property rights, competition, and prudent regulation. Reforms resulted so far in a two-tier banking system with four commercial state-owned banks replacing the monobank. Further, specialized banks have been

created which are no longer sector-restricted, and a limited number of private banks were allowed to enter the market due to liberalization. Enterprise reform and restructuring efforts also included the establishment of four financial state-owned asset management companies, with the aim to transfer bad debt to China's asset management companies (see chapter 4.1.4.3).⁷² Reforms did not terminate sector-specific lending provided by policy banks and state commercial banks. Further, the government did not formulate any plan for state-owned bank privatization. Guided by the scientific concept of development strategy, the People's Bank of China, the Chinese Banking Regulatory Commission and other administrative authorities encourage commercial banks to adapt their lending to specific borrowers in light of relevant government industrial policies; loan growth is restricted administratively. Encouraged industries include enterprises with cutting-edge technology, market recognition and competitiveness; national key construction or infrastructure projects such as urban power grid development, railway, airport and highway network construction; small and medium enterprises; technology upgrading projects, merger & acquisitions; ecological and environment-friendly projects; construction of rural infrastructure, medical and sanitation facilities, and elementary and high school premises; building of low-rent houses and affordable houses for urban low-income residents; post-disaster reconstruction (CBRC 2008). Thus, monetary policy remains tailored to domestic macroeconomic conditions. In response to the global financial crises, lending was increased following an investment plan being part of stimulus measures in the country. With the view to support competitiveness of large state-owned enterprises, ten strategic sectors were announced to be strengthened: shipbuilding, petro-chemicals, light industry, equipment manufacturing, non-ferrous metals, textiles, electronics and information technology, autos, iron and steel and logistics (OECD 2010).

Interest rates are subject to benchmarks with limits around these benchmark rates, and banking institutions must set their rates within the limits. The Chinese case proves that ownership and control over financial resources allows the government to channel investment decisions in the banking sector to achieve its strategic objectives. Resource allocation toward politically desirable projects follows credit policies,

⁷² In return for bad debts, China's banks received ten year bonds paying a taxable 2.25 per cent per annum (State Council 2000).

which are in line with national industrial policies. Reforms in the Chinese banking sector are tackling competition in the market and prevailing informal relationships, which hinder institutional change and market allocation of resources. Even though structural reforms have taken place to a certain degree, but effective banking restructuring fell short and continuous extension of soft loan credits is permanent. Bank reformers are challenged to strengthen financial discipline on the domestic market by improving risk management and credit quality while adhering government directives to support growth in the country at the same time. It can be stated that the central government has taken an active role in bank regulation.

4.1.4 External Corporate Governance and Institutional Change in State-Owned Banks

Bank loans are the main source of financial investment in the state-owned sector. As of 2009, bank loans accounted for 83 per cent of total funds raised by the domestic non-financial sector, up from 76 per cent in 2001 (see table 10). The share of government securities in financing has remained more or less the same, from less than 1 per cent in 2001 to 2 per cent currently. Enterprise bonds on the other hand have seen a slight increase from less than 8 per cent in 2001 to 9 per cent during the same period. The share of equity financing fell slightly by 1.5 per cent to 6 per cent, which is attributed to the ongoing reform in the stock markets. These figures prove that policymakers continue to rely on the banking sector for financing.

in %	2001	2002	2003	2004	2005	2006	2007	2008
Bank loans	76	80	85	83	78	82	79	83
Equity financing	8	4	4	5	6	6	13	6
Government securities	1	1	1	1	6	7	4	2
Enterprise bonds	8	4	4	5	6	7	5	9
Total	100	100	100	100	100	100	100	100
<i>Notes:</i> 1. <i>Equity financing in the table does not include financing by financial institutions on the stock market.</i> 2. <i>Government securities financing in 2007 does not include RMB 1.55 trillion of special government bonds.</i> 3. <i>Enterprise bonds include bonds issued by enterprises, short-term financing bills, medium-term notes, and corporate bonds.</i>								

Table 9: Percentage of financing to the domestic non-financial sectors (2001-2008)

Source: People's Bank of China 2009

Allowing lending decisions to be taken according to commercial criterion would hinder the state as well as the Communist Party in financing the state-owned sector and projects following national policies. Compared to other financial systems, the banking sector plays a crucial role in risk sharing. Bank deposits mainly derive from household savings, and by holding the majority of assets in banks, the state is regarded as guarantor that savings are protected from risk. Even though, the number of small investors in the Chinese financial market is steadily increasing, but in the United States as well as Anglo-Saxon countries, the proportion of individual households are holding assets in equities is much higher, and therefore are much more exposed to risk.

Bank loans in China consist of a mixture of short-term and long-term repayment periods. At the end of 2008, short-term loans amounted to RMB 12.9 trillion, an increase of 12.3 per cent compared to 2007. Medium and long-term loans were RMB 16.4 trillion, a rise of 20.2 per cent versus the previous year. In 2003, the share of medium and long-term loans was about 40 per cent of total loans. In 2008, the share of medium and long-term loans was 51 per cent. The increase in medium and long-term loans is the result of government construction projects, which are often financed by long-term loans with terms of 20 years or more (Shih 2009).

	2003	2004	2005	2006	2007	2008
in %						
Short-term loans	51.5	48.2	44.1	42.7	42.8	40.2
Medium & long-term loans	39.6	43.0	44.9	47.4	49.9	51.3
Other loans	8.9	8.9	11.0	9.9	7.3	8.5
Total loans	100	100	100	100	100	100

Table 10: Percentage of short-term and long-term loans of banking institutions (2003-2008)

Source: Annual report CBRC 2008

Infrastructure projects involve investments in sectors such as transportation, warehousing and postal services, electricity, gas, water production and supply, water conservation, environmental protection, public facility management and the manufacturing sector. National growth is mostly financed by granting public-sector loans. Policy lending is possible, as differing interest groups are interested in rent protection. Policy lending implies that investments do not necessarily go to high quality projects which results in soft budget constraints. Even when banks themselves are subject to hard budget constraints, lending policies of banks following national policies can result in bad debt problems and consequently in soft budget constraints.

4.1.4.1 Delay of Institutional Change and Path Dependence

In the framework of the transformation process, Chinese state-owned banks did undergo the process of institutional change to a certain degree. Institutional change involves the building of new governance institutions and the solving of the solvency crises of the state-owned banks that dominate financial intermediation. Currently, the institutional framework of the banks involves the coexistence of old and new corporate institutions, characterized by informal institutional arrangements. Chinese policymakers chose to empower state agencies for enterprise and bank restructuring. Thereby, reform priorities became more focused on effective monitoring, concerning credit growth, restructuring costs of banks, the need for repeated bailouts, and the soundness of bank supervision. Institutional change in the banking sector is heavily marked by path dependence and lock-in effects. This situation is regarded as reform-reluctant and hinders in depth institutional reforms. Path dependence is apparent due to the exertion of influence against widespread reforms, as the government as well as the Communist Party adheres to their policy that Chinese state-owned banks' core activity is to provide financial resources to state-owned enterprises and infrastructure projects according to national policies. Further, they did not retreat from their

dominant position in the sector, thereby assuring their exclusive control over finance (see chapter 4.1.2, table 6). Many financial institutions are facing lock-in effects resulting from the inability of enterprises to pay down loans. Before reforms were introduced, bank behaviour on lending decisions was passive following the requirements of the plan. Since reforms were introduced, and banks were transformed into commercial banks with the objective to improve credit quality and investment decisions, lending behaviour needed to change. Reform efforts center on the ability of the state to impose gradually a new set of rules based on governance standards with the objective to improve transparency and efficiency. The emphasis of the reforms is on the ability of the state to act strategically toward certain sectors and regulate the economy so as to induce state agents to act in the interest of the state. Policymakers are challenged to the extent that old and new corporate bodies with differing levels of power need to be translated into an institutional coherence targeting a consistent economic policy.

In developed countries, institutional change would be based on strong economic incentives working best in mature financial and banking sectors. In the Chinese case, market-based incentives are not necessarily adequate for the Chinese model of institutional change, where regulations and policies follow political and strategic reasoning of the state and the Communist Party. In the financial restructuring process, the state as well the Communist Party are facing the dilemma to be in the necessary situation of effectively changing behaviour and build new institutional capabilities by diffusing policymaking power, balancing the divide between state and society, and to pursue their strategic interests in legitimization. By viewing institution building in China as a gradual process in developing public capabilities, gaps in objectives between transparency and efficiency orientation of the state, on the one hand, and the value-orientation of the Communist Party, on the other, can be identified in the governance process. Transparency and efficiency orientation in the banking sector is supporting the state in its efforts of industrialisation in the country. Value orientation in the banking sector reflects the Communist Party's commitment to social and environmental reforms in the country. In China, institution building is a gradual process, in which relevant political and economic actors learn with new roles and rules to solve common problems of interest. It can be stated, that the Chinese approach in the financial sector reform involving path dependence does not support privatisation

activities and led to an expensive solving of the bad debt problem (see chapter 4.1.4.3), a stable banking sector with increased lending capability, and a strong state supervisory authority. Change of bank behaviour mainly targets the state objective to improve authorities monitoring capabilities and to learn to deal with new corporate rules that can change behaviour in the state-owned sector.

4.1.4.2 Transformation related Agency Problems

In the same manner as in the enterprise reform, the introduction of the banking reform did not show intention to abolish state ownership, but rather to increase efficiency in the banking sector with special regard to the increasing non-performing loan problem. In banking, several agency relationships problems appear, such as asymmetric information problems, free rider problems, moral hazard and high transaction costs. Informational problems occur as the debtor is ex-ante better informed as the creditor about his willingness and ability to pay back a credit and the debtor is ex-post better informed as the creditor about his willingness and ability to pay off debts. Banks are playing a central role in Chinese economy, as they are holding corporate information on enterprises, on which they are approving and holding loans. Traditionally, enterprise-bank relations in China are very strong and Chinese enterprises rely on loans from banking institutions to cover their financing needs. In turn, banks have effective control over enterprise access to working capital and can influence enterprise activities. This puts banks into a preferred position with the competency to monitor enterprises and to execute control. Since the state is the largest shareholder of the state-owned banks, at the same time the state is also the largest debtholder of the enterprises. As already observed in the chapter on the state-owned enterprise reform, shareholder concentration in the state-owned sector is high, so that the state and the Communist Party have a large incentive to monitor corporate management and corporate decision-making through the board. In China, the market for corporate control is inactive, due to the imperfection in the capital market. Compared to the United States and Anglo-Saxon countries, the frequency of merger & acquisitions and hostile takeovers is low. Therefore in China, management selection is resulting from poor performance applied as a control mechanism, dependent on the capability of the largest shareholder to monitor management. Chinese large banks are acting as an intermediate between the state and the Communist Party and the state-owned enterprises, having a diversified portfolio of projects for which they provide finance.

Although Chinese state-owned enterprises rely to certain extent on high rates of internally retained revenues for financing, but banks have enough control over enterprises by dealing with external finance sources such as bank loans. Bank monitoring influences financing decisions whether financial resources are allocated into safe or risky projects, and whether money would be invested into risky projects at all.

In China, corporate control mechanisms are functioning, as the state is able to monitor corporate management in large enterprises. Chinese state-owned banks are given a very effective monitoring role over enterprises internal management behaviour as well as external financing behaviour. This involves the magnitude and the length of a bank loan, the reputation of banks, as well as the number of lenders. Monitoring and controlling the quantity of credit is regarded as a reliable control mechanism for macroeconomic stability. Prices are not controlled by state anymore, and they are regarded as a less reliable control mechanism due to their volatility in a constant changing environment and especially in times of crises and recession. Asymmetric information problems and high transaction costs associated with external finance, apparent in agency relationships can here be mitigated due to traditional informal relationships between the state, the Communist Party, the banks and the enterprises. By restoring state-owned banks solvency, moral hazard problems of expectations of further bailouts were limited as well as adverse selection problems of banks declaring additional financial aid although not needed. The experience proves that close enterprise-bank relationships have a positive impact on growth rates in an economy. Gerschenkron (1962) argues that economic growth in Germany results from the bank-based system and close relationships between the industrial and the banking sector, whereas the market-based system in Anglo-American countries cannot show the same results. Having the capability to monitor the overall financial situation of enterprises, banks are also in the position to monitor revenues raised by enterprises which is meaningful information with regard to future tax incomes for the state. Under the assumption that Chinese state-owned banks exclusive role is to be the corporate monitor institution on behalf of the state, this role would be weakened if demand for bank loans would decrease. The actual situation of the underdeveloped capital market strengthens the state's power in monitoring and controlling enterprises and the reform process as a whole. Corporate governance practices are applied in the

banking sector so that agency problems can be solved, by improving banks' capability to monitor enterprise behaviour. In the last years, Chinese state-owned enterprises show continuous improvement in efficiency and profitability. Since banking institutions are the monitoring device for enterprise behaviour, it can be concluded that the state uses its control rights and presence on the board to govern and influence corporate management towards efficiency and profit maximisation.

4.1.4.3 Transformation related Soft Credit Constraints

In the previous chapter, it was illustrated that the corporate governance role of banks is characterised by the involvement of traditional close and long-term relationships between several interest groups in the banking landscape. On the one hand these relationships show their advantages by reducing informational problems, but on the other hand close relationship trigger further issues having a negative impact on corporate governance in the banking sector. Close ties of bank-enterprise relations can lead to conflicts of interests, especially when it comes to question of credit quality and subsidisation. Soft credits in the banking sector are a form of soft budget constraint (Kornai 1980), where banks pour financial resources into poor projects as they have no incentives to make productive investments in the enterprise sector *ex ante*, as they know that they will be bailed out *ex post*. In a socialist state, like it was the case in China and the socialist countries in Eastern Europe soft subsidies, soft taxation, and soft credits were all sources of soft budget constraints. In order to overcome the soft budget constraint in the socialist state, a shift from government to bank financing of state-owned enterprises was undertaken. The main issue with soft lending derives from the fact that it hinders market-driven allocation of financial resources through the financial market. Boycko, Schleifer and Vishny (1996) and Berglof and Roland (1997) argue that competition in conjunction with the entrance of new enterprises providing projects with high quality, would terminate soft lending on poor projects.

As already mentioned before, in China credit lending is still sector-oriented and credit approvals are following recommendations from state agencies. There are several motives, supporting the maintenance of the soft loan system. State-owned banks are playing a crucial financing role in enterprise restructuring. Sound restructuring

demands high financial resources, especially as among the restructured enterprises, there exist a number of enterprises with low performance. Especially for loss-making enterprises, restructuring would unlikely be successful without banks involvement. In a market-driven environment, those enterprises would be closed and declared for bankruptcy. During the reform poor performance by enterprises did lead to bailouts by the state through continuous soft lending with the aim that they can survive. Therefore the government possess a controlling influence in the restructuring process instead of choosing privatization or liquidation of enterprises. Soft credits are regarded as a legacy of the socialist economy, and became a serious challenge for the transformation economy. The persistence of the soft loan system is maintained as it is regarded as a control of credit allocation by the state and Party, which remained after 1978; and is still active. During the transformation process, new corporate institutions have been introduced in state-owned banks as well as in the state-owned enterprises with the aim to replace old institutions within the enterprises. The analysis of the four commercial state banks (Industrial & Commercial Bank of China, China Construction Bank, Agricultural Bank of China, and Bank of China) has shown which are all ranked among the Fortune's 2010 Top 20 enterprises in China, that the majority of the top management still holds close ties with the Communist Party, as they are party members and hold high level positions in the Communist Party. In the socialist market economy these links between the state and the economy are still present. Also in the reform period the preservation of these informal relationship and ties is maintained which allow selective access to scarce resources, where formal institutions cannot become effective. As already mentioned in chapter 2.5., a weak institutional environment and poor enforcement of the rule of law, allow the coordination function of the central system still to function. As reforms failed to dismantle old structures, the state and Communist Party will maintain the soft loan system in favour of strategic industries, which does not only guarantee the realisation of national industrial policies, but also the support of economic interest groups at the national and local level in the country. Additionally to the financing role, state-owned banks are playing an important role in the social and political stability of the country. Large loss-making enterprises and dominant employers in remote regions are beneficiaries of soft loan policies, thereby these enterprises are prevented from liquidation or closure. Mass layoffs are an unpleasant alternative to the state and Communist Party, since unemployment goes against the anticipated social stability in

the country. Even though, enterprises might not bring an income, but workfare encourages long-term employment in the community, where individual income is created that generates taxes for local governments. It can be stated, that soft lending policies do not necessarily generate an economic return on investment, but do generate a social return on investment. Government intervention in capital allocation ensures projects for which social returns are the highest, concerning questions of employment, avoidance of spillover effects, environmental issues and the social function of state-owned sector. Policymakers are sensitive about this social return, which are demanded by stakeholders in the reform process. Even though, soft lending policies make banks more vulnerable from an economic point of view, but their social function in the economy cannot be denied. The state as the owner of state-owned enterprises and is consequently interested in high economic returns on investment. Investments into projects with social returns are of high interest for the Communist Party, which are the beneficiaries of the soft loan system and do not show interest in losing access to soft credits. Losing access to soft credit would also entail a loss in political credibility and control over resource allocation. The state and Communist Party are challenged to balance economic and social investment needs as well as to assure a healthy banking sector in order to sustain growth and stability in the country.

Market liberalization in the Chinese banking sector is marginal, so borrowers mainly depend on the state-owned banks for their access to credit. As banking institutions are working according the central government macroeconomic policies, soft lending continues and low quality project will not be squeezed out of the market. Therefore moral hazard problems occur in combination with non-performing loans, as borrowers expect to be bailed out in the future, regardless of the investment risk. Biased resource allocation might be also the reason why private enterprises and farmers are still lacking credit access to commercial banks and other formal lenders, and rely much more on informal financial facilities. According to IFAD (2001), credit is of normally obtained by farmers from the informal market at a cost estimated to be more than four times that of credit obtained from official credit institutions. From the farmers' perspective, therefore, the informal credit market is far more important than the official credit market (IFAD 2001). Under the assumption that private business would come up with projects for financing with high returns, state-oriented banks might withdraw from financing poor projects with low returns and bail out of already

given projects, and turn to project with highest returns. According to a survey by Beijing's Central University of Economics, in 2007 informal lending reached RMB 2 trillion (USD 290 billion), or 28 per cent of total bank loans. Much of the lending is funded by bank deposits channeled into the informal sector (OECD 2010:90). Although lending to small and medium enterprises has been encouraged by authorities, but access to bank and capital market finance remains limited. According to a banking survey on the mainland banking landscape (KMPG 2010:14), there exist several reasons for the reluctance of banks to provide bank financing to small and medium enterprises. Bank lending is linked with risk and most small and medium enterprises lack of land use rights, property or real estate to put up as collateral. In rural areas, the situation is even more complex, since in the past land was used for farming and very often owned by the collective. Since the property rights system is still developing, entrepreneurs in the rural area cannot put up their land as collateral. Further, banks are still limited in their ability to price for risk. Additionally to these challenges, small and medium enterprises need to improve their quality of financial information, which also includes the tracking of credit records.

