

We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China

**Li-Wen Lin
Curtis J. Milhaupt***

Introduction

China's emergence as a global economic power poses enormous explanatory challenges for scholars of comparative corporate governance. While China appears to present a new variety of capitalism, frequently labeled "state capitalism," the features and implications of this system are still poorly understood.¹ Particularly since China's economic system may be in its early stages of development, understanding the mechanisms by which state capitalism currently operates and how they may change as Chinese enterprises globalize is a pressing task for researchers.

One highly distinctive characteristic of state capitalism in China is the central role of about 100 large, state-owned enterprises (SOEs) controlled by organs of the national government in critical industries such as steel, telecom, and transportation. Although few of these firms are household names in the West, they dominate major industries in China and are increasingly active in global markets. As *The Economist* recently noted, "as the economy grows at double-digit rates year after year, vast state-owned enterprises are climbing the world's league tables in

* Lin is a PhD Candidate in the Sociology Department of Columbia University. JSD, University of Illinois. Milhaupt is the Parker Professor of Comparative Corporate Law, and Fuyo Professor of Japanese Law, Columbia Law School. Helpful comments on an earlier draft were received from Yuen Ang, Donald Clarke, Robert Ferguson, Ronald Gilson, Jeffrey Gordon, Benjamin Liebman, Nicholas Howson, Mariana Pargendler, Hugh Patrick, Randall Peerenboom, Frank Upham, and participants at workshops in Beijing, and at Columbia, Cornell, Fordham, NYU and Vanderbilt Law Schools. We also thank interviewees in Beijing from business, government, and academia who generously shared their knowledge and insights with us. Interviews were conducted on an anonymous, background basis.

¹ As one commentator puts it, "[H]aving co-opted Western capitalism and mirrored many of its surface features, China today poses an unprecedented and profound challenge to Western capitalism that scholars and policymakers have only begun to grasp." Marshall W. Meyer, *Is it Capitalism?*, 7 *Management & Org. Rev.* 5, 8 (2010).

every industry from oil to banking.”² China now has the world’s third largest concentration of Global Fortune 500 companies (sixty-one)³, and the number of Chinese companies on the list has increased at an annual rate of 25% since 2005. These are China’s national champions.

More than two-thirds of Chinese companies in the Global Fortune 500 are state-owned enterprises. Excluding banks and insurance companies,⁴ controlling stakes in the largest and most important of the firms are owned ostensibly on behalf of the Chinese people by a central holding company known as the State-Owned Assets Supervision and Administration Commission (SASAC), which has been described as “the world’s largest controlling shareholder.”⁵ Though the elite firms such as Sinopec or China Mobile are listed on stock exchanges in Shanghai, Hong Kong or other world financial capitals, they are nested within vertically integrated groups. Their majority shareholder is the “core” company of the group – which is itself 100% owned by SASAC. The core company coordinates the group’s activities and transmits business policy to group members, who are contractually bound to promote the policies of the state. Individual corporate groups are often linked through equity ownership and contractual alliances to groups in the same or complementary industries, provincial level business groups, and even to non-economic state-controlled institutions such as universities. Top managers of national champions simultaneously hold important positions in the government and the Communist Party.

While the basic outlines of this system are now widely known, in many respects the concept of state capitalism in China – particularly the organizational structure and broad

² “Let a Million Flowers Bloom,” *The Economist*, March 12, 2011, at 79.

³ Behind the United States and Japan. Fortune 500 rankings are based on revenues.

⁴ The banks are majority owned by other agencies of the state, and supervised by the Chinese Banking Regulatory Commission and the People’s Bank of China.

⁵ Boston Consulting Group, SASAC: China’s Megashareholder (Dec. 1, 2007), available at http://www.bcgperspectives.com/content/articles/globalization_strategy_sasac_chinas_megashareholder/. SASAC’s distinctive qualities as a controlling shareholder are analyzed in Part IV infra.

governance regime surrounding these national champions – remains a black box.⁶ Scholars have explored numerous facets of investment, monitoring and organization in western firms, but for China, research is only beginning to unpack “state ownership.” How were failing state enterprises transformed into global players, and what foreign models did Chinese economic strategists look to for inspiration? How are nationally important firms related to one another and to their sources of financing, and what links the national champions to government and Party institutions? What incentive structures operate within this system? How does the Chinese party-state behave in its role as controlling shareholder? What are the implications of this system for our understanding of Chinese corporate governance and for the potential future transformation of corporate capitalism in China?

Scholarship to date has provided only fragmentary answers to such questions. In part, this is due to scarcity of reliable data, but it is also a result of the way scholars have approached the subject.⁷ Most corporate governance scholars working on China, for example, have taken the individual firm – the publicly listed company – as the unit of analysis, even though corporate groups are pervasive in China’s state-owned sector and the listed firm is just one part of a complex web of corporate entities and relationships that characterize Chinese state capitalism.⁸ Moreover, scholars often begin and end their analyses by benchmarking the governance

⁶ The black box quality perpetuates sweeping generalizations that obscure the mechanisms at work within the system. Consider the following characterization:

China is the leading practitioner of state capitalism, a system in which governments use state-owned companies and investment vehicles to dominate market activity. The primary difference between this form of capitalism and the Western, more market driven variety, is that decisions on how assets should be valued and resources are allocated are made by political officials (not market forces) with political goals in mind.

Ian Bremmer & Devin T. Stewart, China’s State Capitalism Poses Ethical Challenges, *China Business*, Aug. 17, 2010, available at http://www.atimes.com/atimes/China_Business/LH17Cb01.html.

⁷ This phenomenon is hardly unique to China. During Japan’s economic ascendance, scholars working within the U.S. tradition had theoretical “blindness” which obstructed their understanding of Japanese corporate structures and economic institutions. Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization*, 102 *Yale L.J.* 871 (1993). See *infra* TAN.

⁸ The oversight is puzzling, because many corporate governance scholars are legal academics, and the corporate group is a *legal* concept in China. See *infra* text at notes 37-38.

attributes of Chinese listed companies against global (which typically means U.S.) corporate governance standards and institutions. This approach produces insights, to be sure, but it invariably focuses the analyst's attention on what the Chinese system *lacks*, as opposed to how it is constructed and actually functions. We believe that, as was the case with scholarship on Japanese corporate governance in the 1990s, real headway in understanding China's variety of capitalism will come by analyzing the system on its own terms, rather than principally by reference to something it is not.

In this Article, we explore the mechanisms of state capitalism in China by analyzing the distinctive system of industrial organization in which the country's largest state-owned enterprises were assembled and operate. To aid in the exploration, we expand our focus beyond the usual corporate governance concern with agency relationships and try to understand the relational ecology that fosters production in a system where all roads eventually lead to the party-state. We introduce two simple analytical constructs for this purpose: *Networked hierarchy* is our term for the way top-down governance features within individual state-controlled corporate groups are coupled with pervasive linkages to other state-controlled institutions. *Institutional bridging* is our term for the widespread use of systematized fasteners uniting separate components of the system. This is the mechanism for the creation of networks, which promote information flow and provide high-powered incentives to actors in the system. Together, these features can be thought of as means to assemble what Mancur Olson called an "encompassing organization" – a coalition whose members "own so much of the society that they have an important incentive to be actively concerned about how productive it is."⁹

⁹ Mancur Olson, *The Rise and Decline of Nations* 48 (1982).

While there is much more to the Chinese economy than the national champions,¹⁰ there are many good reasons to examine the institutional ecology in which these SOEs function. By several measurements, the state sector is a significant part of the national economy.¹¹ Perhaps more importantly for our purposes, as recent scholarship has noted, “SOEs [everywhere] remain surprisingly understudied.”¹² China’s nationally important SOEs have joined the ranks of the largest firms in the world and are plainly worthy of deep exploration in their own right. The national champions are the fullest expression of state capitalism in China – the global face of China Inc. It is impossible to fully understand the institutional features of the Chinese economy without examining its largest, central actors. Bigness, as signified by the Global Fortune 500 list, does not necessarily indicate efficiency or innovative capacity, traits that will be key to the long-term success of the national champions in the global economy. But the emergence of large Chinese SOEs as major domestic and global actors has enormous potential implications across a range of dimensions.¹³ Finally, given the relatively early stage of development of Chinese capitalism, a robust exploration of its largest and most politically connected firms may provide insights into how the state-directed system may evolve over time – or at least suggest which

¹⁰ For an argument that the success of the Chinese economy lies not with state capitalism, but “bamboo” (entrepreneurial) capitalism, see *The Economist*, March 12th-18th (2011). For other work emphasizing private entrepreneurship in China, see, e.g., Yasheng Huang, *Capitalism with Chinese Characteristics: Entrepreneurship and the State* (2008); Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (2002).

¹¹ As of 2010, total assets of the 120 national SOEs equaled 62% of China’s GDP; total revenues were 42% of GDP. The same year, total profits of the national SOEs were \$129 billion, more than two times the total profits of the 500 largest privately owned enterprises. Individual Operation Conditions of Central Enterprises 2010, released on October 21, 2011, on the web site of China’s State-Owned Assets Supervision and Administration; An Analytical Report of China’s Top 500 Privately Owned Enterprises 2011, released on Aug. 25, 2011 by the All China Federation of Industry and Commerce. However, with only 9.36 million workers in the national SOEs as of 2009, the share of total employment is very low.

¹² Mariana Pargendler, *State Ownership and Corporate Governance*, working paper, at 48 (2011).

¹³ A non-exhaustive list: too-big-to-fail dynamics, monopoly power, Chinese global soft power, possible negative externalities generated by poor corporate governance practices, and resource allocation issues.

features of the current system are susceptible to change and the possible directions in which change may occur.¹⁴

Having defined our task as unpacking the conceptual black box of Chinese state capitalism, we necessarily focus on the central SOEs with the tightest connections to the Chinese party-state in its various institutional manifestations. Our analytical focus should not be mistaken for an attempt to demonstrate the comparative advantages of state enterprise ownership, to hold the national champions aloft as paradigms of efficiency, innovativeness, or good governance, or to show that the state-owned sector is more important to the development of the Chinese economy than the private sector. Moreover, as with any stylized account, ours at times sacrifices granular detail in the hopes of achieving conceptual insight. In operation, Chinese state capitalism is likely more conflict laden and heterogeneous, and less internally cohesive, than our stylized account may imply.

The Article proceeds in five parts. We begin in Part I by briefly examining scholarly analysis of Chinese corporate capitalism and its limitations. Drawing a parallel with attempts to understand the Japanese *keiretsu* two decades ago, we suggest that the existing literature on China can be complemented and extended by broadening the focus beyond the standard concern with monitoring of publicly listed firms that predominates in the corporate governance literature. Analyzing the relational ecology in which large state-owned corporate groups operate promises

¹⁴ Comparing the institutions of 19th and 21st century U.S. corporate capitalism may be instructive in considering China's future institutional trajectory. The system in existence today in the United States – from firm ownership structures to the surrounding set of regulatory and market institutions – eventually emerged out of the so-called robber baron era. Three aspects of the U.S. experience seem salient to China. First, China's present system of national champion capitalism bears some similarity to the U.S. robber baron era: an economy dominated by large, politically connected conglomerates operating in a weak institutional environment without anti-trust scrutiny. Second, it shows that massive change in corporate capitalism can occur in the span of a half century. Third, it serves as a reminder that large corporations exert tremendous influence on the surrounding social, political, and institutional structures in which they operate. For illuminating discussions of the U.S. historical experience, see, e.g. William G. Roy, *Socializing Capital: The Rise of the Large Industrial Corporation in America* (1997); Martin J. Sklar, *The Corporate Reconstruction of American Capitalism, 1890-1916: The Market, The Law, and Politics* (1988).