The Chinese government took several measures to tackle the bad debt issue. First, in the last years, all commercial state banks were recapitalized, and the costs of bad debt restructuring through recapitalization were assumed by state. The same measures were witnessed in Western countries during the financial crises in 2008, where banks were recapitalized. In China, restructuring was chosen for troubled banks as the only option, as they are too large to fail. Their bankruptcy would have entailed the risk of a systemic crisis in the national economy. Recapitalisation was made along with improvement of the bank's management and operational efficiency, and with the aim of improving the capital adequacy ratios (CAR) in the banking sector, which in turn allowed the four banks to write down their non-performing loans faster. Credit losses and write downs came directly out of retained earnings, which are part of a bank's common equity base. The accumulation of bad loans had a negative impact on the profitability of the banking sector, and the assessment of the bank capital assets was difficult. Additionally, the poor quality of the loans reduced revenues of the banks, and fiscal income for the state were not assured. At the end of 2008, the CAR of the Bank of China stood at 10.81 per cent, China Construction Bank at 10.17 per cent, Industrial and Commercial Bank of China at 10.75 per cent and Agricultural Bank of

China at 8 per cent. Since 2003, the People Bank of China alone has already spent over USD 100 billion on recapitalisation and bad loan write-downs, with more still coming from bank's own profits and government tax breaks (Anderson 2005:9). In fact in the past the percentage of nonperforming loans of the total volume of credit has been reduced.

Second, a substantial amount of non-performing loans were transferred to asset management companies. The burden of restructuring the nonperforming debt was shifted to asset management companies, which in turn, will seek repayment with high interest rates of past obligations from borrowers or selling off the rights on bad assets on the market. This measure might be regarded as a kind of factoring "Chinese style" as bad debt is transformed into new liabilities for enterprises, which makes enterprises effectively responsible for recovering past obligations. According to needs of the national economy and sustainable development, Chinese banks allocated credit to specific industries and enterprises, without appropriate assessment of creditworthiness. Thereby Chinese banks are operating in favour of the Communist Party in financing the realisation of reform programs, such as the *construction of a harmonious society* and *the scientific concept on development*. Loans have not been dealt according to economic criteria, but rather according to political criteria, which are regarded as *policy loans* (政策贷款). As state-owned enterprises are not independent from policy lending, the non-performing loan issue became urgent. In the past, due to lending under the credit plan and administration of interest rates, state-owned commercial banks accumulated a bulk of nonperforming assets. In 1999, four state-owned asset management companies - China Xinda Asset Management Corporation (中国信达资产管理公司)⁷³, China Huarong Asset Management Corporation (中国华融资产管理公司)⁷⁴, China Great Wall Asset Management Corporation (中国长城资产管理公司)⁷⁵, and Orient Asset Management Corporation (中国东方资产管理公司)⁷⁶ - were established to take over bad assets from banks then manage and resell them. The Chinese asset management companies are financed through four financial sources, following government regulations, such as through Ministry of

⁷³ Corresponding to the China Construction Bank

⁷⁴ Corresponding to the Industrial and Commercial Bank of China

⁷⁵ Corresponding to the Agricultural Bank of China

⁷⁶ Corresponding to the Bank of China

Finance equity, borrowing from the People's Bank of China, and commercial borrowing from other financial institutions and asset management company's bonds (State Council 2000). By holding huge shares on enterprise debt, these asset management companies possess a powerful control instrument over enterprises on behalf of the state. So beside state-owned banks, the asset management companies play a role in corporate governance based on ownership rights. China's non performing loan market size is extensive. According to data provided by the Chinese Banking Regulatory Commission (Annual Report 2008), the share of non-performing loans in the four commercial banks was reduced by nearly 15 per cent within five years. Restructuring efforts are not limited to the four big banks alone, but also include other types of banking units. The takeover of non-performing loans by the asset management companies was necessary with regard to the restructuring process and the preparations for stock market listing of the four commercial banks.

in %	2003	2004	2005	2006	2007	2008
Share in total loans	17.9	13.2	8.9	7.5	6.7	2.4
Substandard	2.7	2.4	2.2	1.5	1	1.1
Doubtful	9.4	6.8	3.4	3.1	2.4	1.1
Loss	5.7	4	3.4	2.9	3.3	0.2

Table 11: Percentage of non-performing loans of major commercial banks (2003-2008)
Source: Annual report CBRC 2008

One measure was not taken into considerations, such as the closing of insolvent banks, where the burden of the bank restructuring costs would have been shifted to suppliers of credit, which are in the Chinese case the shareholders and depositors. So far the Bankruptcy Law in China has not been very effective due to political-economic constraints. The Enterprise Bankruptcy Law of the People's Republic of China, which was adopted at the 23rd meeting of the Standing Committee of the 10th National People's Congress of the People's Republic of China, came into effect on June 1, 2007. It is China's first Bankruptcy Law since 1986, which was applied only to state-owned enterprises, and many of the provisions were inadequate for China's market-socialist economy. Having in mind, that the modern Bankruptcy Law is still very young and bankruptcy courts lack of practical experience, bankruptcy proceedings do not represent to be an appropriate alternative for restructuring in the moment. So as the state obtains majority ownership over state-owned banks as well as enterprises, it plays two roles in soft lending activities; as capital owner as well as capital borrower.

As already described in chapter 3.1.5 savings derive from several sources, such as the individual households, the government and state-owned enterprises. All these depositors have trust in the state-owned banks that their deposits are safe and liquid. Closing of banks in China would lead to the situation that depositors would have an incentive to withdraw their deposits from their accounts, which would lead to systemic crises in the national economy and to the potential collapse of the vulnerable banking system. Confidence in the banking system would be lost and system bank runs would follow with the aim to safeguard deposits, because deposit guarantee is not given anymore. Ownership of banks enables the government both to collect savings and to direct them toward strategic long-term projects (La Porta 2002:3). Actually, this is the case in China where financial resources are channeled to meet the demand of state-driven and politically motivated investments in strategic important industries in the domestic market. Therefore, the state is naturally concerned not to lose funds and knows about the prompt responsiveness of depositors to bank failure and entailed loss of confidence in the system. The banking sector is vulnerable to instability and under the assumption that a large number of banks are technically insolvent, they will be kept alive through government support. In 2010, a book has been published discussing in an article “Why Chinese banks do not go bankrupt” (中国银行业为什么没破产?) (Jinqian tongzhi 2010), which addresses the phenomenon in Chinese banking sector, that the financial market are not cleaned from weak and insolvent banks so far. Several reasons are described supporting the approach that state ownership in the banking sector contributes to financial stability and long-term growth in the domestic market. Additionally, it can be stated that an increase of profitability in the banking sector leads to a strong position of the institutions and reduces automatically the risk of bankruptcy. Even when the interest rate in Chinese banks are low, individual and institutional depositors consider their deposits implicitly guaranteed by the state, which results among other reasons in the highest saving rate in an international comparison. Currently in China, the introduction of deposit insurance⁷⁷ is under discussion, which would represent a strong contribution to the financial safety net especially to household depositors. The Chinese

⁷⁷ Deposit insurance aims to achieve the following: (1) to protect the small depositor, who is normally not privy to information about the management of financial institutions; (2) to keep the financial system stable and make the financial industry and financial transactions more efficient by averting bank runs; (3) to provide a fair and competitive market for financial institutions that differ widely in size, regional concentration, nationality, and other respects; and (4) to clarify the responsibilities and rights of depositors, financial institutions, and the government and to minimize the burden on the taxpayer in case of bank failures (www.bis.org).

government is keen to prevent any banking crises in the domestic market, which would have a negative impact at the expense of the households and the whole domestic economy. Such a crisis would lead to additional costs for support programs and government bailouts and would seriously endanger the ongoing reform and restructuring process. The restoration of state-owned banks solvency limits moral hazard problems and adverse selection problems, which would lead to additional costs and indirect taxes, thereby suppressing domestic demand. Soft credit constraints are possible, since financing of the state-owned sector does not only matter from an economic point of view, but also from a political and social viewpoint. Loss of public trust in the financial and macroeconomic stability of the country might lead to social unrest and public discontent, which concerns the state and the Communist Party.

4.1.4.4 The Role of Banks and Credit in Enterprise Restructuring

The transformation from a planned to a market-based economy did not change the relationship between the state and the state-owned banks. The vertical, reciprocal relationship is still maintained. Banks main function on behalf of the state, as the main shareholder, is monitoring of enterprise behaviour acknowledging the existing conditions in the transformation country. Corporatisation of state-owned banks was initiated with the aim to improve efficiency and transparency in the banking sector. While during the enterprise sector reform, the state aims to retreat from its dominant position to a certain degree, in order to assure that market mechanism works, in the banking sector the situation is different. The state does not show a tendency of retreating from its dominant position and from its overall control function in order to assure that state control continuous to work. State control over financial resource allocation is crucial, since during the transformation process immense social and restructuring costs occurred, which need to be financed. Chinese banks are playing a crucial role in corporate governance in China, due to fact, that they are holding a big share of enterprise debt, which allows them to possess a powerful control instrument over enterprise revenue and cost, and the reform process as a whole. Due to the traditional enterprise-bank relationship, the state and the Communist Party possess information about management, enterprise financial situation and future projects; at the same time giving them the ability to implement preferred strategies in relevant industries. The nature of restructuring activities depends from industry to industry,

which requires in any case investment. Investments in enterprises derive either from equity or debt. In general, corporate governance literature extensively analyses different governance modes of monitoring and control in Anglo-American countries compared to the ones in Continental Europe and Japan. Thereby agency issues should be solved how to motivate agents to act in the interest of the principal, so that investment decisions are based on all information available and finance is protected. Holmström and Tirole (1997) discuss in their article, that equity as well debt holders can monitor either actively or passively. Active monitoring involves hands-on evaluation of a firm's operations, investment decisions, and capacity and willingness to repay. Passive monitoring involves collateral on securities, where before a lending decision is made, the value of the enterprise collateral is evaluated rather than operations of the firm. Baer and Gray (1995) describe in their working paper the experience of Hungary and Poland with debt as a control device in restructuring for medium and large enterprises. Dittus and Prowse (1995) describe the experience of Russia, where banks are playing an important role since debt represents to be a powerful control instrument over enterprises. Further the analysis in their working paper shows the role of banks in corporate governance based on ownership rights. By comparing existing systems of corporate governance, several examples show that banks are playing a major role in the governance mechanism through the ownership of enterprises. La Porta et al. (2000) describe several cases of government ownership of banks around the world, like in Asia, Africa and South America, with the objective of possessing direct ownership over strategic industries and control over finance. By holding enterprise equity or debt through investments, state-owned banks are playing an influencing role in corporate governance based on ownership rights. In China, the investment company Central Huijin, makes equity investments in the large commercial banks on behalf of the state, and exercises ownership rights and performs obligations as an investor with the aim of profit maximization of state-owned assets. At the same time, the large commercial banks apply the money for further equity investments in state-owned enterprises. Ownership rights based on debt are executed by the asset management companies, which are holding huge shares on enterprise debt on behalf of the state.

Bear and Gray (1995) argue that effective credit monitoring requires information, market oriented incentives for creditors and a developed legal framework for debt

collection. In China, active monitoring is predominant by the main shareholder in the banking sector, with lower importance to the equity market as well as institutional investors. Still, the state as the owner of the banks depends on a supportive general framework, such as legal conditions for restructuring and liquidation, adequate disclosure and accounting standards, in order to be able to overcome information shortcomings. Formal information channels on enterprises might be poor due to the lack of adequate accounting standards and the absence of independent auditing (see chapter 5). Investment and lending decisions require reliable information and high levels of uncertainty counters the reforming process in the economic environment. Still the monitoring competence of the state is functioning, since missing corporate legal and institutional requirements on financial accounting and disclosure are adjusted through informal network channels. Long-term enterprise-bank relationships have a significant value in the Chinese business landscape, since they have a big impact in resolving information asymmetries in credit lending. Further the state-owned banks are playing an influencing role in the realisation of efficiency and profitability objectives in state-owned enterprises, as they are highly interested in debt repayment. Debt monitoring is especially important since equity monitoring still needs time for development due to an underdeveloped capital market, and shareholder rights and disclosure is still not functioning. The state, as the owner of the banks and the enterprises, does not only have an interest in debt information borne by banks but also by tax and social security offices. Until today, state-owned enterprises have a strong interest in limiting information in enterprise performance and take advantage from weak tax enforcement regulations. Especially in times of financial crises, overdue tax and social security arrears are favored channels of financing. Since adequate disclosure following the requirements of the socialist-market economy is still evolving, the state has the possibility to monitor management behavior and enterprises economic situation through the regular review of bank credit portfolio as well as through the extension of credit conditions. In February 2010, the China Banking Regulatory Commission (CBRC 2010) issued two regulations that aim to tighten banks' lending and risk management controls. The new regulations target the introduction of lending quotas and improved risk control after granting loans as well monitoring of repaying capabilities of borrowers. Both regulations support the state with a control mechanism for examining the state-owned banks compliance and behavior with directives on lending restrictions.

New and strong revivals of policy lending might lead to an unavoidable increase of bad loans, as projects following the national policies will not necessarily follow prudent credit assessments. The bad debt ratio of Chinese state-owned banks is very likely to increase in the future, especially as the government is taking measures towards pushing investment activities in urban and rural areas in order to avoid a slowdown in economic growth in the country. Within the framework of the reform program of *the construction of a socialist new countryside*, financial institutions have adjusted industrial credit policies according to the state's macro-economic industrial policies. The Agricultural Development Bank of China published in its 2008 annual report, which details regarding the launch of various products that are in line with the objective of supporting sustainable and the healthy development of China's agriculture sector. Banking products that have been launched include the *Green Home Loan* and *Jin-Yi-Nong* (Benefiting the Farmers). Moreover, a series of distinctive products and services were launched such as *Company and Farmers* guaranteed loans, working capital loans for farmer's specialised cooperatives, seasonal loans for leading agricultural enterprises, *Six-Party Cooperation and Insurance* loans and cross-guaranteed farmer loans. Financial services such as the *Kins Payment Express* and *Farmers' Insurance Express* were also created (Annual report 2008, Agricultural Development Bank of China). National policies support infrastructure programs such as the development of Western China and Central China and the revitalisation of the old industrial bases in Northeast China. An increase for loans granted is observed in infrastructure construction in medium and large-sized cities in the Western, Northeastern and Central Chinese areas. Selected key industries, operating in the agricultural and rural economy will receive exclusive support by means of corporate loans with a lower focus on risk management requirements.

The banking sector is facing a dilemma at the moment, as a response to conflicting government demands. The reduction of bad loans improves banks' efficiency and profitability, but the global financial crises requires state banks to contribute to economic stimulus packages that lead again to an increase of bad loans. The CBRC (2008) states in its latest annual report that with economic slowdown, credit risk has increased and several industries are suffering from the pressure of non-performing loans rebounding. Furthermore, the newly acquired risk control capability of Chinese banks will be challenged, especially as demand for commercial loans and subsidised

loans are growing rapidly. In the Chinese case it can be concluded that so far credit is the primary mechanism for channelling financing into the transformation economy. Bank finance is the preferred financing channel, as the state persists in maintaining financial control over the economy. Since no market of corporate control with a leading role in corporate governance and finance exists so far in China, therefore debt is representing to be a substantial control device in the framework of the restructuring of the state-owned sector. Control over credit lines, capital and credit allocation is important for the state in order to maintain the ongoing reform process with the aim of economic progress in the country. Profitability improvement in the four state-owned commercial banks proves that the state did not retreat from its efficiency orientation within the state-owned sector, thereby pushing the banks to operate globally. The state requires banks to work profitable with the aim of generating an economic return of investment and tax revenues for the state. By supporting the state in maintaining financial control over the economy and the reform process, the Communist Party is pursuing the realisation of its policy of the *construction of a harmonious society* and the *scientific concept on development* with the aim of generating social return on investment. The Communist Party is assisting the state in its efforts in the ongoing reform process with the aim of political and social stability in the country.

4.2 Capital Market

Beside the banking sector reform, corporate governance also involves the reform of the stock market in China. Here again, corporate governance efforts are targeting the improvement of efficiency and transparency in this area.

China's first stock exchange was founded in 1891, namely the Shanghai Share Broker's association, and was renamed in 1904 to the Shanghai Stock Exchange. From 1911-1949, Shanghai was an important international financial centre in the region. In 1918, the Beijing Securities Exchange was established. After the foundation of the People's Republic of China, in 1949, both stock exchanges were closed, as they represented a symbol of the capitalist economy. The Chinese stock market in the post-Mao-era does not have a very long tradition as the stock exchange in Shanghai was reopened in 1990 and the one in Shenzhen in 1991. While many

developed markets have a single-exchange structure, China’s market structure is different. The original purpose of the Chinese state in allowing the issuance of securities was to raise capital, rather than establishing a trading market for security holders. The purpose, which was politically motivated, was to mobilise the high private saving rates of Chinese households for investments in the state sector and the domestic economy (Heilmann 2001). Besides the primary market, a secondary market evolved, which stimulated black-market trading and over-the-counter transactions. Eventually the Shanghai and Shenzhen stock exchanges were established. At the end of 2008, China’s mainland stock market had 1625 listed companies and more than 152 million investor accounts (CSRC, Annual report 2008). The transformation of Chinese SOEs into corporations facilitated listings on the stock exchange and has empowered Chinese companies to raise funds through initial public offerings. In 2008, the global financial crisis hit China’s equity market dramatically. At the end of 2008, the total market capitalisation of the companies listed on the two stock exchanges in Shanghai and Shenzhen was RMB 12.1 trillion, representing a decrease of 63 per cent from the end of 2007.

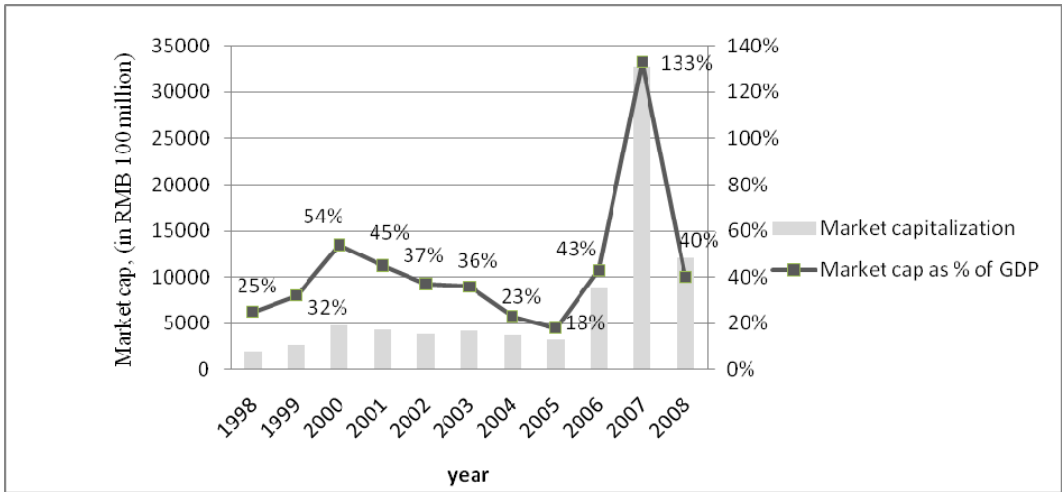


Table 12: Market capitalization as a percentage of GDP (1998-2008)
Source: Compiled by the author, CSRC Annual report 2008

The market capitalisation of the stock exchanges at 2008 year-end accounted for about 40 per cent of China’s GDP in 2008. The stock market has been characterised

by significant growth over the years, with total market capitalisation increasing from RMB 1.9 trillion in 1991 to RMB 12.1 billion in 2008⁷⁸.

4.2.1 Current State of China's Stock Market

In comparison with other international markets, China's stock market is characterised by its own unique features.

Firstly, China's stock market is mainly dominated by state-owned enterprises. Today, 70 per cent of Chinese listed enterprises are characterised by substantial government ownership (Zhu Jiaming 2010) compare to 80 per cent in 2004 (DB Research 2004:6). The stock market represents an effective alternative for financing SOEs expenditures, in addition to the existing investment fund channels like bank loans, fiscal grants and subsidies. Although the capital market is less developed compared to financial institutions, it is still regarded as an important source for raising funds. The central government understands that a functioning stock market facilitates the mobilisation of private savings to finance SOEs and to diversify investment risks that are otherwise concentrated in the state-owned banking system (Wong 2006:396). The development of the stock market is to be seen under the condition that state ownership and monopolistic control over the financial sector remains dominant. In contrast, collectively owned companies and TVEs are prohibited to go public, as at the inception of the stock market, local governments tended to focus on initiating share issuance with collective enterprises only. As a result, in May 1990, the State Council issued a regulation that restricted share issuance to SOEs only. By doing so, the government reserved the stock market as a fund raising vehicle for SOEs only, thereby maintaining monopolisation over the uses of funds even after the stock market had emerged (Wong 2006:396).

Secondly, another unusual feature of China's stock market is that after an initial public offering the Chinese government retains a majority ownership in the firm. Only a small proportion of shares are traded on the stock market, and the majority of the capital stock remains in public ownership, the so called *split share structure* (股权分置) (CSRC 2005). Up until 2005, this structure divided shares into tradable and

⁷⁸ Total market capitalization refers to the market value of all shares issued by China's listed firms.

non-tradable shares. Only one-third of the stocks are traded, which are sold to private shareholders and openly traded on the market. The other two-thirds of the equity capital are under the control of state asset management agencies or SOEs themselves. These non-tradable shares are not exchanged on the open market, but outside of the market. It has to be taken into consideration that the issuance of shares to private person would create private ownership in the long run. It can be stated that the market is highly segmented, based on regulations. By keeping state property untradeable the state tries to maintain control, and by implementing the split share structure the state also manages to raise external funds. In 2005, China's stock market started to reform the split share structure (CSRC 2005) with selected pilot companies, by reducing the volume of non-tradable shares and increasing the amount of fully tradable shares.

Domestic and international investors face a system of differing share classes. The limited volumes of traded stock is again divided into A shares, which are restricted to domestic investors and B shares, in USD denominated shares for domestic and foreign investors. In total, share issuance of publicly traded companies is divided into six different types of shares (China Statistical Yearbook 2008):

A-shares: denominated in Chinese RMB, are available for trading for domestic private and institutional investors. In 2002, the central government opened the A-share market to qualified foreign institutional investors (QFII).

B-shares: denominated in USD, available for trading for foreign investors. In 2001, the central government opened the B-share market to domestic individual investors.

C-shares: denominated in Chinese RMB, are available to state-owned legal persons (e.g. state-owned companies, banks).

H-shares: are shares of Chinese companies, floated and listed on the Hong Kong Stock Exchange.

N-shares: are shares of Chinese companies, floated and listed on the New York Stock Exchange.

L-shares: are shares of Chinese companies, floated and listed on the London Stock Exchange.

The B-share market's total market value is only 2.4 per cent of the A-share market's value (DJI 2002:12). In comparison to the A and B shares, the Hong Kong listed H-

shares and the New York listed N-shares only play an insignificant role on the Chinese stock market. With respect to ownership, stocks are grouped into state-owned shares, legal person shares, social public shares, employee's shares, etc. State-owned shares account for the dominant proportion of all shares, and are owned either directly or indirectly by the state. The small percentage of traded shares and the high influence of the government are not consistent with good corporate governance.

Year	National Listed Companies	Shanghai Stock Exchange	Shenzhen Stock Exchange	A Share Only	A & H Share	A & B Share	B Share Only
1990	10	8	2	10			
1991	14	8	6	14			
1992	53	29	24	53		18	
1993	183	106	77	183	3	34	6
1994	291	171	120	227	6	54	4
1995	323	188	135	242	11	58	12
1996	530	293	237	431	14	69	16
1997	745	383	362	627	17	76	25
1998	851	438	413	727	18	80	26
1999	949	484	465	822	19	82	26
2000	1.088	572	516	955	19	86	28
2001	1.160	646	514	1.025	23	88	24
2002	1.224	715	509	1.085	28	87	24
2003	1.287	780	507	1.146	30	87	24
2004	1.377	837	540	1.236	31	86	24
2005	1.381	834	547	1.240	32	86	23
2006	1.434	842	592	1.287	38	86	23
2007	1.550	860	684	1.396	45	86	23
2008	1.625	864	761	1.459	57	86	23

Table 13: Number of listed companies in China (1990-2008)
Source: Chinese Statistical Yearbook 2009

On November 5, 2002 the China Securities Regulatory Commission (CSRC) and the People's Bank of China (PBOC) introduced the QFII (Qualified Foreign Institutional Investor) program as a provision for foreign capital access to China's A-share market, and to allow foreign investors to invest in treasuries, convertible bonds and corporate bonds. In this way, foreign fund management institutions, insurance companies, securities companies and other asset management institutions that met the stipulated

requirements⁷⁹ were allowed to invest in China's securities market as QFII. On August 24, 2006, the China Securities Regulatory Commission (CSRC), the People's Bank of China and the State Administration of Foreign Exchange (SAFE) promulgated the new *Administrative Rules on the Onshore Securities Investment by Qualified Foreign Institutional Investors (QFII)*. Regulations on QFII define investment limitations on the sum a single QFII, and all QFII together can invest in a single Chinese listed company. Administration concerning the approval and investment quotas is done by the CSRC and the SAFE. The CSRC is in charge of deciding which foreign investors qualify for the programme; the SAFE is in charge of QFII quotas distribution. Apart from the few institutional investors that are defined as QFII investors, foreigners are prevented from trading on the Chinese stock market. Foreign investors can only freely trade in Hong Kong. In turn, Chinese investors are holding off in so far as Chinese currency accounts are not yet convertible. Participation of institutional investors in the Chinese stock market anticipates on one hand the inflow of foreign capital, and on the other hand the improvement of corporate governance practices.

Good corporate governance practices align the interest of a firm's management with its owners, namely the shareholders. In Western countries corporate governance identifies a conflict of interests between the management and ownership, also known as the principal-agent problem. Another kind of conflict, which is applicable for China, concerns the majority shareholder and minority shareholder. In China the dominant majority shareholder is the state. The state does not necessarily have the same objectives as the minority shareholder. In fact, the state is not only a majority shareholder, but also the legislator and strongly influences the capital market (Mahlich/Zhu 2005:84). As a result conflicting interests are inevitable. In China, minority shareholders represent mainly individuals, who are the main investors in the stock market, rather than institutional investors. Individuals do not represent a danger to the government of losing control of ownership, as they do not have the power to influence ownership. In the past, the Chinese stock market has not been in very good condition was in danger of collapsing (Economist 2009). State and administrative interference in market coordination have prevented a collapse. The dilemma is that every time the state shows an inclination of selling shares of state-owned enterprises,

⁷⁹ Detailed requirements for QFII see: Pißler 2002.

the stock market prices collapses due to the fear that the market will be flooded with newly tradable shares. The only way to prevent a collapse of the Chinese stock market is by capitalisation.

The issues the government has to face up to can be divided into two questions: What will be the price of the non-tradable shares? And who might be the potential buyers? Answering the first question; like other economic phenomenon, the valuation of a stock market is dependent on the equilibrium of supply and demand. A sudden increase in supply – in this case, the availability of tradable shares - inevitably leads to a drop in price if demand fails to increase accordingly. Faced with an explosion of shares, any market would be at risk of a collapse. Up until now, the Chinese stock market has responded negatively to the anticipation of a huge increase in the supply of shares. Answering the second question, it is obvious that foreign investors, like multinational companies and institutional investors, can be considered as potential buyers. According to international regulations for corporations, this type of shareholders can have a strong influence, even they do not hold a majority stake. This would result in the state losing control and influence. To summarizing, it can be said that the government currently faces a dilemma as on the one hand the state is aware of the fact that a deepen reform of the Chinese stock market is necessary to prevent it from a collapse and on the other the government does not want to lose ground and control to foreign investors.

Besides the challenges mentioned above, an observation on the structure of the market is also necessary. China's stock market lacks truly blue-chip stocks and so is dominated by a large number of smaller capitalisation stocks, giving it a pyramid structure. By contrast, developed markets tend to be dominated by a small number of large blue-chip stocks, giving them a funnel-shaped structure (DJI 2002:24). Blue-chip companies generally share four characteristics: (1) large market value; (2) low volatility; (3) high liquidity; and (4) solid shareholder base. Normally they represent a high percentage of the total market value. Chinese blue-chip companies, like HSBC and China Mobile, are mainly listed outside of China, in Hong Kong, Singapore and New York. There are several reasons why Chinese blue-chip companies prefer to be listed outside of China. The Hong Kong stock market is much more attractive for blue chip companies as the market is much more mature and has a very good reputation. In

addition the trading environment is very good, as more banks are tied to the stock market and the market demonstrates lower volatility. By contrast, China's stock market demonstrates exceptionally high volatility, as it has experienced several bear markets in the last decade.

4.2.2 The Split Structure Reform of the Stock Market

The Chinese government is aware of the issues of the Chinese stock market. Recently, measures have been taken to prevent a collapse of the stock market. At the end of 2003, foreign investors were allowed into the A-share market.

In October 2006, the CSRC adopted a standard to allow the conversion of non-tradable shares into freely tradable shares, by announcing *Administrative Measures on the Split Share Structure Reform of Listed Companies*. The realisation of the new regulations required the approval of the CSRC and a two-thirds majority of the outstanding shareholders with tradable shares. The deadline for all companies to comply with the regulations was scheduled for December 2006 (CFA 2007:4). According to CSRC (2008), by the end of 2007, 1298 companies listed on Shanghai and Shenzhen Stock Exchanges had either initiated or completed the process of floating the non-tradable shares, accounting for 98 per cent of the total listed companies that were subject to the reform.

Under the reform, the owners of non-tradable shares negotiated a compensation plan and various agreements with tradable shareholders in order to convert their shares into tradable ones. Protection of the interests of tradable shareholders is essential to safeguard investor confidence. Ongoing efforts to make non-tradable shares tradable increases the free float and reduce the presently high price-earnings ratios. This new regulation represents a move towards a more dispersed ownership structure in China, away from concentrated government ownership. The elimination of non-tradable shares in initial public offerings allows the broader access of minority shareholders and institutional shareholders in the Chinese stock market. At the same time, rules regarding the purchase of non-tradable shares by foreigners have also been relaxed.

The government strictly regulates initial public offerings. By selecting qualified companies, the government does not primarily focus on the performance of the company or economic indicators, but rather takes into account individual interests and political considerations. The domestic stock market is controlled by the government through its quota system on initial public offerings. This kind of selection process has a negative impact on the stock market as a healthy stock market needs healthy companies. The government sets the quota for new listings each year and selects qualified companies based on provincial and sector allocation, and – up until 2001 – even determined where the new stocks would list. China is the only country in which the government completely controls the size of the stock market, the pace of issue and the allocation of resources (DJI 2002:22). China's stock market does not operate primarily for privatisation but rather as a capital-raising tool for state firms. As the companies have been chosen on the basis of non-commercial criteria rather than by economic criteria, corruption and bribes were often tied up in the process. Statistics show that at the end of 2004 among all 1377 Chinese listed companies, 987 are controlled by holding companies, accounting for 71.7 per cent (OECD 2005b). Financial oversight over the capital market is essential for the government, thereby avoiding losing ground and control of SOEs to foreign investors. Authorities are determined to improve the functioning of the stock markets, but access to the market by financial institutions is still heavily restricted. Besides the improvement of profitability of the companies and the development of the market structure, the government does not show a willingness to promote high ownership diversity in the national economy.

4.3 Basel Capital Accord and Rating in China

Since China's commitment under the WTO to open its commercial banking sector to foreign competition by January 1, 2007, Chinese policy makers are keen to put into practice the implementation of Basel requirements, following the international bank capital standards. The Basel II and Basel III implementation has to be seen in the light of the ongoing corporate governance efforts in the banking sector. The Basel capital accords are a standardized approach for risk management, strong supervision and disclosure standards that support sound corporate governance. Risk management objectives target the value maximisation of shareholders. The term Basel II and Basel

III⁸⁰ implies the initiative of the Basel Committee on Banking Supervision that creditor banks have to follow stringent international requirements concerning the credit approval process. The Basel Accord is based on three pillars: minimum capital requirement, supervisory review and market discipline. Therefore, creditor banks have to hold capital reserves of 8 per cent when approving commercial loans, subject to the creditworthiness of clients. When the creditworthiness is better, the capital reserves held will be lower, and consequently the loan will be cheaper. In this context, rating procedures and rating agencies are becoming relevant, as an in-depth analysis of the company helps to make a statement about the capability of a company to pay back its commitments in due time. Against the background of change in corporate financing, moving away from the classic bank loan to equity financing on capital markets, ratings are gaining immensely in importance. Enterprises have to be prepared to achieve optimal credit ratings, which have an impact on favorable credit terms and access to international capital markets. Two rating approaches exist, which assess the creditworthiness of debtors. The first approach applies an external rating procedure measuring the risk of a borrower. It is also called *standardised approach* and is undertaken by private public rating agencies such as Standard & Poor's, Moody's, and Fitch. The second approach applies an internal rating procedure, which is carried out by commercial banks internally. It is called an *internal rate based approach* (IRB), which is a tool that supports banks in applying their own risk estimation systems, in accordance with certain criteria and information disclosure requirements. The foundation of efficient capital allocation is through modern risk assessment mechanisms, which allow for a price policy that is oriented on the effective measurement of risks. An influencing corporate governance measure concerning the risk management in the state-owned banking sector is the Chinese corporate governance code for state-owned banks. According to Article §§ 7: "Each pilot bank shall adopt a system of risk management, which covers the credit risk, market risk and operational risk, and is effective in identifying, measuring,

⁸⁰ According to principles of the Basel I Capital Accord, which came into effect in 1998, creditor banks had to hold capital reserves of 8 percent when approving commercial loans, but the creditworthiness of clients did not play a role. Basel III refers to a new update based on Basel II (came into effect in 2004). The revision to the Basel Accords (came into effect in 2010) is anticipated by the Basel Committee on Banking Supervision to update their guidelines for capital and banking regulations in response to the financial crises in 2008 (Bank for International Settlement 2010, www.bis.org).

monitoring and controlling risks”. All banks⁸¹ listed in China’s Top 20 ranking by Fortune 2010, mention in their annual reports risk management activities having a clear focus on Basel II implementation and the construction of an internal rating system to improve credit risk measurement under the guidance of Basel II and regulatory requirements. Corporate governance systems and measures are substantial as public financial statements can produce meaningful information about the activities of the banks to the state. In all the banks mentioned above, the risk management framework comprises the board of directors, a risk management committee under the board, an internal control committee and a risk management department.

In 2007, the China Banking Regulatory Commission (CBRC) published the *Guidelines on the Implementation of the New Basel Accord by China’s Banking Sector*. According to CBRC, the implementation of Basel II is scheduled as followed (CBRC 2007b):

- In 2008, supervisory rules regarding Basel II implementation were issued and the existing capital regulation requirements were subject to modifications and amendments by the CBRC.
- In 2009, a Quantitative Impact Study (QIS) was conducted by the CBRC with the aim of evaluating the impact of the Basel II implementation on the capital adequacy of banks.
- Chinese banks that are required to implement Basel II standards shall start the adoption process in 2010, under specific conditions implementation can be postponed to 2013 at the latest. The rest of Chinese banks can choose to undertake the Basel II implementation after 2011, on equal terms as those banks that are required to implement Basel II standards.
- A bank that is planning to adopt Basel II should make an official application to the CBRC at least six months prior to the adoption. The CBRC started to accept such applications at the beginning of 2010.

⁸¹ Industrial and Commercial Bank of China (中国工商银行), Agricultural Bank of China (中国农业银行), Bank of China (中国银行), and People’s Construction Bank of China (中国人民建设银行).