to provide a much richer understanding of where Chinese corporate capitalism originated and how it is currently organized. In Part II, we style state capitalism under the national champions as a *networked hierarchy* replete with *institutional bridges* to other institutions of the state, the Communist Party, and the government, and briefly trace the developmental arc of the corporate groups to their present state. In Part III, we use these analytical concepts to illuminate the key components and main organizational characteristics of the national business groups. We contrast certain features of the groups with those in Japan and Korea, which served as models for Chinese economic strategists in the 1990s. In Part IV, we analyze SASAC's behavior as a controlling shareholder within the larger institutions of the party-state. We explore the ways in which SASAC shares the role of controlling shareholder with the Party, and the institutional bridges linking the Party, the national champions, and the government in the management of state-owned enterprises. In Part V, we explore the implications of our analysis both for comparative scholarship on the Chinese corporate system, and for the future evolution of China's variety of capitalism, particularly in light of increasing global activity by its national champions.

I. Understanding China Inc.

Two decades of comparative corporate governance scholarship have shown that successful forms of corporate capitalism do not have identical features around the world. To the contrary, firms differ systematically in their ownership structures, sources of financing, and the surrounding set of national legal and market institutions in which they develop.¹⁵ The spark for this insight, now so thoroughly explored as to seem prosaic in hindsight, was the striking economic ascendance of another East Asian country – Japan – in the 1980s. Two decades ago,

¹⁵ This basic insight spawned a related literature on the “varieties of capitalism.” The seminal work contrasts “liberal market economies” such as that of the United States with “coordinated market economies” such as those of Japan and Germany. Peter Hall & David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001).

observers recognized that while Japanese firms were globally competitive, their ownership structures, financing patterns, and governance norms bore little outward resemblance to those of U.S. public firms, whose features had long been taken for granted as the natural end point of an evolutionary process in the formation of the “modern” corporation.¹⁶

Today, the world is once again confronted with a distinctive and globally important economic system in East Asia whose features appear opaque and even menacing to outsiders.¹⁷ Although China’s economic system has received a label, much work remains to understand how “state capitalism” is organized. As in the case of Japan in the 1980s, most of the corporate governance literature on China is preoccupied with agency costs and monitoring in publicly listed firms. Indeed, Ronald Gilson and Mark Roe’s twenty-year old observation on the intellectual obstacle to understanding Japanese industrial organization remains apt in relation to China: “Viewing the Japanese system through Berle-Means blinders, in the belief that it reflects only an effort to bridge the separation of ownership and control, will cause us to misunderstand it and, as a result, to miss the lessons that comparative analysis can offer.”¹⁸

Similar to the way in which the early literature on Japan sought to locate the “missing monitor” in the main bank system, many analysts of Chinese corporate capitalism have focused exclusively on agency problems in listed companies.¹⁹ The search for solutions has taken most

¹⁶ The standard reference is of course Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* (1932). Mark Roe was one of the first scholars to expose the historical and political contingency of U.S. corporate governance, and to contrast it with the Japanese system.

¹⁷ Analysis of Congressional hearings in the 1980s and 2000s suggests that U.S. lawmakers have many of the same questions and anxieties about Chinese firms and government industrial policy today as they had with respect to Japan two decades ago. See Curtis J. Milhaupt, *Is the U.S. Ready for FDI from China?: Lessons from Japan’s Experience in the 1980s*, in *Investing in the United States: Is the U.S. Ready for FDI from China?* 185 (2009) (Karl P. Sauvant, ed.).

¹⁸ Gilson & Roe, *supra* note 7, at 881.

¹⁹ An example of this approach is Chi-Wei Huang, *Worldwide Corporate Convergence within a Pluralistic Legal Order: Company Law and the Independent Director System in Contemporary China*, 31 *Hastings Int’l & Comp. L. Rev.* 361 9(2008). A small number of western scholars have focused on Chinese corporate groups. See, e.g. Lisa A. Keister, *Interfirm Relations in China: Group Structure and Firm Performance in Business Groups*, 52 *Am. Behavioral Scientist* 1709 (2009); Lisa A. Keister, *Engineering Growth: Business Group Structure and Firm*

commentators down a path whose grooves were cut by U.S. corporate governance logic, with a focus on independent directors, the market for corporate control, and robust securities regulation. This approach generates a lengthy list of (predominantly U.S.-style) formal institutions whose development is deemed crucial to the future transformation and improvement of Chinese corporate governance.²⁰ What it fails to do is confront a puzzle at the core of contemporary Chinese capitalism: how is a system without a plethora of formal institutions deemed important to Western firms producing a rapidly expanding list of Fortune 500 companies and supporting high and sustained levels of economic development in China?

Some commentators, recognizing, but largely sidestepping the puzzle, claim that “relationships” are the key to success of the Chinese economy.²¹ This is almost certainly an accurate observation. But analysis of the precise nature of these relationships and their role in the scheme of Chinese industrial organization is typically omitted in favor of references to cultural proclivities or historical influences.²² As one of us has argued in joint work with Ronald Gilson, “governmentally encouraged commercial performance” under an authoritarian political regime attuned to incentives may be doing the work of formal legal institutions in the Chinese economy, allowing small-scale reputation-based trading to be scaled up to the point where entry into the global economy is possible.²³ And as we suggested there, business groups fostered by

Performance in China’s Transition Economy, 104 *Am. J. Sociology* 404 (1998). A rare corporate governance account of China focusing on party structures and their influence on corporate law norms is Nicholas Howson, China’s Restructured Commercial Banks: *Nomenklatura* Accountability Serving Corporate Governance Reform?, in China’s Emerging Financial Markets: Challenges and Global Impact 123 (Zhu Min, Cai Jingjing & Martha Avery eds., 2009).