Increased convergence and harmonisation activities among regions have lead to a general adoption of the Basel capital accord in Asia Pacific (Deloitte 2005). Japan, Hong Kong, Singapore and South Korea intend to implement Basel standards, as well as emerging banking markets including India, Malaysia, Thailand and Indonesia. All these countries agree on their commitment on adoption, but vary concerning the timeframe of targeted reforms. Claessens et al. (2006) criticizes the fact that the reform of the international financial architecture, including the Basel capital accord, excludes relevant inputs from developing countries. This leads to costly domestic financing, increased capital costs and a reduction in access to external financing for developing countries.

Capital adequacy ratios and risk management capacity are regarded as useful risk prevention tool for influencing the actions of banks. In February 2004, the China Banking Regulatory Commission (CBRC) promulgated the *Administration of Capital Adequacy Ratios of Commercial Banks Procedures*, following approval from the State Council. Simultaneously, the implementation of the supervisory review and market discipline is required under Basel II. Early in 1995, the Law of the People's Republic of China on Commercial Bank⁸² already stipulated that it was necessary to build up capital reserves of 8 per cent for credit transactions. The capital adequacy procedures can be regarded as a concrete mechanism for calculating financial reserves. These procedures are based on the 1988 version of the Basel I capital accord but also take into account the new Basel II capital accord⁸³. The capital adequacy ratio refers to the ratio between the capital, which is held by a commercial bank, and the risk-weighted assets of the commercial bank. According to the provision, the capital adequacy ratio shall not be lower than 8 per cent, and the core capital adequacy ratio shall not be lower than 4 per cent. Thus, the provision complies with the 8 per cent capital adequacy ratio set by the Basel II capital accord.

Given capital management activities published in the annual reports, all banks listed in China's Top 20 ranking by Fortune 2010 meet the Basel II requirement of 4 per cent concerning the core capital adequacy ratio. At the end of 2008, the core capital

⁸² Article §§ 39 when granting a loan, commercial banks shall abide by the following provisions on the control of assets-liabilities ratios: (1) the capital adequacy ratio may not be lower than 8 per cent (CBRC 1995).

⁸³ The principles of the Basel II Capital Accord came into effect in May 2004, under the light of the Asia financial crises and the need for a revision of financial supervision (Bank for International Settlement 2010, www.bis.org).

adequacy ratio of the Agricultural Development Bank of China was 8 per cent (Annual Report 2008, Agricultural Development Bank of China), whereas China Construction Bank Corporation's stood at 10.17 per cent (Annual Report 2008, China's Construction Bank). In 2008, the Industrial and Commercial Bank of China had a core capital adequacy ratio of 10.75 per cent (Annual Report 2008, ICBC) and the Bank of China had a core capital adequacy ratio of 10.81 per cent (Annual Report 2008, Bank of China). Following the reserves requirements is crucial for prudential supervision, as this measure goes against excessive lending by banks and reduces the risk of bankruptcies. Currently, the China Banking Regulatory Commission is working on establishing an internal-rate-based approach in accordance with Basel capital accord requirements. Furthermore, the commission aims to improve the risk management capabilities for domestic banks. In fact, all banks that implement the internal-rate-based approach are also involved in increasing the capital base, in order to raise the capital ratio to required levels.

According to the Basel II capital accord, overdue loans are assessed with a higher risk weight, depending on the provision made for the outstanding amount of the loan. As discussed earlier, Chinese banks are still facing the massive problem of nonperforming loans. Over the last few years, AMC's were established to take over the burden of the non-performing loans. Consequently, Chinese banks have been recapitalised and shifted the ultimate risk-influencing factor to the AMC's, which allows for better risk assessments. In the Chinese case, it is worth contemplating whether loan allocation following the Basel II Accord criteria will be realistic in the near future, or not? The state is in control of financial allocation to make sure that economic reforms can be realised. Chinese banks have also been challenged with improving market discipline through better disclosure of information, improved governance effectiveness and the promotion of prudent risk management. Corporate governance and international accounting standards have been introduced, but enforcement remains weak. The following Chinese banks received capital injection by the state over the past few years:

Year	Chinese Bank	Capital injection in USD
2009	Agricultural Bank of China	30 billion
2008	China Development Bank	20 billion
2008	Agricultural Bank of China	20 billion
2007	China Everbright Bank	2.64 billion
2005	Industrial and Commercial Bank of China	15 billion
2004	Bank of China	22.5 billion
2004	China Construction Bank	22.5 billion

Table 14: Capital injection to Chinese banks

Source: Compiled by the author and based on various sources (China Daily 2004b, Asia Times 2006, International Herald Tribune 2008)

In fact, the measurement of potential credit risks is a method to mitigate the risk of non-payment that always influences bank-lending decisions. According to Basel II capital accord, interest rates for loans will be dependent on how much financial reserve banks have to put aside. Enterprises with a high creditworthiness will benefit from low interest rates and enterprises with a low creditworthiness will be burdened with high interest rates as the banks themselves face high costs of equity capital. So far, as a result of the government's control of interest rate policy, loan rates do not reflect risk (Pei 2006). According to theory, regulation and supervision is essential because of the existing asymmetric information problem between the depositor and the bank. More transparency in information disclosure is crucial for the Chinese state-owned sector, as Chinese enterprises and banks are interested in receiving financial resources from national and international investors and Chinese stock markets want to work on an international level. Currently, all Chinese banks are listed on the stock market. Implementing Basel II helps them gain a good reputation in the stock market and builds up investor confidence. Furthermore, Chinese large banks aspire to expand overseas. Overseas subsidiaries are required to comply with Basel requirements. As a result, the adoption of international accounting standards and compliance with Basel capital accords is in line with corporate governance mechanisms, which responds to the needs of international rating agencies.

At the moment, four external credit rating agencies exist in China, which are authorised by the People's Bank of China to rate publicly issued corporate bonds: China Chengxin International Credit Rating Co., Ltd. (中诚信国际信用评级有限责

任公司), China Lianhe Credit Rating Co. Ltd. (联合资信评估有限公司), Dagong Global Credit Rating Co., Ltd. (大公国际资信评估有限公司) and Shanghai Far East Credit Rating Co., Ltd (上海远东资信评估有限公司)⁸⁴. These agencies work according to international rating criterion such as global credit rating agencies like Fitch, Moody's and Standard & Poor's, all of which have established offices in China. Besides the rating agencies mentioned above, there are also around 50-60 regional Chinese credit-rating agencies. They have been established by the central bank and the major banks in China, but they do not work according to international standards and do not have high acceptance in the market (Ballreich 2008:64).

Although Chinese credit-rating agencies exist and have gained operational experience over the years, little attention is paid to their credit ratings. Chinese bonds are only rated after the approval of the National Development and Reform Commission (NDRC) and the State Council, resulting in consequent AAA ratings, which does not provide confidence to investors (Kennedy 2003:37). Therefore, observers assume that these ratings do not reflect the actual performance situation of Chinese enterprises and question their credibility. Kennedy (2003:39) argues that Chinese credit-rating agencies face the difficulty of obtaining reliable financial information from listed enterprises they can work with. Furthermore, Chinese credit-rating agencies lack experienced rating professionals who can provide appropriate analyses. Finally, it is assumed that Chinese credit-rating agencies, which work under strong competition, are interested in gaining market share in the domestic market and are ready to hand out AAA rating to keep their customer portfolio. Chinese credit-rating agencies have to respond to the public's interest in providing relevant and accurate market information and transparency, otherwise they run the risk that their ratings will be classified as irrelevant.

From an international perspective, large Chinese banks are gradually moving towards establishing operations in global financial markets. Consequently, they have to abide by international governance regulations and comply with Basel capital accord requirements. The obvious challenge for Chinese banks is to integrate rating

⁸⁴ In 2003, Shanghai Far East Credit Rating Co., Limited was admitted to the Association of Credit Rating Agencies in Asia (ACRAA). It is the first credit rating agency in China to join the association. Since 2003, Shanghai Far East Credit Rating Co., Limited is a subsidiary of Xinhua Financial Network (Xinhua Finance).

mechanisms in their operational business and for them to become a relevant part of their risk management activities. Large banks, mostly in developed countries, which apply the IRB approach, have substantial competitive advantage (Claessens et al. 2006). Reform pressure for the implementation of corporate governance standards and a developed credit culture comes from the international capital markets, where state-owned banks are exposed to global competition for scarce financial resources and market forces. In order to comply with international standards, the state is promoting stringent capital adequacy requirements, which entail an increase in credit costs for domestic enterprises and households.

The improvement of risk management and an adequate credit culture in China's socialist market economy is significant, especially in the light of dominant ownership. Weak market of corporate control and weak institutional arrangements are an incentive for high-risk taking and low credit quality. The major cause for banking problems is directly related to lax credit standards and poor portfolio risk management. By strengthening regulations in risk management, the central government has changed its credit policy to a certain degree with the aim that credit risk exposure is reduced or at least maintained within acceptable parameters. The new rules of risk assessment might not be able to capture all relevant information, taking socio-political considerations into account. The Basel capital accord requirements support the state in its efforts to measure, monitor and control credit risk as well as to determine that state-owned banks hold adequate capital levels against potential risks. Corporate governance asks for a new definition of the role of the state in the banking landscape, but in this area, the state cannot retreat from its dominant position. By keeping control over credit allocation and interest rates, the state is able to maintain financial control over enterprises and the reform process. It is assumed, that it is the state's responsibility to deal with risk that might cause bank bankruptcy and therefore it is the state, which has to assume significant risk related to the costs in case of failure. The implementation of the Basel capital accord including the foundation of the internal rate based approach is limited since objectives in risk management need to consider domestic requirements, such as expenses for enterprise restructuring, for recapitalization of the banking sector, for establishment of social safety net and pension system. Strengthening of credit risk management and prudent loan growth strategy is strongly connected to the state's corporate governance efforts in efficiency and transparency improvement in the financial sector. As already outlined before,

investment decisions following economic, social and environmental needs are determined by the state. The state is not only dominant shareholder, but also creditor in the state-owned sector. As a shareholder, the state is interested in credit allocation for reinvestment resulting in high revenues and dividends. As a creditor, the state is interested in secured credit allocation and a healthy credit culture. Corporate management of enterprises influences credit quality as they are much better informed about the ability and willingness to pay off debts. In order to solve this classical principal-agent problem, the state aims to influence management behavior by the installment of risk management regulations. The introduction of strong capital and liquidity standards accompanied by better risk management and supervision have significant implications in corporate governance, as it allows the state to be in the position to directly monitor the accumulation of debt in the state-owned sector, and at the same time strengthening the resilience of its banks and the banking system. Further, the maintenance of capital adequacy ratios supports state-owned banks in their efforts of standardization in capital allocation, as well as of enhancement in capital cost effectiveness.

The state and the Communist Party are challenged that economic and social reforms become successful. From the financial point of view, it is critical that the transformation process is accompanied by improvements in supervision, risk management and governance, as well as greater transparency and disclosure. The financing of economic and social reform programs is an integral part of the realisation of the *scientific concept of development* and the *harmonious society*, and therefore is highly linked with efforts in corporate governance and corporate social responsibility. In order to be able to allocate resources effectively, according to the financial needs of the differing economic, social and environmental reform programs in the country, investment risk must be transparent and information about investment type must be disclosed. The state as well the Communist Party, both share the same interest in exclusive financial resource allocation, which allows them to respond to domestic requirements in regard to economic growth, employment and environmental issues.

4.4 Conclusion

The reform of the financial sector is a significant element in the transformation process, in order to allow policymakers to develop the necessary infrastructure for a sound financial system within state ownership. The transformation from a central planned economy to a socialist market economy requires institutional reforms, since financial institutions played a very limited role under the system of central planning. Institutional change is still not completed in the financial sector and this might be a significant reason why protection of this sector is more important than in others. In the banking sector, institutional change is anticipated to solve collective problems of financing and monitoring by improving institutional capacities. The introduction of corporate governance transformed state-owned banks into corporations with the state as main shareholder, where new institutions are replacing existing ones. In the reform process, state-owned banks are playing various roles, thereby corporate performance and financial resource allocation is controlled and monitored by the government and the Communist Party. Most East-Asian countries⁸⁵ are characterised by ownership concentration whether it is family-based or government-based (Claessens/Djankov/Lang 1999b).

The relationship between state-owned banks and the state did not change in the framework of reform. Figure 11 gives an overview of the vertical relationship between state-owned banks and the government in the financial system. The vertical relationship between the institutions has not altered over time. The state and the Communist Party continue to impose direct influence on state-owned banks by holding the main part of control rights, and state-owned banks continue act as intermediary between the state-owned sector and the state. They are regarded as a control instrument on behalf of the state, by providing a clear picture about the financial needs of the differing reforms steps and the transformation process. Large commercial banks are mobilizing and allocating savings, thereby they heavily rely on funds from individual households and enterprises. On the other hand, they provide financing to borrowers, such as the government, the state-owned sector and households.⁸⁶ High saving rates resulting from low consumption in the economy,

⁸⁵ Apparent in Indonesia, Philippines, Thailand, Korea.

⁸⁶ Domestic credit to the private business sector is still limited in China (see chapter 4.1).

made resources available for investment. The availability of resources, in the form of extensive credit programs and investments are possible since the public has confidence in the bank system and deposit their income in the banks instead of consumption.