²⁰ For insightful analyses of Chinese corporate governance within the agency cost paradigm, see, e.g. Xin Tang, Protecting Minority Investors in China: A Task for Both Legislation and Enforcement, in Hideki Kanda, Kon-Sik Kim & Curtis J. Milhaupt eds., *Transforming Corporate Governance in East Asia* 141 (2008); Donald C. Clarke, The Role of Non-Legal Institutions in Chinese Corporate Governance, *id.*, at 168.

²¹ See, e.g., Franklin Allen et al., Law, Finance, and Economic Growth in China, 77 *J. Fin. Econ.* 57 (2005).

²² See *id.* (attributing success of Chinese economy in absence of sound legal institutions to Confucian belief system).

²³ Ronald J. Gilson & Curtis J. Milhaupt, Economically Benevolent Dictators: Lessons for Developing Democracies, 59 *Am. J. Comp. L.* 227 (2011).

the political regime and deeply entwined with Chinese Communist Party leadership may be central to the developmental success of the regime.

This project is an attempt to dig deeper into the structure and organizational ecology of the business groups at the center of China's system of state capitalism. Our account attempts to unearth the mechanisms underlying the uniquely encompassing nature of Chinese industrial organization and its concern not only with corporate governance, but also with production, the transmission and implementation of industrial policy, and the maximization of *state* welfare, at least as interpreted by elite actors within the system.²⁴

II. Chinese Industrial Organization as a Networked Hierarchy

State capitalism as practiced in China has a remarkably complex architecture. Before examining the plumbing, it will be helpful to get a view of the entire edifice. In this part, we develop a simple stylized model of Chinese industrial organization as it relates to nationally important firms and the corporate groups in which they are nested. We identify the principal components of the groups and illustrate their linkages graphically. Having sketched the outlines of the system, we take a step back to briefly trace its origins.

A. A Simple Analytical Construct

We call the organizational structure of state capitalism as practiced in China a *networked hierarchy*. This term captures a chief characteristic of the scheme of industrial organization: vertically integrated corporate groups organized under SASAC, the state-affiliated controlling

²⁴ Taking the group rather than the individual firm as the unit of analysis produces immediate insights. One salient—and to date completely unexplored—facet of business groupism in China is that it is a *legal* concept: business groups must be registered with the state in order to enjoy the advantages of such affiliation, and they are formally bound together by legal agreements known as Articles of Grouping that specify their objectives, membership, and governance structures. Thus, analysis of business groups in China is not subject to the criticism advanced by one strand of Japanese corporate governance commentary, which argues that the concept of *keiretsu* is a “fable” created through ideologically driven data mining. Yoshiro Miwa & J. Mark Ramseyer, *The Fable of the Keiretsu* (2006). Whatever one makes of this argument (for a rebuttal, see Curtis J. Milhaupt, *On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions*, 27 *Law & Soc. Inquiry* 425 (2002)), business groups in China clearly exist in the eyes of the state. See *infra* text at notes 37-60.

shareholder, with strategic linkages to other business groups as well as to governmental organs and state institutions such as universities, enmeshed in a helix-like personnel appointment process of rotations managed jointly by the Communist Party and SASAC.

The hierarchical aspects of Chinese industrial organization are readily apparent. They range from the vertical integration of firms along the production chain to the top-down character of industrial policy formulation and transmission in an authoritarian political regime.²⁵ But the Chinese system is not simply one in which vertically integrated groups transmit commands from state economic planners to SASAC and down through a chain of vertically integrated firms. These hierarchical structures are embedded in dense networks – not only of other firms, but also of party and government organs. These networks appear to facilitate information flow from the bottom up as well as from the top down. They foster relational exchange and collaboration on many levels of the production and policy implementation processes. And they provide high powered incentives to leaders within the system because success in one realm brings rewards in others. This combination of authoritarian hierarchy and collaboration within high-powered incentive structures is reminiscent of another capitalist mechanism of transitions – private equity investments.²⁶

As we discuss below in detail, these dense networks are the result of numerous pathways that link individual components of the system. Some are engineered through formal legal means, such as by contract or through shareholding relationships. Others are the result of personnel

²⁵ The vertical authority structure in Chinese SOEs is a reflection of the siloed, hierarchical governmental structure (known as *xitong*, or “system”) for economic management from which they were created. The *xitong* are “a group of bureaucracies that together deal with a broad task the top political leaders want performed.” Kenneth Lieberthal, *Governing China: From Revolution through Reform* 218 (2d ed. 2004). China’s SOEs were created out of reform efforts which sought “to restructure relationships so that the government and party no longer directly administer most enterprises and social organizations (such as research institutes). The government ... focus[ed] on providing a regulatory and broad policy framework, rather than detailed administrative control.... The communist party ... retain[ed] the right, however, to appoint the leaders of these units, even after they are no longer subject to government administrative management.” *Id.*

²⁶ Gilson & Milhaupt, *supra* note 22, at 233.

practices followed by the Communist Party and SASAC. Still others are incorporated into the distinctive notion of “representation” in Chinese governmental organs, which assigns seats to select business leaders. We call this feature of the system *institutional bridging*.

One helpful way to view these constructed networks at the center of Chinese state capitalism is through the lens of Mancur Olson’s concept of an “encompassing coalition.” For Olson, this is a group representing a large enough segment of the population that it has incentives to grow the pie, as opposed to a “distributional coalition” representing a narrow segment of society, which tries to get a bigger slice for its members.²⁷ Olson focused on group size as the key distinguishing characteristic between encompassing and distributional coalitions, but in addition to size, it seems important that the encompassing coalition include all members whose participation can have a major impact on development—a broad cross-section of political and business elites in society. The networked hierarchy resulting from institutional bridges is a means of creating precisely this type of large, elite coalition with control over developmental policy formulation and implementation.

We again emphasize that our aim in introducing these concepts is descriptive, not normative. We are not claiming that these features of Chinese industrial organization necessarily lead to production efficiency. Olson himself noted that encompassing organizations will not necessarily lead to efficiency under all circumstances. The networks we describe most likely produce countervailing effects: They enhance efficiency by fostering information sharing, reducing opportunism through repeat play, providing high-powered incentives, and reducing frictions in policy implementation. But they also reduce competition and transparency, multiply

²⁷ Mancur Olson, *Rise and Decline of Nations*; These ideas were developed further in Olson, *Power and Prosperity* (2000), in which he introduced the notion of the “stationary bandit.”

agency relationships, and soften budget constraints.²⁸ The interesting question for us is not whether the state sector is more efficient than the private sector, but how the state sector has supported economic growth and produced globally important firms in the absence of formal infrastructure deemed essential in the standard theories on the relationship between institutions and development.

B. A Stylized Model

Next, we make use of the networked hierarchy and institutional bridging concepts to bring into focus the main organizational features of, and linkages among, the corporate group structures in which the national champions are nested. Figure 1 is a stylized picture of a national champion group.

[Insert Figure 1 here]

Four features of this structure are highlighted here, as they will be the focus of our attention in the succeeding parts of the paper. First, in contrast to the main postwar Japanese *keiretsu* and the Korean *chaebol*, Chinese business groups are vertically integrated firms focused on a particular industry or sector, not diversified groups involved in a wide range of industries. In complementary fashion, and again in contrast to *keiretsu* and *chaebol* structures, shareholding is hierarchical: firms higher in the structure own downstream subsidiaries, but there is very little upstream or cross-ownership among group firms. Second, most of the national business groups in China contain four main components: (1) the core (holding) company, whose shares are wholly owned by a government agency in the form of SASAC; (2) one or more publicly traded

²⁸ Consistent with this conclusion, studies provide conflicting accounts of the efficiency of China's state-owned sector. See, e.g., studies cited in William Allen & Han Shen, *Assessing China's Top-Down Securities Markets*, in *Capitalizing China* (2010). For a positive account, see Alberto Gabrielle, *The Role of the State in China's Industrial Development: A Reassessment*, 52 *Comp. Econ. Stud.* 325 (2010). At least according to data released by SASAC, the national SOEs are more profitable than the largest private firms. See *China's State-Owned Assets Supervision and Administration Yearbook* (2010); *China Enterprise Management Annual* (2010) (showing total profits in 2009 of 133 national champions of 815 billion RMB, versus 218 RMB for the 500 largest privately owned enterprises, by revenue). Of course, access to low-cost funding may help account for higher profitability of the state sector.

subsidiaries—the global face of the national champion—a majority of whose shares are held by the core company; (3) a finance company, which serves many important financing needs of the group, and has certain parallels with the Japanese main bank;²⁹ and (4) a research institute that coordinates innovative processes of the group. Third, monitoring is carried out within two parallel structures, a familiar one provided by the corporate law, with SASAC as controlling shareholder, and a party-based structure that shadows the corporate hierarchy, especially as to high-level managerial appointments.

Crucially, however, these group components, as well as their top individual managers, are extensively networked to the larger system of industrial organization. Although the various corporate groups are distinct from each other both legally and functionally, complementary groups are linked in important ways. Inter-group joint ventures, strategic alliances, and equity holdings are the corporate mechanisms providing such linkages. But the party-state, acting through SASAC and the Organization Department of the Party, provides another, probably more crucial, means of uniting the groups into a complementary whole. Finally, the economic aspects of this structure are linked through institutionalized personnel channels and political practices to governmental organs such as the National People's Congress, to important party organs, and to non-economic state institutions such as universities. These are the institutional bridges that unite separate components of the system.

C. Origins of Chinese Corporate Groupism

As one scholar has noted, “The formation of business groups has been one of the most profound components of China’s efforts to engineer industrial growth. The deliberate disengagement of formerly state-owned enterprises from the command of administrative bureaus

²⁹ As explained *supra*, eligibility to set up a finance company is one of the key benefits of registration as a corporate group.

is, in part, a result of the perception that business groups with specific structural characteristics protected firms in other countries from the shocks and challenges of development.”³⁰

Governmental encouragement of business group formation to foster the growth of national champions is obviously not unique to China. In the twentieth century, business groups served as engines of development in many countries around the world pursuing radically different economic strategies, including South Korea under Park Chung Hee, Chile under Augusto Pinochet, and Japan under the Meiji oligarchs.³¹ In many respects, China’s use of business groups reflects the same motivations for group formation at work elsewhere, including filling institutional voids in weak rule of law environments, internalizing capital markets, marshalling scarce resources, and reducing the transaction costs of administering economic policy.³²

Business groups around the world have typically originated with family founded enterprises. Family ties, reputational networks, and repeated dealings create an environment conducive to commercial activity in the absence of formal institutions. Successful entrepreneurs may be hand-picked by political leaders to work with the state, and may receive a variety of state-provided benefits to promote business group growth and diversification. Thus, in the typical pattern, business groups form as an outgrowth of the family firm in response to both institutional weaknesses (e.g. lack of functional courts to enforce contracts among trade partners)

³⁰ Lisa A. Keister, *Engineering Growth: Business Group Structure and Firm Performance in China’s Transition Economy*, 104 *Am. J. Soc.* 404, 436 (1998).

³¹ See Gilson & Milhaupt, *supra* note 22, for more on the role of business groups in the economic development of South Korea and Chile.