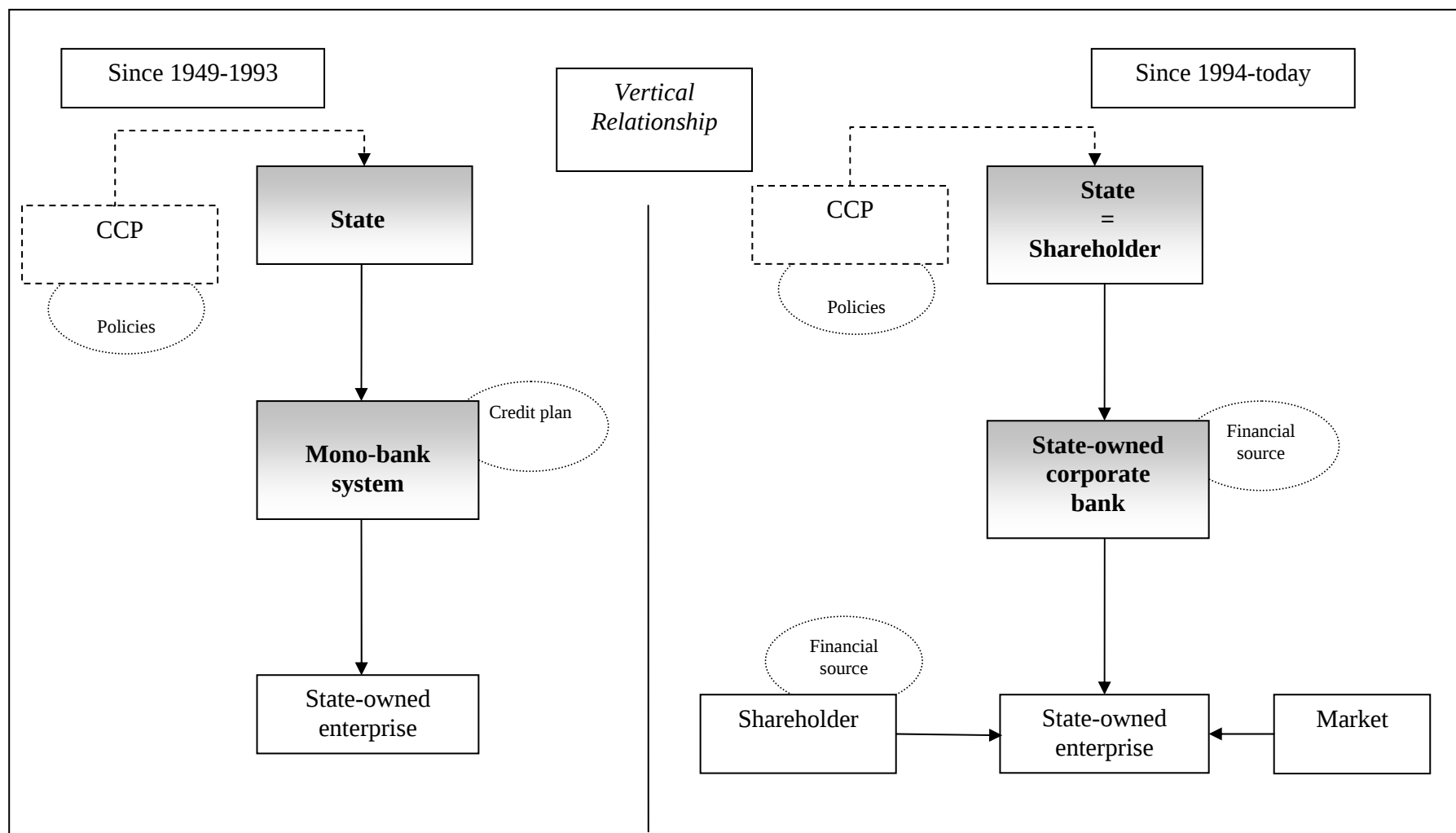


Figure 11: Vertical relationship between the state and state banks

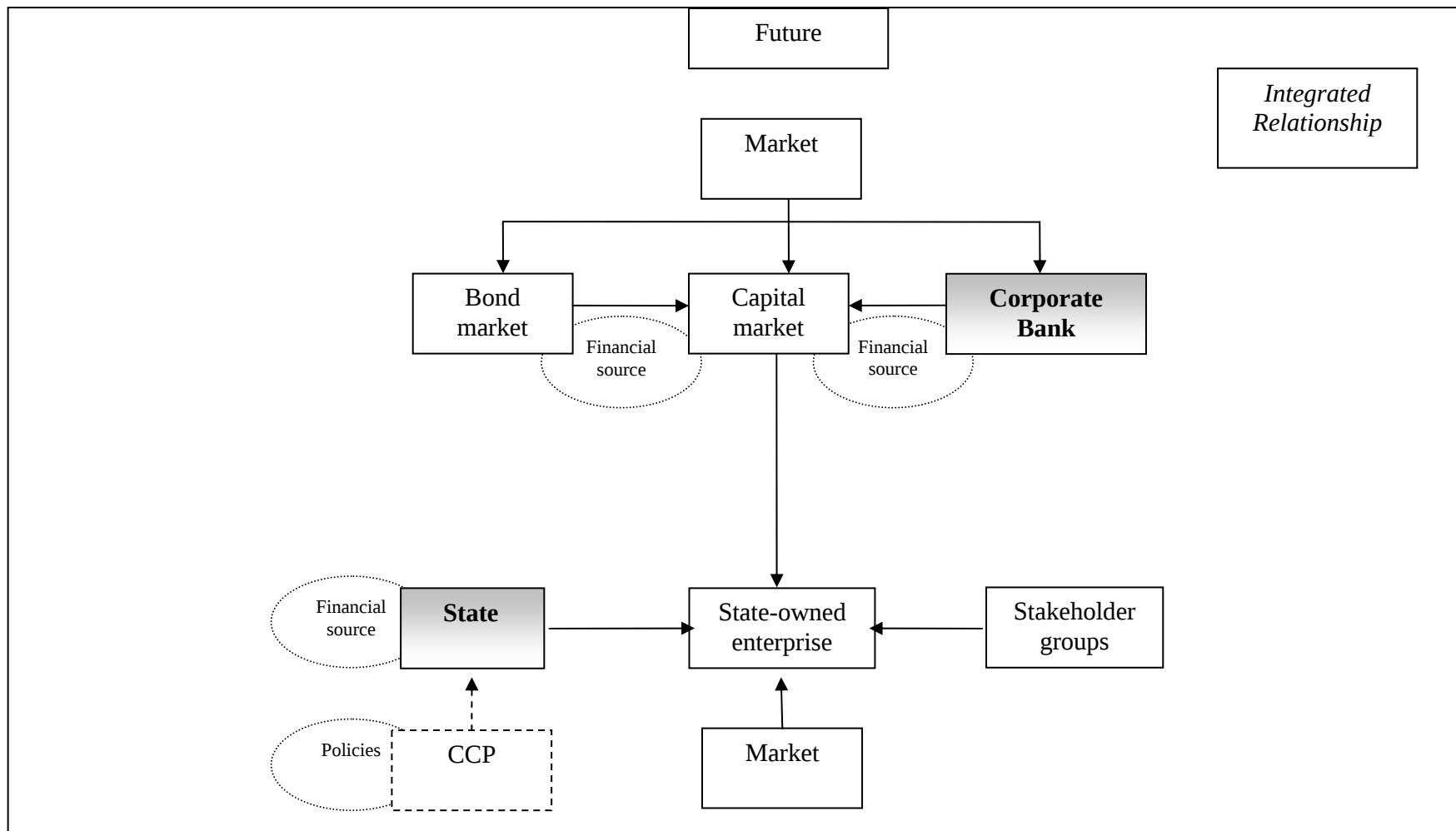


Figure 12: Integrated relationship between the state and state banks

The reform of the financial sector is delayed and the financial sector remains unreformed, since the state as well as the Communist Party does not retreat from their dominant position in financial resource allocation. In fact, reforms did not change the role of the government in the financial sector, and the separation of policy lending from commercial business activities as required by corporate governance has not been very effective so far. Restructuring efforts were successful in turning the state-owned banks into profit-oriented enterprises with a solid capital base, but the cleaning of bad debts from the books of the commercial banks might not be enough to countervail future debt in the long run. The banking sector does not assist the growing small and medium business sector and the agricultural sector in their needs for credit provision, but serves primarily the financial needs of the state-owned sector and individual households. So far, financial institutions and commercial banks are not in the position to allocate freely savings toward profit-generating investments and the private sector which would cover their cost of intermediation. In the private sector, credit is obtained from the informal market, official credit institutions are of less importance.

Chinese state-owned banks are facing the same governance challenges that are faced by state-owned enterprises in terms of defining the appropriate relationship with the state and the Communist Party. Thereby the original role of the banking system to support, monitor and control financial resource allocation on behalf of policy objectives has not changed over time. The transformation process requires high amounts of financial resources for enterprise restructuring, recapitalisation of the banking sector, establishment of the capital market and the introduction of a social safety net and a pension system. The establishment of corporate governance standards following market-oriented principles is hindered since decisions on credit lending do not necessarily consider risk management requirements, but rather political and social objectives. Reforms are pursued by the government within state ownership, thereby maintaining centralised control over access to the banking sector, printing of money, determination of credit rates and credit allocation. The Chinese case shows that bank-dominated financing is not transparent, as a high level of acceptable information disclosure is missing. Corporate governance standards support the state by improving efficiency in the state-owned sector as well as transparency and supervision with regard to its financial situation. Corporate governance systems and measures are substantial as public financial statements produces meaningful information for

investment decisions. Standardized accounting standards, disclosure of financial statements and functioning information systems have a positive impact on enterprise behaviour, as transparency and control is automatically improved. As long as the capital market in China remains underdeveloped, policymakers will rely on the banking sector for financing. The financial sector plays a key role, as credit allocation to defined state-owned industries is resulting into profitable revenues, which safeguards fiscal revenues for the state in the long run. Negative aspects such as the high economic costs of the unreformed banking system resulting from non-performing loans and inefficiency are tolerated.

At the time, when reforms were introduced to the country, the central policy approach emphasised *high economic growth* of the Chinese economy, and financial funds were channelled to the state-owned sector with the objective to receive high returns of investment on behalf of the shareholder only. Corporate governance standards were introduced with the objective to improve the monitoring and control capability of state agents within the framework of the state-sector restructuring. Control over finance, allows the state to push for industrialisation in the country, and transparency within the state-sector allow the state to prove progress in its industrialisation efforts. Since the central policy approach changed to the *scientific concept of development* and the *harmonious society*, the interest of other stakeholders needs to be taken into consideration, which require financial resources for social and environmental reforms. A stable financial infrastructure and environment is an essential prerequisite for the realisation of ongoing reform programs with regard to the *scientific concept of development* and the *harmonious society*. With the Communist Party's commitment to corporate social responsibility, the Party has taken over a mediator role for different social interest groups. Since its claim to power is not legitimated by democratic elections, it has to respond to demand for social returns on investment coming from differing interests groups; otherwise its ruling status would be in danger. By assisting the state in maintaining control over finance, social reforms and the support of economic interest groups at the national and local level in the country are credible. Financial fragility of the banking system with regard to bank runs and systemic risk is a vivid threat to the legitimisation of the Communist Party, as well as to its monopoly position in the political system. China is the country with the highest saving rate in the world, and through means of state control, the household deposits

are safeguarded. Credit allocation relies on household deposits, and the state acts as a guarantor for the security of household deposits in the banks. Moral hazard problems are obvious, since the Communist Party would not let allow bank failure in order to ensure a healthy financial sector, which would lead beyond doubt to social instability in the country. Letting market forces freely determine monetary policy could result in a collapse of the economic balance, by slowing growth and increasing social instability. In addition weaknesses in the financial infrastructure justify continuing state authorities' intervention, as the possibility of a domestic banking crisis is a threat to the country's economic and political stability. A domestic banking crisis would result in a fundamental confidence loss of the Chinese public and the international community in the banking system and would have an immense negative impact on investment and economic growth. Beside the monitoring and control function of state-owned banks, the rationale behind high levels of state regulation in the Chinese banking sector can be explained among other reasons with threat of banking instability, depositor protection and social instability. The Communist Party is supporting the state in its efforts maintaining control over finance in the country with the objective to guard against those threats, which would undermine the Communist Party's monopoly position as well as its legitimisation in the political landscape of the country. The introduction of corporate governance linked with corporate social responsibility in the financial sector entails a consensus over capital allocation involving state control and broader stakeholder participation in the reform process.

<i>Actor</i>	State	CPC
<i>Goals</i>	Control over credit line Control over credit allocation and interest rates Control over capital flows and capital allocation Control over recruitment Control over household deposits, as credit lending is based on the deposits Banking system is a control device over debt Banking system is a tool for funding national policies Confidence of the Chinese public in the stability of the banking sector Successful realisation of reform programs in transformation economy	
	Industrialisation Economic and financial stability	Legitimate one-party claim Political and social stability
<i>Role</i>	Guardian of the interests of the Chinese public in order to maintain economic stability in the country.	Mediator and spokesperson of differing social interest groups in order to maintain political and social stability in the country.

Figure 13: Objectives in the banking sector

The Chinese financial market is characterised by monopolist behaviour and protectionism due to government regulations. The banking sector and the capital market are also facing reform pressure from international investors and requirements from international capital markets. Compliance with corporate governance and with the Basel capital accord are internationally accepted standards for enterprises working globally. As the state is pushing state-owned banks to operate overseas and to become global players, they need to respond to the demands of the international community. Since state-owned enterprises are working in an environment of imperfect competition, international exposure is a good measure for their performance. Being competitive in the international markets might be a good indicator of the health of an enterprise as well as of the long-term performance. The same is applicable for the capital market. The state requires that the stock markets in Shanghai and Shenzhen attract international investors' capital. Compliance with corporate governance is regarded as a trust strengthening tool for international investors, where corporate information disclosure and transparency is managed in a standardised and uniform way.

In the future state-owned banks will be challenged by the ongoing implementation of Basel II and III rules. The implementation of corporate governance will be carried on

but combined with further policy lending, which hinders effective corporate governance. Policy lending will continue due to four reasons:

Policy lending to large state-owned enterprises continues

Policy lending to large state-owned enterprises will continue since the restructuring process is ongoing and still not completed. But policy lending will be much more restricted and only exclusive industries will benefit from soft credit approval processes. Further, selected large state-owned enterprises are defined to be the mainstay of the national economy. Chinese policymakers are interested in supporting and strengthening the domestic market to guarantee further economic growth in China. In the past, China focused on export growth. In 2004, China overtook Japan as the world's third largest exporter, just behind Germany and the United States. Now, since international markets have been saturated and demand is declining, Chinese policymakers have turned to the domestic market to sustain future economic growth. The Chinese state is the main infrastructure provider in the country. In underdeveloped regions of China, the demand for infrastructure is high, and industrial enterprises can provide necessary products and services to them. Some of these infrastructure projects might not be profitable from an economic point of view, but of strategic importance to the state. Chinese state-owned banks will continue policy lending activities in order to finance these infrastructure projects. Economic effectiveness and profitability aspects are not necessarily the dominant variable in the decision-making process for credit lending, since strategic considerations are also taken into account.

Policy lending to small-and medium enterprises in rural areas continues

Policy lending and the expansion of financial services in Chinese rural areas will increase. In 2006, at the 10th National People's Congress, Chinese policy makers announced the construction of a *socialist new countryside* with the objective to improve living standards in rural areas. In particular, small-and medium enterprises in the countryside and underdeveloped regions will benefit from soft credit approval

processes. Here again, the demand for infrastructure is high, and industrial enterprises can provide necessary products and services to rural areas.

Policy lending will continue in order to avoid spill-over effects

The economic viability of the state-owned sector and a stable level of investments are of utmost priority. State-owned enterprises do not matter to the state under a purely economic viewpoint. Both state-owned enterprises and state-owned banks fulfil a social function in Chinese society and play an active role in employment security. The threat of a high unemployment rate, social unrest and political instability is of concern to the state and to the Communist Party. Soft lending is politically desirable since economic returns are not the only variable in credit allocation, but also social returns.

Furthermore, Chinese state-owned banks are deposit-taking institutions, not only of individual stakeholders, but also of public stakeholders. Problems at the financial market scene, which starts at one bank, can trigger a banking crisis which spreads throughout the whole national banking system. Such spill over effects can undermine the confidence of individual and public depositors in the banking system. As a consequence of these crucial risks, banks are subject to substantially greater regulatory and state dominated interference, having an impact on developing governance structures.

Policy lending will continue since state-owned banks are acting as a monitoring and control device on behalf of the state

Chinese banks are acting as intermediary between enterprises and the state. By holding enterprise equity and debt, state-owned banks are a control instrument over enterprise behaviour and the reform process in the state-owned sector as a whole. Information disclosure and high levels of transparency in corporate enterprise information is still developing, state-owned banks are so far the only reliable information channel to the state to be able to monitor and control corporate management behaviour. Efficient use of capital is influenced by

decision-making of management. Control over state-banks allows the state to maintain its monitoring capacity over corporate boards of directors. Since the transformation process requires continuous financial funds, policy lending through the state-owned banks will go on, and bank executives will be challenged by adhering government directions in policy lending while effectively monitoring and controlling credit risk. Due to imperfection in the capital markets, no alternative financing channel exist, consequently deficits in the economy need to be compensated with soft loans and subsidies.

Market-based financing through the issuance of stocks is regarded as an important financing alternative for state-owned enterprises, especially for those which need external capital rapidly to grow in an international competitive environment. In order to get prepared for an initial public offering, enterprises must provide clear compliance with corporate governance standards, such as shareholding rights, transparent financial disclosure and accounting, and a transparent operating system. So far, the capital market in China is still underdeveloped and market discipline cannot become effective as state administration is dominant. Furthermore the rule of law and regulatory mechanism for investor protection remain poor, and corporate governance standards effectiveness is limited. It will take some time to develop the capital market, thereby following international standards of disclosure and transparency, applicable not only to the state, but also to other stakeholder groups. Today, domestic and international investors are facing obstacles in receiving financial information and corporate disclosure remains limited. The introduction of corporate governance in the financial sector determines the upcoming shift from bank financing to direct financing of the capital market and stock exchanges. Despite the strong role of the banking sector, financial disintermediation is developing in the Chinese financial market, and the traditional credit-lending banking model for financing will alter in the course of time. This will signify a shift from monitoring of management by creditors (state-owned banks) to monitor of management by equity-holders (state). This shift will have significant implications on corporate governance, as state-owned banks will not anymore act as intermediary between enterprises and the state, but the state will directly monitor corporate management and enterprise behaviour. This move will reduce agency problems caused by the use of debt between state-owned

enterprises and the state in the role of the shareholder. In order to strengthen market discipline, large state-owned enterprises will continue to be pushed to go for initial public offerings. Thereby state-owned enterprises will be in the situation to receive finance from external channels, and reliance on traditional bank financing will be reduced. Policymakers will expand the scope for qualified foreign institutional investors (QFIIs) and qualified domestic institutional investors (QDIIIs) in order to bring in fresh capital to local stock exchanges. In particular foreign funds of qualified foreign institutional investors are important as it is highly linked with the build-up of foreign exchange. In particular in a time where export trade is declining, having a negative impact on the balance of trade. In general, the introduction of institutional investors to capital markets has a positive impact on risk management, on the improvement of governance structure of domestic listed companies, as well as on institutional reform.

China's stock market needs to deepen the reform of its tradable shares. In 2005 pilot activities have been undertaken for reform. Reforms tackle the problem of the separation between tradable and non-tradable shares. On the stock market, non-tradable shares have a negative impact on the pricing mechanism. The question is how stock prices will develop while maintaining the stability of the market. The realisation of fully tradable shares on China's stock market is of sensitive nature and will take some further time. Summarising, it can be said that the government is currently in a dilemma as on the one hand the state is aware of the fact that a deeper reform of the Chinese stock market is necessary to prevent it from a collapse. On the other hand the government does not agree to lose ground and control to foreign investors.

In the financial market reform, the Communist Party and the state need to respond to the financial needs of the reform process and major interest groups at the national as well local level. The government is aiming to deploy financial resources resulting in a profitable state-owned sector and stable economy, but at the same time the Communist Party has to assure the availability of financial resources for social and environmental reform programs, as requested by differing interest groups. The key challenge of the Communist Party and the state in the financial market reform are not particular policies per se, but who has the authority in capital allocation since every

interest group wants to get a piece of the cake. Under the assumption that financial capital is scarce, the balance of differing interests between the state, the Communist Party and all stakeholder groups is necessary with the objective to find a consensus over effective resource allocation in the reform process.

5 Accounting reform

Part four of the thesis presents the actual situation and measures taken towards the reform of the accounting system in China, as traditional Chinese accounting methods are no longer appropriate for the socialist market economy. The socialist market economy requires a financial infrastructure essential for a modern state, where creditors and debtor are informed about the outcome of their investments in enterprises. Today financial information does not only serve for economic decision-making, but also possesses a social function. The vital importance of this area, internally as well internationally, is recognised by the state as well as the Communist Party in China, especially in the framework of economic reforms. Financial statements and financial information are the basis of financial management decisions and are a crucial element in the effective running of the state-owned sector and the reform process which is looking for improved decision-making. Policymakers recognised that the improvement of corporate governance is essential for the creation of sound companies, financial market integrity and an attractive investment climate. Among its key recommendations, corporate governance identifies a full adoption of international financial reporting standards for listed companies as a critical ingredient for improving transparency. Corporate transparency is a particularly important component of good governance by means of shareholder protection. Domestic and international shareholders and investors require accurate and reliable information in order to take well-considered economic decisions. In a centrally planning economy, the accounting system served as an information and control tool over the fulfilment of pre-determined plans. Today the accounting system has to address the requirements of differing shareholders and stakeholders, who have an interest in the financial situation of the listed enterprises operating in the socialist market economy.

5.1 Terms and Definitions

5.1.1 Definition of International Accounting Standards

Discussion on international harmonisation of financial accounting standards is the result of differing financial accounting practices among different countries. Harmonisation of reporting standards does not only implicate transparency and rising information needs among international investors and the public, but it also reduces the costs of raising capital by enterprises. Bushman/Smith (2001) defines “the governance role of financial accounting information as the use of externally reported financial accounting data in control mechanisms that promote the efficient governance of corporations”. Rajan/Zingales (1998b) demonstrate a positive relationship between financial accounting information and economic performance.

Since the 1980’s, measurement of harmonisation, related to compatibility and comparability between the existing accounting standards at the national and international level has obtained importance among academic research (Nobes 1983, 2004; Archer/McLeavy 1995; Ding et.al 2007). Experience has shown that differences in the accounting rules of the different countries have caused investors to make wrong decisions, due to a lack of accurate information or a lack of explanations by the auditors of a certain country with respect to financial statements of such countries as compared with international accounting principles (Archer/McLeavy 1995; Ding et.al 2007). In the beginning, the differences in accounting practices identified were attributed to environmental factors, like differences in culture and economic systems (Davidson/Kohlmeier 1966; Nobes 1998). Later other factors that have an impact on accounting practices were considered, such as the historical development of a nation’s economy, development of capital markets (Nobes 1998), differences in legal systems including accounting laws, differences in the nature of property rights, the structure of companies within a country and institutional factors (Ball et al. 2000). As a result of increased globalisation, capital markets recognise the consequent need for relevant and reliable accounting information on an international basis. International accounting harmonisation aims to achieve uniformity in accounting practices. Therefore, security exchanges demand multi-national

companies to provide financial statements according to international accounting standards (IAS).