³² Guanyu Xuanze Yipi Daxing Qiye Jituan Jinxing Shidian de Qingshi [Instructions on Selecting a Group of Large Business Groups for Experimentation] Chinese State Council Document No. 71 (1991); Guanyu Zujian he Fazhan Qiye Jituan de Jidian Yijian [Several Opinions on the Construction and Development of Business Groups], promulgated by the National Economic System Reform Commission and the National Economic Commission, Dec. 16, 1987.

and government policy (e.g. loans at preferential interest rates to make large-scale investments in heavy industry).

In post-reform China, the path was quite different. When China moved away from central planning, the economy was bereft of private entrepreneurs, littered with redundancies in productive capacity resulting from autarchic economic policies, and highly fragmented along bureaucratic lines. Chinese economic strategists were intrigued by Japanese and Korean business groups as a model for promoting economic development,³³ but there was no blueprint for their replication in China. The business groups in existence today did not spring fully formed from the minds of Chinese economic planners; rather, they resulted from a long process of experimentation with collaborative forms of production.

Early on, the most pressing task was integrating disjointed economic structures and improving resource allocation. In the early 1980s, the Chinese government launched a series of regional and enterprise-level initiatives to promote these reforms. One such initiative was the introduction of business alliances (*jingji lianying*) as a mechanism of enterprise-level integration. These alliances, typically formed by contract, were designed to encourage inter-jurisdictional and cross-industry collaboration among SOEs, and between SOEs and other organizations, such as research institutes and universities. Collaboration within a business alliance could take various forms, such as stabilizing supply-demand relationships or sharing marketing and

³³ In 1979, a group of Chinese scholars visited Japan several times to understand the organization and operation of the *keiretsu* and reported their research to the State Council. See Zongliang Hu & Wei Zang, *Jituan Gongsi Zhanlue: Zhiding, Shishi yu Pingjia* [Group Companies' Strategies: Analysis, Implementation and Evaluation] 3 (2005); See also Lisa Keister, *Engineering Growth: Business Group Structure and Firm Performance in China's Transition Economy*, 104 *Am. J. Soc.* 404, 405 (1998). An interview with a government official who served in an economic ministry under Deng emphasized the Chinese leader's attraction to Japanese industrial organization and economic regulatory structures.

production facilities.³⁴ Used primarily from 1980-1986, approximately 32,000 business alliances were formed among over 63,000 SOEs.³⁵

The business alliance concept, however, proved ineffective in promoting economic reform. The alliances suffered from a lack of unified leadership and created regulatory gridlock by exponentially increasing the number of government agencies with jurisdiction over economic ventures.³⁶ Over time, economic strategists in the government became dissatisfied with purely contract-based collaboration, and shifted strategy in the second half of the 1980s. While the business alliance fell out of favor, these early forms of collaboration created nascent firm networks and governance mechanisms that became the building blocks for the construction of business groups in the years to follow.

In the next phase, policy makers relied on more durable and encompassing forms of collaboration among enterprises. In place of contracts, organizational structures based on shareholding were used to link firms. SOEs were organized into groups in order to deepen specialization, promote economies of scale, gain competitiveness in domestic and international markets, and separate the commercial activities of SOEs from the regulatory role of the government. In 1987 the central government unveiled a legal definition of “business group,” and specified the organizational requirements for registering as such. The introduction of a formal business group concept by central government authorities sparked a fever of group formation at the local level. But often these groups were little more than hastily transformed administrative

³⁴ Regulations promulgated by the State Council in 1980 provided the framework for such alliances. The regulations specified that alliances should be formed by contract, with provisions governing the scope of collaboration and profit and loss allocation. In addition, the regulations required the formation of a committee comprised of alliance members to manage the alliance.

³⁵ The 1987 Government Work Report of the State Council, released in the 5th Meeting of the 6th National People's Congress, March 25, 1987; Yue Wu, *Qiye Jituan Fali Yanjiu* [Research on the Legal Theory of Corporate Groups] 102 (2003).

³⁶ For example, a business alliance between two enterprises in different industries and located in different regions would result in oversight by four government agencies—two industry regulators and two local governments.

units of local governments, lacking in economic coherence and functional governance mechanisms.

In response to these problems, the Chinese central government took more control over the creation of business groups in the 1990s. The State Council constructed fifty-seven experimental business groups in 1991 and added sixty-three additional groups in 1997. These 120 experimental groups were concentrated in critical industries, such as automobiles, machinery, electronics, steel, and transportation. The groups benefitted from a range of preferential policies in areas ranging from taxation to government contracts and eligibility for stock exchange listing. The stated purpose of the government in forming these groups was to achieve economies of scale, facilitate inter-firm collaboration, and enhance international competitiveness. Formation of vertically integrated groups also had the administrative advantage of streamlining control over the economy: a small number of major firms would serve as conduits through which policy could be transmitted to vast numbers of enterprises organized under the core firms. By the mid-1990s, creation of national champions was explicitly recognized as a goal of the central government.³⁷

After years of experimentation with organizational structure, in 1998 a relatively clear concept of the business group emerged with the promulgation of Provisional Rules on Business Group Registration. Though “provisional,” these rules are still in effect. Subject to various threshold qualifications,³⁸ a business group is defined as a group of entities comprised of four layers: (1) a parent company and (2) its controlled subsidiaries (the two required layers), along with (3) non-controlled subsidiaries and (4) other firms which collaborate with the core company

³⁷ Guanyu Guomin Jingji he Shehui Fazhan “Jiu Wu” Jihua he 2010 Nian Yuanjing Mubiao Gangyao de Baogao [An Outline Report on the 9th Five-Year Plan of National Economy and Social Development and the Perspective and Goals of 2010], passed on March 17, 1996, by the 4th Meeting of the 8th National People’s Congress.

³⁸ In order to form a group, the parent company must have registered capital of at least 50 million RMB (about \$7.5 million) and at least five subsidiaries. The total registered capital of the parent and its subsidiaries must be at least 100 million RMB (\$15 million).

or its subsidiaries (two optional layers). Figure 2 illustrates the basic structure of a business group under the regulatory framework. In order to be registered, group members must enter into an agreement (Articles of Grouping) specifying the group’s boundaries and internal governance rules. Only registered business groups qualify for important benefits, such as eligibility to establish a finance company.³⁹

[Insert Figure 2 here]

This group formation process, together with the more basic step of “corporatization” of state enterprises – that is, the transformation of state agencies involved in economic activity into joint stock corporations – raised a variety of well documented agency problems, including the most vexing: When a corporate asset is theoretically owned by “the people,” who is the principal? In recognition of this problem, several attempts were made to create a controlling shareholder, leading to the establishment of SASAC in 2003. In theory, SASAC represents the state as “owner” and exercises shareholder’s rights on its behalf. SASAC’s distinctive role as a controlling shareholder within the context of the party-state will be examined in Part IV below.

III. National Business Groups

We now use the networked hierarchy and institutional bridging concepts to examine in some detail the key members, networked structure and internal governance mechanisms of the groups (Parts III.A-C) and provide two examples to illustrate the variants of corporate groupism in China (Part III.D).

A. Components

³⁹ On finance companies, see *infra* text at notes 40-50.

1. *Core (Parent) Company*: As noted, Chinese corporate groups have a multi-tiered hierarchical structure. At the top of the group is the core company. Core companies were typically formed by “corporatizing” a government ministry with jurisdiction over a particular industry. For example, each of the core companies in the national petroleum groups was hived off from the former oil ministry and transformed into a corporate entity. The core company acts as a holding company, serving as an intermediary between SASAC and group firms that engage in actual production. The core company coordinates information flow and resource allocation within the group. It transmits policy downward from the state to group members, and provides information and advice upward from the group to state economic strategists and planners. As Chinese commentators explain, “The key sectors and backbone industries are still controlled by the state through wholly state-owned or state-invested enterprises...In reality, the state can control the nationally important industries and key areas to lead the economy simply by grasping a few hundred large state-owned holding companies or business groups.”⁴⁰

2. *Listed company*: The external face of the national champion is not a group of companies but a single firm, whose shares are publicly traded on Chinese or Hong Kong stock exchanges and often on other major exchanges as well. For example, PetroChina, one of the largest oil companies in the world, whose shares are listed on the Shanghai and New York Stock Exchanges, is the external face of the CNPC Group, whose core company is the China National Petroleum Corporation. SASAC’s strategy in managing groups under its supervision has been to consolidate high quality assets in specific companies and to seek public listing for those firms. These listed firms are the focus of most scholarship on Chinese corporate governance to date.

⁴⁰ Haihang Zheng et al., *Guoyou Zichan Guanli Tizhi yu Guoyou Konggu Gongsi Yanjiu 2* [Research on the Management System of State-Owned Assets and State-Owned Holding Companies] (2009).

3. *Finance company*: One of the key benefits of registration as a group is eligibility to establish a finance company – a non-bank financial institution that provides services to group members.⁴¹ Finance companies are exempt from the general prohibition on inter-company lending.⁴² Under the current legal framework, a finance company provides services on behalf of group members similar to those of commercial and investment banks. Subject to approval by banking regulators, they are authorized to engage in a wide range of activities, including accepting deposits from and making loans to member companies, providing payment, insurance, and foreign exchange services to members, and underwriting the securities of member firms. They also engage in consumer finance related to the products of group members, and invest in securities issued by financial institutions.⁴³ Deposits from group member companies comprise their main source of funds. Almost all finance companies are members of state-owned groups, either at the national or provincial level,⁴⁴ and many are formidable in size. Table 1 compares the asset values of the largest finance companies as of 2009 with the asset values of Chinese banks. As the table indicates, by assets, the largest finance company in China is comparable in size to the country's twentieth largest bank.

[Insert Table 1 here]

In its role as the hub of group financial transactions, the Chinese finance company is a partial analogue to the Japanese main bank, at least as it operated in the heyday of postwar Japanese corporate finance and governance. However, there are several key differences. In

⁴¹ See Administrative Measures on Finance Companies in Business Groups, Art. 2, issued by China Banking Regulatory Commission on July 27, 2004, revised Oct. 28, 2006. Authorization is not automatic. Aside from various threshold capital and profitability requirements, bank regulators require that the business group's functions be consistent with the government's industrial policies. Administrative Measures on Finance Companies in Business Groups, Art. 7, item 1.

⁴² General Provisions on Lending, Art. 61.

⁴³ Administrative Measures on Finance Companies in Business Groups, Arts. 28-29.

⁴⁴ As of 2009, there were nine collectively or privately owned Chinese finance companies and four under foreign ownership, the latter serving German and Japanese corporate groups. Six foreign owned finance companies that operated independently of business groups were forced to close or transform into banks in 2000.

contrast to widespread, if low level, cross-shareholding ties between Japanese main banks and their most important borrowers, the Chinese finance company holds virtually no equity in other group member firms, and few or no firms other than the core company own shares in the finance company. While the finance company can be utilized by the core company to help monitor group members,⁴⁵ there is no evidence that finance companies perform an independent monitoring function, particularly with respect to the core company or listed companies in the group.

The Japanese banking system, particularly its perceived corporate governance benefits, was attractive to Chinese observers during the formative period of China's process of economic transition in the early 1990s.⁴⁶ In this period, legal and economic scholars widely argued that equity ownership by the main bank in its borrowers had important governance benefits,⁴⁷ and that the main bank served as a "delegated" or "contingent" monitor on behalf of other lenders to group firms.⁴⁸ It was even argued that the main bank substituted for the market for corporate control in Japan by displacing managers of financially troubled firms.⁴⁹ Yet China's finance companies bear only weak resemblance to the main bank system, serving primarily as an instrument of the core company for the purposes of internal group capital allocation. Moreover, unlike the situation in Japan, at this stage there is little equity ownership of banks by the corporate sector, although this may be changing.