In 2001, the International Accounting Standards Board (IASB) was created and started its operations with the following objectives, concentrating on the process of international harmonisation:

- *Develop, in the public interest, a single set of high quality, understandable and international financial reporting standards for general-purpose financial statements.*
- *The IASB co-operates with national accounting standard-setters to achieve convergence in accounting standards around the world.*

The IASB replaced the International Accounting Standards Committee (IASC) in standard setting. The IASC issued international accounting standards (IAS) and one of the primary reasons for its creation was to advance the international harmonisation of financial accounting standards. Uniformity of accounting standards and international harmonisation is still an ongoing process, including the implementation of IAS/IFRS in different countries. Harmonisation involves the formulation of accounting regulations, which are applicable in a similar way in capital markets, which have become increasingly globalised. The IASB wants all countries worldwide to adopt international accounting standards, as it is the easiest way of promoting harmonisation. Since 2005 in the European Union, listed enterprises have been obliged to prepare consolidated accounts in accordance with international financial reporting standards (IFRS), which also contain the international accounting standards (IAS). Beside implementation of IAS/IFRS on a worldwide basis, compliance with IAS/IFRS in the differing countries will be of ultimate interest for research in the future. In fact, developed and developing countries are differently affected by the implementation of IAS/IFRS, therefore the International Accounting Standards Committee Foundation recognised the “need to have an understanding of the impact of IFRS as they are adopted in particular regions” (IASB 2004).

5.1.2 Definition of Transparency and Financial Disclosure

Strong disclosure of a company's financial information and transparent practices contribute to the market integrity of the company and its shareholders, as well as to the domestic economy of a country. Bearle and Means (1932) argue that due to separation of ownership and the control function of management, the management might be in a position to take actions for personal gain which could be disadvantageous for the owner. Therefore, an urgent need for reliable information exists, which protects the interests of shareholders as well as provides them with a tool to assess managerial performance. The early work of Bearle and Means explains the necessity of publishing accounting reports containing information about financial conditions and performance results of operational business. Companies that are interested in accessing the securities market have to provide this kind of information. Coase (1937, 1960), and Alchian and Demsetz (1972) developed the contract theory as an approach to reducing and mitigating agency problems respectively. Accounting plays a critical part in contract building activities, as lending arrangements between the enterprise and the creditor include accounting-based debt covenants. Watts and Zimmerman (1986:196) bring forward the argument that "if accounting is an important part of the firm's contracting process and agency costs vary with different contracts, accounting procedures have the potential to affect firm value and/ or the manager's compensation".

Both the standards of corporate governance of the Organisation for Economic Cooperation and Development and the international accounting standards deal with transparency and financial disclosure. By fulfilling disclosure requirements companies are responding to the needs of the capital markets. A strong disclosure regime that promotes real transparency is critical for market-based monitoring of companies and is central to shareholders' ability to exercise their ownership rights on an informed basis.

According, to the Organisation for Economic Cooperation and Development, the corporate governance framework should ensure timely and accurate disclosure on all material matters, including financial situation, performance, ownership and governance of the company (OECD 2004a). Insufficient or unreliable information results in markets not perfectly functioning, an increase in the cost of capital and the

poor allocation of resources. Generally, the objective of disclosure is to provide information on events or uncertainties known to management that would have a material impact on reported financial information. Disclosure standards assist domestic and international investors in understanding a company's financial situation, changes in financial condition and results of operations.

5.2 Historical Background of Accounting Reform

This chapter offers an examination of the accounting functions and the status of accountants for a better understanding of the system in a centrally-planned economy. Reform efforts need to consider the changing role of the plan, the market and the institution of state finance. Before 1949, the accounting model was following the same principles as required in the international financial community. During the period 1949-1978, the accounting function was reduced to a simple comparison of planned and actual data, and served as an information and control tool of state bureaucracy for the fulfilment of the predetermined plan. The main function of accounting was twofold. On one hand accounting was a tool to observe and coordinate annual budgets provided by the state according to plan. On the other hand accounting served to monitor enterprises' revenue generation which was directed straight to the state. In a command economy, the budget represented the key tool in managing state and financial discipline over state-enterprises, where state ownership dominates. As economic planning and control was centralised, state budgets served for redistribution of finance and provided a substitute to market mechanisms. From the period 1949-1993 the central government directed state budgets to state-owned enterprises, therefore the central government had direct access to the state-owned enterprises, as it received their profits. Government savings were not generated through taxation, as there was practically no tax imposed on households. Therefore Chinese accounting system was characterised by a fund-orientation, where the state-owned enterprises paid their surplus to the state and received a share of fund allocation in return. Revenues of state enterprises were mainly plan-determined, and served likewise as a plan and control figure for the state, and did not result from the market driven by demand and supply.

The profession of certified public accountants was first introduced to China in 1918. Before 1949, when China turned into a central planned economy, public accounting

firms and accountancy profession existed. Large private and state-owned enterprises applied double-entry bookkeeping like in Western countries. In 1953⁸⁷, following the Soviet accounting style, China adopted a unified socialist accounting system. Accounting regulation in China has been strongly shaped by political ideology discourse, as under Mao Zedong accounting was condemned as a capitalistic class tool that had the purpose of controlling and monitoring enterprise profits by the ruling class. Profit realisation was regarded as capitalist by exploiting the labour class in the country. The dominant political ideology under Mao's regime was characterised by class struggle primacy, public ownership and central planning. The class struggle primacy which was orientated from the Marxist leading thought of class struggle generated explicit debates on accounting practices in China.⁸⁸ Under central planning, accounting practices were highly influenced by the Soviet accounting practices (Ezzamel et al. 2007). Under Deng Xiaoping the role of accounting changed to a neutral technology and a science within a socialist market economy. Now under Hu Jintao, accounting is rather viewed as a technical and ideological-free tool, providing information not only to the state and the Communist Party, but also to outside shareholders and stakeholders.

The model of the Soviet accounting system primarily served the needs of central planning, providing statistical information and standardised, uniform information. Financial information was cumulated for the primary purpose of being available to the state. In general, the state, including local governments and government agencies were the user of financial information. The entire legal framework in the Chinese socialist economy determined what information should be available, in which way, and to whom it should be available.

State-owned enterprises were regarded as administrative institutions under the control of the state, local governments and relevant government bodies. The accounting system, adopted from the Soviet Union, was a highly centralised administrative one (Nayaran/Reid 2000). Specific and strict government control over financial matters existed, relating to sourcing, production and marketing activities. There was a vague

⁸⁷ By 1955, all private ownership was transformed into public ownership, as state-ownership or collective-ownership.

⁸⁸ See detailed discussion on political ideology and accounting change in China (Ezzamel et al. 2007).

distinction between accounting, finance, taxation and profits since the government was the sole owner of enterprises. In fact, accounts were prepared according to the needs of finance and tax regulations. The sole purpose of the accounting system was to maximise state revenue, which was considered necessary for sustaining and legitimising central planning, protecting public ownership (Ezzamel et al. 2007:680), financing bureaucracy and granting public services in the country. The role of accounting was assumed to be subordinate to the interests of the state, especially in the light of soft budget constraints, which is in contrast to the hard budget constraint. In Western countries, accounting is applied as tool for companies working under a hard budget constraint, where resource allocation is dependent on profitability and efficiency.

Through the process of economic reforms the accounting system has been made more adaptive to the socialist market system, thereby accounting for the changing role of the central planning and the state budget. With the introduction of market mechanisms and an orientation towards decentralisation in the economy, state-enterprises are compelled to work profitable and to find sources of financing. Because of this the demand for more sophisticated financial management and financial accountability became urgent. With the introduction of the accounting standards for business enterprises (ASBE) in 1992, the Ministry of Finance constituted conservatism as a relevant principle in accounting. Furthermore the Ministry of Finance promulgated multiple industry-specific and ownership-specific uniform accounting systems⁸⁹, predicated on the accounting standards for business enterprises and accounting standards.

In 2000, the Ministry of Finance adopted an Enterprise Accounting System, serving all industries and thus replacing the industry-specific and ownership-specific accounting systems. At that time conservatism in accounting was permitted to a degree comparable to that in Western countries, but building secret reserves⁹⁰ was still not accepted (Ezzamel et al. 2007:691). The introduction of market elements in

⁸⁹ There existed 13 industry-specific accounting systems, as for manufacturing, merchandising, transportation, railway transportation, aviation transportation, agriculture, postage and telecommunication, real-estate development, construction, financial institution, insurance, tourism, and joint ventures with a foreign partner. There also existed 2 ownership-specific accounting systems: one for shareholding enterprises (1992) and one for enterprises with foreign investment (1985) (Ministry of Finance 1992, 1993).

⁹⁰ Building secret reserves was regarded as a tool for covering surplus revenues and accumulating capital.

the economy and greater decentralisation in the state-owned sector led to the accounting reform, where the role of accounting was newly defined – from fund accounting to capital accounting. The changing economic environment broadened the scope of users of corporate financial information like non-state bodies, outside shareholders, stakeholders, oversee-investors, and creditors etc.. Further accounting regulations were adapted, following the requirements of the system of socialist market economy.

5.3 Accounting Reform in China

Accounting reform in China has been extensively investigated by many scholars (Chen et al. 2007; Chen/Cheng 2007; Xiang 1998; Wang Yaotang/Zhang Li/Zhao Ziyi 2004; Huang Yujia/Zhang Yongji 2007; Pang Bixia 2007; Qu Xiaohui/Gao Fang 2006). Xiao et al. (2004) argues that in the Chinese case political interference is an influencing factor, where the central government assumes an active role in the implementation of international accounting standards. In contrast, in countries with a developed capital market, market forces influence the development of accounting standards, although the government might be involved in the operational enforcement of accounting standards.

The legal basis for accounting in China relies on the Accounting Law of People's Republic of China, adopted at the 9th meeting of the Standing Committee of the Sixth National People's Congress in 1985, and revised in accordance with the *Decision on Amending the Accounting Law of the People's Republic of China* in 1993, and again revised by the Standing Committee of the Ninth National People's Congress in 1999. This law is relevant for all enterprises, regardless of company's legal form. The State Council issues administrative laws and regulations on accounting matters. The accountancy system is based on the accounting standards for business enterprises (ASBE), promulgated in 1992 with the aim of bringing China's accounting practices in line with international accounting standards. The ASBE, promulgated by the Ministry of Finance, is relevant to domestic companies. The ASBE are based on international accounting standards and include adoptions to local conditions. Amendatory requirements for listed companies are imposed by the China Securities Regulatory Commission.

On February 16, 2006, the Ministry of Finance of the People's Republic of China adopted a new basic standard and 38 new Chinese accounting standards that are in line with international financial reporting standards⁹¹. Since January 2007, Chinese companies listed on the Shanghai and Shenzhen stock exchanges are required to present their accounts based on international financial reporting standards, set by the International Accounting Standards Board, which are now in use in more than 100 countries⁹². Since 2008, the use of the new CASs has been expanded to all state-owned enterprises controlled by the Chinese central government, and since 2009 to all large and medium-sized companies in China. Accordingly, there is a unified accounting framework that is applied to all enterprises in China. The move signals a commitment by the Chinese government to create rules and regulations that are friendlier to international investors (Jian 2006).

In 1992, the promulgation of accounting standards for business enterprises represented the first step towards the standardisation of financial behaviour in China and the harmonisation of China's accounting standards with international practice. Soviet-based accounting regulations were replaced, and the planned-economy accounting system was transformed into a market-economy accounting system. The accounting standards specified the use of double-entry accounting (also used under Soviet-based accounting regulations), accrual based accounting (also used under Soviet-based accounting regulations), consistency and conservatism. Additionally, the CSRS released in March 2003 a directive on quarterly reporting applicable by listed companies, including a profit and loss statement, data on total assets and net cash flow from operations.

Before the implementation of the ASBE, the representatives of the Ministry of Finance were sceptical that the adoption of the conservatism principle and manufacturing costing in the ASBE would have a negative impact on government revenues and taxation (Xiao et al. 2004:209). Furthermore, ASBE, which is

⁹¹ See detailed comparison of the new Chinese Accounting Standards and IFRSs for business enterprises, published by Deloitte in Chinese and English, available under: <http://www.iasplus.com/dttdpubs/0607prcifrseenglish.pdf>, <http://www.iasplus.com/dttdpubs/0607prcifrsechinese.pdf>.

See Practical Guide to Chinese Accounting Standards CAS 18 Income Taxes in Chinese language, which went into effect for 2007 reporting, published by Deloitte, available under: <http://www.iasplus.com/china/guidetocas18.pdf>.

⁹² IFRS adoption and use around the world, see www.iasb.org.

categorised as being more conservative compared to the former accounting system, was only applicable to joint-stock enterprises and listed enterprises. Thus, limited application helped authorities prevent broadening the scope of loss-making enterprises (Xiao et al. 2004:209), which would have led to significant problems and additional economic and social costs in enterprise restructuring. The new accounting system was introduced with the aim of improving the transparency and comparability of accounting information provided by Chinese enterprises which influences the decision-making process of resource allocation. Accounting reform involves the improvement in accounting measurement and disclosure standards, and the establishment of regulatory and institutional framework for financial reporting.

5.3.1 Internal Corporate Governance and Relevance of International Accounting Standards in China

In 2006, the China Securities Regulatory Commission (CSRC 2006) issued *The Regulations on Information Disclosure of Listed Companies*. According to the regulation:

Article §§19 Listed companies have to publish financial reports, following their disclosure duties, which include those of annual reports, interim reports and quarterly reports. Furthermore, any information that could have a major impact on the investors' decisions shall be disclosed. The financial reports of a listed company shall be audited by CPA firms with qualifications for practice in securities- and futures-related business.

According to theory, the release of accounting-related laws, regulations, guidelines and standards improve the regulatory framework of corporate governance. Financial reporting and information disclosure are decisive means for corporate management to communicate enterprise performance and governance to shareholders and stakeholders. Corporate disclosure is an essential tool for the effective functioning of the capital market. Demand for financial reporting and disclosure arises from information asymmetry and agency conflicts between management and investors (Bearle/Mears 1932). Information asymmetry is negatively related to the cost of equity capital. As empirical studies have revealed, in most East Asian countries, including China, the simple adoption of international accounting standards is not

sufficient to resolve the transparency problem (Ball et al. 2000). Ball et al. (2000) further states that financial information in Asian countries⁹³ generally tends to lack transparency, resulting from the fact that “information quality is determined to a large part by the underlying economic and political factors influencing managers’ and auditors’ incentives, and not by accounting standards per se”. He concludes that adopting high quality standards might be a necessary precondition for transparency, but it is not a sufficient precondition to guarantee transparency in the long run, when institutions are not reformed.

Before 1994, Chinese enterprises generated financial resources mainly for internal funding, through a budget provided by the central government, and after 1994 the main source for funding is the Chinese banking sector, through commercial credit lending. As a result of the non-performing loan problem coupled with increasing demand for financial resources, the central government is in the necessary situation to receive accurate and transparent financial information in order to have support in its decision making capability over efficient capital allocation in the framework of economic reforms. Management of the socialist market economy requires constant decisions related to investments and the accounts of the state-owned enterprises. Budgeting and forecasting processes, as well as decisions in pricing and sales, purchase and investment, and salaries require accurate financial information. Since the state does play several roles in the domestic economy, financial information is required at different levels, and transparency supports the state in his effort for effective resource allocation. As a regulator, the central government and state agents are interested in the allocation of resources and the regulation of enterprise activities. Accurate financial information supports policymakers in order to regulate activities of enterprises, determine taxation policies and levy the taxes, and as the basis for national income. As a shareholder, the state is interested in information which enables to assess the ability of the enterprise to pay dividends. As a creditor, the state is interested in financial information that enables to assess the repayment capability of debtors with regard to loans and interest. Since bank-based financing is predominant in China, so the state has a special interest in the reduction of risk exposure. As an investor, the state provides risk capital and is concerned that projects with risks

⁹³ East Asian countries chosen for research are Hong Kong, Malaysia, Singapore and Thailand.

inherent in will provide a return on investment. Financial information is helpful in determining buying, holding or selling decisions. By playing all these roles in the domestic economy, the state is facing a multitude of agency problems, characterized by different levels of information asymmetry. Corporate governance standards and the regulations on information disclosure support the state to mitigate these agency problems with the objective to overcome the lack of information. Accuracy and transparency in financial disclosure is essential due to the following reasons:

Monitoring role of financial information in the reform process

The reform of the accounting system serves the state's interest in efficiency and transparency improvement within the state-owned sector. Disclosure of financial information in compliance with the recommendations of the corporate governance standards is a significant concern of the state, as the dominant shareholder. It is necessary for the state to get a clear picture of the performance and financial conditions of state-owned enterprises, which is a significant statement regarding the progress achieved in the reform and the state ownership policy. The state promotes the establishment and improvement of accounting and financial reporting which results in useful information for investors, creditors, auditors, rating agencies and other users of those financial reports. Since the state is transferring huge sums of investment into the reform process, financial statements and financial figures are a strong indicator for the progress achieved in the reform process within the state-owned sector. The accounting reform is highly linked with the implementation of the new Enterprise Income Tax Law and the dividend policy. By disclosing key performance indicators, the state can evaluate enterprises' efficiency and profitability. The state, fulfilling simultaneously the role of major shareholder and tax collector, has an interest in high tax revenues from its enterprises, in order to undertake public financing. Corporate governance standards and transparent reporting are regarded as corporate control mechanisms which have a positive impact on tax behaviour. Transparent accounting regulations support the state in setting tax liabilities and in the allocation of tax revenues. As a shareholder, the state is interested in information about dividend payment. Generally, annual reports disclose information such as earnings per share, cash flow from operating activities and dividends payable to shareholders of the company. Financial statements and cash flow statements are significant in regard to dividend payments. Since the state is the dominant investor for

domestic economic reforms, it now requires – since the enterprises are working profitable - a return on investment.

Risk management mechanism in the reform process

The state as the majority shareholder over state-owned banks obtains a strong influence over credit and capital allocation decisions. As a creditor, financial information supports the state in the assessment of debtor's repayment capability with regard to loans and interest. Better financial information may contribute to efficient resource allocation and risk mitigation. In China, total investment is financed by equity or debt and by receiving accurate information about financial conditions, policymakers are in a better position to handle complex financial operations, involving equity and lending activities. Under the assumption that information is imperfect, the state cannot rely on state-owned bank monitoring role only, therefore quarterly and annual reports institutions provide useful information on potential risk which might impact expected return on investment. Financial information also influences corporate management behaviour, because the managers know that enterprise performance will be published, therefore inappropriate risks might not be taken and diversion of funds for own use might be reduced. Having an overall picture of a company's financial position and results of operations, the state can avoid inappropriate strategic decisions and unexpected financial losses. In fact, it can be stated that it is the state who assumes a significant amount of financial risk within the restructuring process, therefore it is the government's responsibility to implement standardised regulations on information disclosure for preventing and dealing with the risks associated. Taking accurate financial reporting as a risk management mechanism, the principal-agent problem between the state and state-owned enterprises and banks can be mitigated.

Corporate social responsibility in the state-owned sector

Accounting and auditing also possess a social function in the accountability framework. The role of accounting has been widened, especially since stakeholder demand information on investments in social and environmental projects in the reform process. Since enterprises in China have been transformed into corporations, they are made accountable to fulfil social and environmental responsibilities in the society. The accounting function can capture efforts and commitments in these areas,

and provide information to stakeholder groups which are concerned with these dimensions. The introduction of the *scientific development concept* and the creation of a *harmonious society* demand the balance of economic growth with concern for social and environmental issues. Generally, listed enterprises report their corporate social responsibility activities in their annual reports. Taking into account China's Top 20 ranking by Fortune 2010, all state-owned enterprises publish either a sustainable development report or a corporate social responsibility report on an annual basis. This is in line with the Communist Party's approach of value-orientation within the framework of economic reforms. By fulfilling a mediator role among differing stakeholder groups, the Communist Party emphasises the need for social responsibility in the state-owned sector. Having an overall picture of companies' corporate social responsibility activities, the Communist Party is capable of monitoring its policy effectiveness. Being accountable to differing stakeholder groups, the Communist Party can demonstrate its strong position for value-orientation on the basis of the progress in social responsibility and sustainable development in the state-owned sector and thereby legitimatise its ruling status in the country.

5.3.2 External Corporate Governance and the Relevance of International Accounting Standards in China

International capital markets are observing an increasing amount of competition for scarce financial resources. As a result, companies are compelled to meet shareholders' and investors' demands for increasing transparency of a company's critical factors for success and processes for success. In the recent past Western countries have undertaken many efforts to meet the necessary requirements. Western industrialised economies require listed companies to disclose publicly their financial accounts. International accounting standards are introduced to provide shareholders and investors with a uniform standard valuation for their assessment. The aim is to develop a single set of accounting standards for worldwide acceptance.

In China, policymakers are aware of the importance of accurate financial disclosure, as generating both domestic and foreign capital for investments is of special concern for the government. Since China's commitment to become a full member of the World Trade Organisation (WTO) in 2001, Chinese companies have been required to

adopt international accounting practices. However, today China is facing a problem of inadequate financial disclosures and a lack of effective corporate governance mechanisms, although reliable and quality financial reporting and disclosures are of importance for enhancing good corporate governance standard and practices. According to theory, the quality of a company's disclosure will be reflected in its stock price and its ability to raise share capital on the capital market. Among other reasons, the adoption of a modern framework of corporate financial reporting is a reaction to the demand of China's capital market. According to an assessment of the IFC (2006), China still continues to fall below the expectations of the international community in the area of corporate governance compared to other emerging market countries. Moreover, ongoing reforms on financial reporting are dissatisfying and financial disclosure remains weak. In general there are several reasons why the implementation of international accounting standards has been pushed forward. Activities undertaken by the Chinese government in promoting harmonisation with international accounting standards are due to internal considerations and external pressure.

Inflow of foreign direct investment

According to the latest FDI Confidence Index 2010 compiled by A.T. Kearney (A.T.Kearney 2010), China is the most favoured destination for foreign direct investment (FDI), being placed before India and the USA. According to the World Investment Report 2009, published by UNCTAD (2009), Chinese inward foreign direct investment flows totalled USD 108.3 billion in 2008, meaning China retained its position of being amongst the largest recipients of FDI in the East Asian region. The adoption of an international accounting model facilitates foreign direct investment. As early as 1985, the Chinese government has already introduced an accounting system for Chinese-Foreign Joint Ventures. The Chinese-Foreign Joint Ventures also contributed to the establishment of auditing firms (Xiao et al. 2004). Accounting standards used by companies during the command economy were inadequate for foreign investors, causing them to lack confidence. Foreign enterprises located in China need to comply with Chinese accounting regulations and reporting standards in their parent company.

IAS/IFRS provides greater transparency in financial statements, which in return attracts increased FDI.

External pressure from international organisations like the World Bank and the International Monetary Fund

The World Bank undertakes a number of activities to support the development and implementation of international accounting and auditing standards worldwide⁹⁴. These activities include “financial support for the relevant international standard-setting organisations; diagnostic work to benchmark countries’ financial reporting standards and practices against international standards; policy advice and financial assistance to support the enhancement of these standards and practices; and participation in international discussions and initiatives aimed at strengthening the regulatory environment, both nationally and globally, in which international standards are applied” (Worldbank 2004). The World Bank and IMF regularly observe standards and codes⁹⁵ related to accounting and auditing regulations in China.

Obtaining an international standing within the financial community

For large Chinese enterprises wanting to become global players on an international level, being listed on international stock markets can be regarded as a seal of quality due to the high quality standards of international stock markets.

Basel Capital Accord

Financial statements play a significant role in borrowing transactions. Basel II Capital Accord requires rating arrangements, regardless of whether a company is listed or not. These arrangements aim to ensure that in the future companies have no leeway to elude from ratings. The Basel Capital Accord strives to improve upon the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face, like the credit risk. In fact, banks are demanding more and more detailed information

⁹⁴ See the Worldbank/ROSC website, including details on core standards for accounting and auditing and country modules, <http://www.worldbank.org/ifa/rosc.html>.

⁹⁵ See detailed report of IMF/Worldbank on observance of standards and codes in China and Hong Kong, <http://www.imf.org/external/np/rosc/hkg/index.htm#pref>.

from borrowing companies according to international standards. This is because banks are also subject to international regulation and conditions. Consequently, management has to convince credit institutions of a company's qualities and has to provide a clear and comprehensible picture of the company's current situation and its future development. Financial information is crucial to a company's risk assessment, in relation with a credit approval process. Indeed, the largest Chinese state-owned enterprises and state-owned banks have raised money via international borrowings, and applied for ratings to international agencies such as Moody's and Standard and Poor's. Financial statements prepared in accordance with IFRS also play a significant role to determine favourable credit terms (Bank for International Settlement 2010, www.bis.org).

Listing on foreign exchange stock and eased access to equity finance

International stock exchange listing rules require companies to adopt internationally accepted accounting principles and standards. IAS/IFRS facilitates the quotation of Chinese company shares on foreign stock exchanges. As China's international exchange activities have increased fundamentally since economic reform efforts have been a priority, Chinese companies have had to adopt internationally accepted regulations. According to the Dow Jones China Offshore 50 Index, in August 2008 56 Chinese enterprises had been listed overseas, namely on the Hong Kong Stock Exchange, the New York Stock Exchange, and the NASDAQ stock market (Dow Jones Chinese Indexes 2008).⁹⁶ The Dow Jones China Offshore 50 Index represents the largest stocks of companies whose primary operations are in mainland China but that trade on the exchanges of Hong Kong and the U.S.⁹⁷ These foreign stock markets are of interest as they are bigger and more liquid than the two national stock markets. Large Chinese enterprises strive to be listed on international stock markets to gain access for equity finance.

⁹⁶ See detailed list of enterprises assigned to Dow Jones China Offshore 50 Index: http://chinaindex.dowjones.com/eng/djchina_offshore.htm. Apart from that, six other indexes are available on the homepage: Dow Jones China 88, Dow Jones China Offshore 50, Dow Jones China Broad Market, Dow Jones Shanghai, Dow Jones Shenzhen and Dow Jones CBN China 600 indexes. These indexes are representing the largest and most liquid stocks traded on the Shanghai and Shenzhen stock exchanges.

⁹⁷ US stock markets require enterprises to prepare the consolidated accounts in accordance with US GAAP, in order to ensure equal treatment of US enterprises and foreign enterprises in regard to capital allocation and scarce resources (www.fasb.org).

Separation of ownership from control resulting in high managerial autonomy

Actual separation of ownership from control and increasing managerial autonomy has led to relevant principal-agent problems. The Ministry of Finance has announced that the use of the new Chinese accounting standards will be expanded to all state-owned enterprises controlled by the Chinese central government starting in 2008, and then to all large and medium-sized companies in China starting in 2009. The new financial reporting requirements and the accounting reform can be regarded as an effective tool towards mitigating the principal-agent problem. The adoption of the new Chinese Enterprise Income Tax Law and the new financial reporting requirements are strongly linked to each other, as the government is determined to intervene against tax avoidance activities on a national as well as a local level (Enterprise Income Tax Law 2008).

Global trend of standardization of accounting standards

There is a general global trend of accounting standards being standardised, due to the development of global financial markets. International financial markets require companies to adopt internationally accepted accounting principles and standards. Harmonisation of accounting standards is the result of the demand for the comparableness of companies' financial performance, and results in an efficient allocation of resources in an international capital market.

5.4 Auditing in China

During the period 1949-1978, the audit profession was non-existent in China. In the early 1980's, auditing occurred due to the inflow of Sino-foreign joint ventures (Xiao et al. 2004). Parallel to this the first accounting firms emerged, followed by the issuance of the Chinese public accountants (CPA) regulations in 1986, and the establishment of the Chinese Institute of Certified Public Accountants (CICPA) in 1988 by the Ministry of Finance.

In the framework of reforms, state-owned enterprises were restructured and transformed into corporations. In the early 1990s a set of accounting standards was

promulgated, applicable to joint stock limited enterprises only. In the early 1990s, the establishment of the Shanghai and Shenzhen stock exchanges triggered an increased demand for independent auditing of accounting information due to the listing of enterprises from investors. In 1993, the Certified Public Accountants Law was promulgated, and in 1995 the CICPA became the setting corporate body for both accounting and audit firms. The Auditing Law of 1994, revised in 2006⁹⁸ and 2010⁹⁹; and China's Certified Public Accountants Law of 1993 represent the legal basis for regulation of auditing practices in China. The auditing profession has increased immensely, since all listed companies including those that issue A- and B-shares are audited by Chinese certified public accountants. The Chinese Institute of Certified Public Accountants, and the Chinese Securities Regulatory Commission, both exercising a monitoring role to regulate the accounting and auditing market.

Auditor independence in China is questioned by academic scholars as well as practitioners (Yang et al. 2001; Xiang 1998; Tang et al. 2000). Originally, Chinese certified public accountants (CPA) firms were founded and administrated by government regulatory bodies. Taking into account that most listed enterprises are under state-control, it is evident that the government as the major shareholder has an interest that financial reporting is accurate. Performance of audits in state-owned enterprises is in line with the state's interest in transparency improvement within the state-owned sector. At the beginning of the reform, the central governments recognised that most state-owned enterprises were in such bad financial shape that neither national nor international investors would lend them money. Although the state could legally raise taxes, taxation was limited due to the need for better financial information. Consequently, there was an appreciation of an audited annual financial statement that could be used to assess an enterprise's performance and fiscal surveillance. The state is interested in monitoring enterprises' performance, and auditing firms are able to deter financial reporting fraud and to report detected fraud. Independent auditing can fulfil its function in an effective corporate governance environment, where risk assessment and independence in the audit process is given. The central government demands audited financial statements from state-owned

⁹⁸Decision on Amending the Audit Law of the People's Republic of China at the 20th meeting of the Standing Committee of the 10th National People's Congress of the People's Republic of China on February 28, 2006.

⁹⁹ Release of revised implementing regulations for audit laws by China's State Council applicable beginning in May 2010. The revised rules cover responsibilities and limits of audit offices, audit procedures, and legal obligations.

enterprises before providing them with subsidies and contracts for national infrastructure projects like construction, manufacturing and other services. Auditing in China is challenged, as party members are represented in the executive boards of the enterprises, and auditors might face political pressure during the reporting process due to vested interests. Addressing this challenge is an essential component in assuring audit quality. Audit certificates are important to companies, especially in credit approval processes and credit ratings, when risk assessment procedures are undertaken. The lack of audited financial statements based on international accounting standards might adversely affect enterprises' credit ratings and consequently increase their borrowing costs. At a time when state-owned enterprises are facing an increased demand for borrowing for infrastructure and other purposes on international capital markets, the state is particularly sensitive towards complying with requirements in the international financial community.

The auditing market in China is highly regulated and entry barriers created by the government exist. The Big Four international accounting firms: Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PriceWaterhouseCoopers, are all well established in the PRC. The first international CPA firms entered Chinese auditing market in the early 1980's, although were only allowed to establish a representative office. Later in the mid-1980's international CPA firms were fully allowed to do business in China, but only in cooperation with a Chinese local partner (Chen et al. 2007). Finally, they have been permitted to merge with local CPA firms (Yang et al. 2001). Since 2007, according to the Chinese securities market regulations, companies that issue A-shares and B-shares are required to publish a financial statement in accordance with CAS only. Before they were required to publish two sets of financial statements, one in accordance with Chinese GAAP, and one in accordance with international accounting standards. Therefore these companies were subject to dual audits, as IAS/IFRS based statements were audited by a local auditor or an international CPA firm. In fact, the auditing of B-shares financial statements accounts for one of the main business areas for the Big Four in China (Chen et al. 2007:5). With the introduction of the new Chinese accounting standards in 2007, firms listing B-shares are only required to report under the New Chinese Accounting Standards (CAS)¹⁰⁰, consequently in the future auditing in the B-share market can be done by

¹⁰⁰ IAS Plus September 2007 Update: <http://www.iasplus.com/country/china.htm#0807>

Chinese CPAs only. Forbes (2006) reported, citing the Financial Times, that the Chinese Institute of Chartered Accountants (CICPA) released a draft policy paper, in which it showed a strong willingness to create ten accountancy firms within the next ten years. The aim of this is to become globally accepted as a valid and competent provider of auditing services in accordance to international standards. This step forward indicates that the government wishes to reduce reliance on foreign accounting firms, and is highly interested in promoting a robust domestic market, even in the accounting field.

In line with the revision of the Audit Law in 2006, the National Audit office issued a 2006-2010 five-year audit development program with the aim of improving the auditing of officials at all government levels, including officials that are members of the Communist Party of China; as well as representatives of state-owned enterprises (People's Daily 2006). The training and the knowledge transfer of the new auditing practices are of high importance by those who are concerned with audits in order to comply with the new regulations.

5.5 Conclusion

China's accounting reform has turned out to be a transformation from an accounting model based on a planned economy to a model based on a market economy. Changes in accounting information reflect the need for more transparency required in the socialist market economy. The state has taken over the role of reformer in accounting and is highly interested in increasing transparency and the disclosure of financial and non-financial information. The reform process in China requires high levels of transparency in financial information which is a significant element in the transformation process, in order to improve effective resource allocation within state ownership. The transformation from a planned economy to a socialist market economy requires institutional reforms, since accounting played a statistic role under the system of central planning. Change in the accounting model is anticipated to solve issues such as agency problems, information asymmetry and low monitoring capability.

Improvements in information disclosure is of special interest for the state, since the relationship between state-owned enterprise and the state did change in the

framework of reform, and the state does not possess direct influence on state-owned enterprises anymore. Gradually, control rights have been transferred to corporate management, and transparent financial information supports the state in influencing corporate management behaviour and enterprise performance. Having an overall picture of a company's financial position and results of operations, the state is in the position to influence strategic decisions and resource allocation. Further, due to soft lending policies and imperfect competition in the domestic market, the state has only limited information on enterprise performance. Accounting principles like conservatism have been introduced to accounting standards, which require enterprises to estimate economically probable losses and the improvement of risk management. Adequate risk management does not only protect shareholder interests, but provide meaningful financial information to parties having a stake in the firm. Chinese banks are now in the situation to operate as profit-oriented companies like in Western countries, thus the consideration of the degree of creditworthiness of potential customers, and the allocation of finance with loan agreements is becoming tighter. Poor information disclosure is associated with greater investment risks. Market-based reporting standards require enterprises to reflect the financial reality. The government wants more transparency in Chinese reporting and accounting in order to monitor financial results better and to improve and strengthen tax discipline. The reform of the accounting system has been undertaken in line with the adoption of the new taxation system, which has been realised with the new Enterprise Income Tax Law for Chinese enterprises. Financial enterprise statements are meaningful for determining tax liabilities; and information on regular tax payments might be meaningful for credit approvals and credit risk assessments. Furthermore the government relies on accurate audited financial reporting in order to track the progress achieved within the framework of economic reforms. Ongoing reforms in financial reporting and efforts in the improvement of financial disclosure are also resulting from harmonisation ambitions of accounting standards in international financial markets. Large enterprises are encouraged by the initiative *Chinese Companies Going Global* to expand overseas. Listing on international stock exchanges requires the compliance with international accounting standards, in response to the needs of international investors and users of financial information. Under the assumption of imperfect information of markets, compliance with international accounting standards and key performance indicators is a good measure for enterprise performance. Benchmarking

with international enterprises based on international accounting standards and financial key figures might be a good indicator of the competitiveness of an enterprise as well of the long-term performance.

The model of accountability has been developed and changed in the reform process, taking into consideration the expanding role of stakeholders. At the beginning of reforms with an emphasis on high economic growth of the Chinese economy, financial information was relevant to the state, in order to receive an entire picture about financial conditions of the state-owned sector, the costs in the reform process, and return on investments. Corporate governance standards and regulations on disclosure were introduced with the objective to improve the monitoring and control capability of state agents within the framework of the state-sector restructuring. Since the central policy approach changed to the *scientific concept of development* and the *harmonious society*, demand for increased information is coming from stakeholders, which engage in investments for social and environmental progress in the country. Since corporations are made accountable to fulfil social and environmental responsibilities in the society, the accounting function can capture efforts and commitments in these areas, and provide relevant information to stakeholder groups. The Communist Party is showing a commitment to corporate social responsibility, and the regular release of sustainable development reports and reports about activities in corporate social responsibility might be regarded as a model of accountability that aims to create better relationships and better communication between the Communist Party and different interest group in society. The dialogue and debate with society is essential since neglect of social responsibility would result in confidence loss of the public and social unrest. Information disclosure and improvement in transparency does not only involve economic progress of enterprises within state ownership, but also progress in social and environmental questions requested by different interest groups in the society.

6 Conclusion and Outlook

The introduction of corporate governance in China is influenced by the requirements of a transformation economy with the objective to find an adequate institutional framework for the socialist market economy. With the implementation of economic reforms, the institutional model applied in the central planning economy is not working for the socialist market economy. Chinese policymakers did not blindly copy a Western model of corporate governance, but instead took relevant elements of existing international models in accordance with the Chinese specific needs of a transformation economy within state ownership. In this view, the introduction of corporate governance and institutional building does not simply pursue the appliance of a Western model of corporate governance in China, which is confirmed by the fact of substantial proportion of state ownership, and strong state control over the Chinese economy and the financial market sector. The key challenge faced by the state and the Communist Party is to find processes which are supporting them in the balance of collective problem solving among relevant interest groups. Thereby questions about the participation of shareholders and stakeholders, authority in policymaking and the governance of processes need to be answered. In general, it is questionable that China with its socialistic history and legacy can be simply transformed into a country working according to a Western model of corporate governance. The thesis analyses corporate governance standards that are supportive in collective problem solving among relevant interest groups at enterprise level from two perspectives. From the internal corporate governance perspective differing interests and power levels need to be balanced in the interrelation of old and new corporate bodies within the enterprises. From the external corporate governance perspective the balancing of different interest groups needs to be assured, since dynamic changes of enterprises' external environment ask for broader stakeholder participation. Additionally, since the relationship between the state and enterprises changed, and the state does not possess direct control over enterprises anymore, control rights need to be shared with other shareholders. As a consequence, domestic and international investors and international capital markets became an integrated part of the Chinese business landscape. In this view, corporate governance standards are supportive in the adaption to international requirements and regulations with the objective that Chinese large enterprises become integrated members in the international business community.

The development of corporate governance in China has gone through several stages, where relevant elements of the existing international models were applied with the objective to find an adequate institutional framework for the socialist market economy. The thesis analyses the role of corporate governance in a transformation economy, and what contribution it makes to the reform process, and where it meets limitations, therefore corporate governance in China still faces challenges.

Based on the analysis, it can be summarised that the *institutional reform is still not completed in the country*. Taking into account, that political change is not anticipated, the process of institutional change under economic transformation is challenged by path dependence and political power concentration. Therefore the establishment of institutional, economic and social pillars is still developing. Nevertheless, the thesis proves that from an economic point of view, the gradual break out of the central planning system was successful, since system-specific conditions have been integrated in the market socialist economy. In China, institutional building is a gradual process, in which economic and political agents need to learn to get along with new roles and rules in order to find a consensus over common issues. In China, socialist and corporate institutional foundations coexist in profit-maximising corporations within state ownership. Consequently, a clear separation of economic activities from the government and the Communist Party hasn't been achieved so far. However, taking the Top 20 Chinese companies according to the latest publication of the Fortune 2010 listing of the World's largest 500 companies into account, the analysis proves that efficiency objectives and profit maximisation within state ownership have been realised to a certain degree. The experience in the Chinese case proves that state intervention is not necessarily in opposition to the functioning of the market with high performance of the economy. On the condition that state intervention is given, corporate governance standards are fulfilling the function being an instrument to have control over corporate management and enterprise behaviour in the socialist market economy, which allows policymakers to run the state-sector in a more efficient and transparent way. Corporate governance standards help to improve and optimise processes within these companies. From this point of view, institution building and the introduction of corporate governance is less about the implementation of a Western model in the Chinese environment, but more about how different interest approaches in the reform process can be balanced in collective

problem solving. The introduction of corporate governance supports the state in institutional building with the objective of overcoming the trade-off between state monopoly and emerging market forces. Institutional reform appears to be characterised by gradualism and reform efforts are carried out as to the Chinese saying *crossing the river by stepping on each of the stones*.

The thesis shows that *the state acts as the modernisation agent in the economy with an orientation for improved efficiency and transparency* within the framework of state-ownership. The Chinese government possesses several roles in the Chinese economy, and is not just a regulator of the legal, economic and social framework alone. By playing several roles, which do overlap to a certain degree, the state requests efficiency and transparency improvement at different areas of the economy. As the dominant regulator, the government is interested in the regulation of enterprise activities and effective resources allocation. The state is engaged in setting regulatory standards adequate for the socialist market economy. The implementation of corporate governance standards demands the selection of an appropriate regulatory framework which is based on the recognition of significant information asymmetries between the state and the state-owned sector. Compliance with international corporate governance standards is still limited as the legal system in China is still not developed and enforcement mechanisms remain weak. The introduction of effective corporate governance is challenged since *the legal system is still underdeveloped*. Having in mind, that the modern corporate law is still very young and the legislative lack of practical experience, it will take some time to become effective in the market-socialist economy. International corporate governance models are based on a mature market-based regulatory framework whereas the Chinese corporate regulatory framework is nascent and necessary basic legal principles are still developing. As the dominant shareholder and investor, the government is interested in high economic returns on investment, including dividend payment and high levels of financial disclosure. The state is the main player in the market and is engaged in commercial activities, instead of concentrating only on its predetermined role of providing public goods.¹⁰¹ Since the beginning of economic reforms in the country, the central policy approach highlights high gross domestic product growth of the Chinese economy. Due to rent-

¹⁰¹ Such as public services, education, health care, regulation and law enforcement.

seeking and opportunistic behaviour of bureaucracy in the state sector, efficiency was low at the expense of the domestic economy. With its claim for efficiency and transparency orientation within state-ownership, the state anticipates to control management behaviour and to change this behaviour into rationale and profit-oriented activities. In the past years of economic reform, resources were allocated to strategic important industries with the objective of the establishment of sustainable and strong domestic economy. Since enterprises are working profitable, the state is demanding a return on investment from the companies and since 2008 the controlling shareholder requests dividend payments. Turning state-owned enterprises into corporations serve the state's interest in efficiency and transparency improvement within the state-owned sector, in order to reflect systematically the implementation process of economic reforms in enterprise profitability, in the taxation system and the dividend policy. As the dominant shareholder and investor, the *government is engaged in efficient capital allocation in the state-owned sector*. State intervention in the financial market is persuasive since the government aims to keep and assure efficient capital allocation with the objective of constant stable growth rates in the economy. High economic costs of enterprise restructuring, bad loan ratios, recapitalisation of banks and repeated bailouts are tolerated in order to finance continuous economic growth. Western economic policies claim that the main function of financial market liberalisation serves in efficient capital allocation. In the Chinese model, the situation is different, where the government performs control over finance with the aim of efficient financial resource allocation. Here the main function of financial institutions is to mobilise savings, efficient allocation and constant growth rates in the economy. Resource availability and resource allocation are decisive for the effectiveness of the state-owned sector. Policy lending hinders capital allocation with the highest economic returns, but might be helpful in receiving social returns. By protecting their monopoly status over the financial sector, the state as well as the Communist Party is consistent in their objective of maintaining the economic, political and social stability in the country. Costs occurring due to macroeconomic instability would be immense, and since it would be the state that would bear it, there is the incentive to safeguard stability. The role of the state is especially challenged in times of financial crises. Since the state is acting as guarantor for macroeconomic stability in the country, deepening of financial crisis and global economic recessions, require the government to take measures to promote domestic economic policies. Control over the financial

sector and investment facilitates the provision of rescue packages to bail out the financial systems and save banks and enterprises from solvency. Further, selected capital allocation antagonizes reduction in economic growth and welfare-decrease. In the light of financial crises, government intervention prevents a financial meltdown and economic collapse respectively which is essential in stabilising public confidence and trust in the economy. As the dominant creditor the government is interested in a healthy credit culture and minimum exposure to credit risk. Knowledge about repayment capabilities of debtors is essential, in order to be able to take adequate measures for risk management activities. Being engaged in credit lending activities, *state-owned banks are acting in corporate monitoring and control over the state-owned sector*. Since state-owned banks are acting as an intermediary between the state and enterprises, they do provide to the state essential information about investment opportunity as well as risk. Therefore, state-owned banks combine several functions in the financial market, which involves saving mobilisation, investment selection and credit monitoring. The separation of commercial lending from policy lending is still not achieved in the banking sector, which leads to increased monitoring problems. The Chinese experience shows that traditionally close enterprise-bank relationships have a positive impact on the monitoring capability of the banks over enterprises. Regardless, whether Chinese banks possess debt or equity in enterprises, banks essential capital is information over enterprises. Corporate governance standards support state agents in providing adequate regulatory policies, so that efficiency and transparency in bank monitoring and compliance of banks with regulations can be improved. Since the capital market is still in its infancy and cannot be installed over night, it is very unlikely that the state will urge a change in the system and reduce the degree of control. Institutional change is still not completed in the financial sector, and this might be a reason why protection of this sector is more important than in other. Ongoing soft credit constraints and policy lending by state-owned banks are not necessarily in line with corporate governance requirements on efficiency and transparency, but they fulfil objectives which are socio-politically desirable. Efficient resource allocation does not only involve project selection with the highest economic returns, but also involve project selection with the highest social returns.

The thesis analyses *the role of the Chinese Communist Party as a mediator in preserving the integration of economic and socio-political interests* within the reform framework. The Communist Party does not only have economic interests in corporations, but also political and social interests centred in their position for value-orientation. Economic interests involve the upholding and improvement of the economic system, with public ownership playing a dominant role, and the strengthening of key industries in order to sustain economic growth (Constitution of the Communist Party of China 2007). With the introduction of the current official guiding socio-economic ideology of the *scientific development concept and the harmonious society*, the Communist Party has incorporated sustainable development, social welfare, a person-centered society and increased democracy in the reform process. The Communist Party's commitment to corporate social responsibility and the creation of the harmonious society is regarded as a synonym of overcoming the trade-off between the monopoly of the political elite and the society. This approach responds to the increasing demand for social problem solving with regard to employment, healthcare reform, social security and affordable housing. By building-up a *socialist harmonious society*, the Chinese Communist Party has shifted the focus from strong economic growth only to promoting economic growth in combination with social welfare in the country. State-owned enterprises have been transformed into corporations and are accountable to fulfill their responsibility in social and environmental areas of the country. Thereby the Chinese Communist Party acts as a mediator in promoting the integration of economic and socio-political interests among differing interest groups. With broader stakeholder participation, corporate governance regulations consider economic, political and social implications within the framework of transformation. Policy agenda reflects the accountability to different stakeholder groups for corporate social responsibility; otherwise there will be no public support for the economic reforms and the political system. Support for the realisation of the requirements of differing socio-economic interest groups is crucial for the Communist Party in order to avoid an imminent legitimacy loss in the country. Corporate governance standards address the need for dialogue and interaction between the main shareholder and various stakeholder groups, with the objective of balancing economic, social and environmental interests in the socialist market economy. This is essential, and stakeholder interests have to be comprised otherwise economic reforms will not be supported by the public anymore, and the

effective implementation of corporate governance regulations and ongoing economic reform efforts might be delayed or even interrupted. Without the support of various stakeholder groups, the ruling status of the Communist Party could be challenged. Expanded participation of various stakeholder groups in the public dialogue legitimates the one-party system in the country, without being in danger of facing public pressure for a multiparty system.

In the beginning of reforms, strong economic performance has represented the single most important source of legitimacy for the Communist Party regime. Now, the Communist Party is showing strong engagement in redefining their former purely growth-focused economic concept of a socialist market economy to one where social and environmental interests of the society are integrated. Corporate mechanisms are applied to harmonise various interests which all have a stake in the firm. It can be stated, that policies do not focus on economic returns alone, but do acknowledge the importance of social returns in the country. Government intervention in capital allocation ensures projects with social returns with regard to employment, avoidance of spillover effects, environmental issues and the social function of the state-owned sector. Policymakers are sensitive about this social return, which are demanded by stakeholders in the reform process. The model of corporate governance applied in China, does not only serve for economic reasoning, but also possess a social function in the transformation process. In this view, effective capital allocation does not only consider profit maximisation and high returns on investment, but also selection of projects with social return. By putting corporate social responsibility on its agenda, the Communist Party recognises the need to take over a mediator role of differing interests of stakeholder groups and to enter into dialogue with these multiple factions. Interest intermediation is in response to the dynamic change in the economic environment and the transformation process where traditional socialist elements are coupled with co-ordinated market mechanism. The thesis concludes that by combining corporate governance and corporate social responsibility, the traditional relation of cooperation between the state and the economy has been maintained. The coalition between economic, social and political interest groups serves primarily for the preservation of social stability and conflict prevention, and is a platform for social dialogue. Thereby the state and the Communist Party support each other in reaching their individual as well as overlapping objectives in the course of reform. In the

Chinese context, corporate governance and corporate social responsibility are instruments applied for the introduction of a sophisticated legal and regulatory framework in the socialist market economy. Unfortunately at the same time, the corporate mechanisms do not help to improve the implementation and enforcement capability in legal issues.

In China, the government and the Communist Party have taken an active role in institution building, in establishment of a regulatory framework and in efficient resource allocation with the objective of sustainable economic, political and social stability in the country. The implementation of corporate governance is limited to the extent that one might expect the implementation of a Western model of corporate governance following market-based requirements only and not considering the requirements of the transformation economy. The thesis concludes that the implementation of corporate governance standards transformed the economy into a hybrid economy which is resulting in its own country or system-specific model of corporate governance, applicable for the socialist market economy. The Chinese model of a hybrid economy is characterised by its own distinctive mixture of state and market forces. The objective of the corporate governance model encourages collective problem solving and consensus building over economic efficiency and growth as well as political and social sustainability within state-ownership in the country.

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9 Appendix

9.1 Abstract

In the last decade a lot of attention has been paid to corporate governance issues, evolution and growth. Worldwide, a large number of countries have issued governance codes, including recommendations on how to achieve good governance.

In Western countries, enterprises are working under established corporate governance systems, which rely on functioning institutional, economical and social pillars. Therefore corporate governance systems in developed countries have already entered a mature stage due to a learning process. Transition economies are still on a learning curve, as most of these countries have recently changed their economic systems from a planned economy to a market-based economy. Most of the ex-socialist countries already introduced legal and institutional foundations combined with market-based mechanisms in order to create structures so that corporate governance can function, but they still did not enter a mature stage. In China, the development of corporate governance has gone through several stages, starting with the reform of the state-owned enterprises in 1978. With the introduction of the banking and fiscal reform in 1994, enterprise reform entered a new stage as financing of the state-owned sector was changed. In 2002, the Chinese corporate governance code was introduced to enterprises, followed by the implementation of corporate social responsibility in 2007 (SASAC 2008). Summarizing, it can be stated that the Chinese model of corporate governance embraces both Western models, including the shareholder orientation as well as the stakeholder orientation. In the last few years a considerable amount of research has been done in the field of corporate governance in an international context, but research on China is still limited, therefore the thesis analyses the development of corporate governance within the framework of transformation in a socialist economy. This thesis reviews some of the key issues in implementing a Western concept in a context of both state ownership and a transformation economy. On the basis of OECD principles of corporate governance five parameters relevant for the internal corporate governance framework in enterprises are observed. The thesis examines the corporate structure of China's top 20 enterprises by studying the annual reports and websites of the enterprises, in addition to the economic methods commonly used in the field of new institutional economics.

9.2 Zusammenfassung

Im letzten Jahrzehnt wurde dem Thema Corporate Governance, dessen Entstehung und Entwicklung viel Beachtung geschenkt. Weltweit hat eine große Anzahl an Ländern einen Corporate Governance Kodex veröffentlicht, mit Vorgaben um eine „good governance“ auf nationaler Unternehmensebene zu erzielen. In westlichen Industrieländern arbeiten Unternehmen bereits unter bestehenden Corporate Governance Systemen, die auf funktionierenden institutionellen, wirtschaftlichen und sozialen Rahmenbedingungen aufbauen. Somit haben sich Corporate Governance Systeme in den Industriestaaten bereits etabliert und einen Reifegrad erreicht. Die Entwicklung von Corporate Governance Systemen in Schwellenländern befindet sich noch in einer Lernphase, insbesondere da diese erste kürzlich von der Planwirtschaft auf die Marktwirtschaft übergegangen sind. Die meisten ehemaligen sozialistischen Länder haben mittlerweile rechtliche und institutionelle Fundamente in Kombination mit marktbasierenden Mechanismen implementiert, um die Strukturen für ein funktionierendes Corporate Governance System zu gewährleisten.

Die Entwicklung der Corporate Governance in China zeigt mehrere Implementierungsstufen auf, die mit der Reform des staatlichen Unternehmenssektors im Jahr 1978 begonnen hat. Mit der Einführung der Banken- und Steuerreform im Jahr 1994, hat die Restrukturierung der Staatsunternehmen eine neue Stufe erreicht, da diese auch die Finanzierung des Staatssektors reformierte. Im Jahr 2002 kam es zur Einführung des Corporate Governance Kodex in China, gefolgt von der Einführung von Corporate Social Responsibility im Jahr 2007 (SASAC 2008). Zusammenfassend kann festgehalten werden, dass das chinesische Modell der Corporate Governance beide westlichen Modelle umfasst, welches sowohl den Shareholder als auch den Stakeholder Ansatz inkludiert. Während in den letzten Jahren im Bereich Corporate Governance im internationalen Kontext zahlreiche Forschung betrieben wurde, ist die Forschung betreffend den chinesischen Modells begrenzt. Die Doktorarbeit analysiert die Entwicklung der Corporate Governance in einem sozialistischen Wirtschaftssystem, und beschreibt die Kernpunkte der Implementierung eines westlichen Modells unter Berücksichtigung von Staatseigentum und Transformation. Basierend auf den OECD Grundsätzen der Corporate Governance wird das Rahmenwerk der Corporate Governance in

chinesischen Unternehmen analysiert. Aufbauend auf der Methode der Neuen Institutionenökonomik, und anhand von Jahresberichten und Veröffentlichungen wird die Ausgestaltung von Leitungs- und Kontrollstrukturen in den führenden gelisteten Unternehmen Chinas untersucht.

9.3 Curriculum Vitae

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| SS 2003 | Guanghua School of Management (MBA-Programm) an der Peking Universität in China |
| SS 2004 | Babcock Graduate School of Management (MBA-Programm) and der Wake Forest Universität in North Carolina, USA |
| 2005 | Abschluss des Magisterstudiums Internationale Betriebswirtschaft & Chinesisch an der Wirtschaftsuniversität Wien mit den Schwerpunkten Unternehmensführung, Strategisches Management und Controlling, und Außenhandel |
| 2005 | Abschluss des Bakkalaureatstudiums Sinologie an der Universität Wien |
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