⁴⁵ For example, the finance company may refuse to remit funds outside the group without approval from the core company, and it can report financial transactions by member companies to the core company.

⁴⁶ See, e.g., Yingyi Qian, Financial System Reform in China: Lessons from Japan's Main Bank System, in *The Japanese Main Bank System: Its Relevance to Developing and Transforming Economies* 552, 577, 585 (Masahiko Aoki & Hugh Patrick eds. 1994). ("The historical similarities suggest that China may benefit more from adopting features of the Japanese financial model than from other [arms'-length financial] models in achieving its objective of restructuring the corporate sector while stabilizing its economy.")

⁴⁷ See, e.g., Gilson & Roe, *supra* note 7; Qian, *supra* note 45.

⁴⁸ See, e.g., Masahiko Aoki, et al., *The Main Bank System: An Introductory Overview*, in *The Japanese Main Bank System I* (Masahiko Aoki & Hugh Patrick eds., 1994).

⁴⁹ Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 *J. Econ. Behav. & Org.* 399 (1989).

Given China's attraction to the Japanese model during a formative period in the formation of business groups, why did the country's economic strategists not pursue a financial and governance structure for its business groups that bore closer resemblance to the Japanese system circa the late 1980s? Two complementary explanations, closely linked to China's overall system of economic governance, might be offered. The first is that dispersion of governance rights in member firms to nonbank financial institutions would potentially dilute and complicate the hierarchical structure of economic management made possible by group formation under centralized state supervision. Second, the creation of nonbank finance companies within business groups – what one commentator has called “outside the plan financial intermediaries”⁵⁰ – poses an obvious competitive threat to the (largely state-owned) commercial banking sector. As such, Chinese regulators have been vigilant about not expanding the scope of finance company activities to the point that they constitute a complete substitute for Chinese commercial banks.⁵¹

4. Research Institutes: Chinese policy makers have encouraged business groups to include research institutes as members in order to promote high technology development and increase international competitiveness.⁵² Most of the national business groups contain one or more research institutes. The research institutes conduct R&D, particularly applied research in areas related to the group's products and production processes. Often, the research institutes collaborate with universities on particular projects to derive complementarities between the applied focus of business R&D programs and the theoretical approach of academic researchers.

⁵⁰ Qian, *supra* note 45, at 569.

⁵¹ Korean *chaebol* groups, whose formative period coincided with government ownership of the banking sector, similarly lack Japanese-style main bank relationships.

⁵² Guanyu Zujian he Fazhan Qiye Jituan de Jidian Yijian [Several Opinions on the Construction and Development of Business Groups], promulgated by the National Economic System Reform Commission and the National Economic Commission, Dec. 16, 1987. Guanyu Tuijin Keyan Sheji Danwei Jinru Da Zhong Xing Gongye Qiye de Guiding [Rules on Promoting Scientific and Design Institutes to be Included in Large- and Medium-Sized Industrial Enterprises], State Council Document No. 8 (1987).

Typically established as not-for-profit institutions, the research institutes receive funding from the core company in the group. Research institutes in groups with a diverse range of products may be multi-layered, with a chief institute affiliated with the core company and second-tier institutes established under particular operating subsidiaries. Intellectual property arising out of the research activities is typically owned by the core company, or allocated by contract in joint projects with outside institutes.

B. Membership and Internal Governance

Membership in most business groups is based on equity ownership of member firms by the core company. Although membership based on purely contractual relations among firms is permitted under the regulations on business groups, it is not common.⁵³ The predominance of equity ties is a reflection of governance concerns by both the core company and the state. For the core company, equity ownership provides a more direct and flexible form of control than contract. For the state, the objectives of group formation are more effectively advanced through corporate ownership than loose affiliations – indeed, as explained above, the original economic alliance concept was abandoned in favor of the business group for precisely for this reason.

In considerable contrast to business groups in Japan and Korea, equity ownership in Chinese business groups typically runs only in one direction: from the core company to downstream subsidiaries. Very little cross share ownership is found in Chinese business groups. Again, governance concerns – both corporate and political – appear to be the primary reason. The core company, as the dominant player in the group, has little use for upstream share ownership. For the government, the core company's role as delegated manager and monitor of group firms would not be enhanced – indeed it may be complicated – by cross shareholding

⁵³ In 2000, 87% of Chinese business groups included no purely contractually related members. Donghoon Hahn & Keun Lee, *Chinese Business Groups: Their Origins and Development*, in *Business Groups in East Asia: Financial Crisis, Restructuring, and New Growth* 210, 216 (Sea-Jin Chang ed., 2006).

linkages among group firms. Moreover, to the extent that cross-shareholding is used to promote enhanced monitoring of group members in countries such as Japan, this function may not be complementary to Chinese corporate group structures given pervasive party involvement in group firms and other forms of party-state monitoring.⁵⁴

Internal group governance structures are specified in a legally binding agreement called Articles of Grouping, which is adopted by all members. The Articles are state-supplied standard form contracts required of all registered business groups, but their specific provisions are largely composed of default rules. In reality, the core company dictates the terms of the Articles, and the internal governance rules grant it veto rights and other enhanced governance rights with respect to the group. Many Articles provide for plenary or management bodies to facilitate group or delegated decision making, respectively, but these organs typically either have only advisory power or are structured so that the core company effectively controls their decision making processes. In short, governance in a Chinese business group is a largely top-down process, but one that is open to information and participation from below.

C. Networks

The foregoing are the main components of the corporate groups and the mechanisms by which members are linked. Next we explore the larger networks in which individual corporate groups are embedded.

1. Inter-group Networks: While groups in the same industry do compete domestically, SASAC has encouraged collaboration among the national groups in overseas projects to increase their global competitiveness. These linkages, often among groups in complementary industries, are designed to facilitate technological development, as well as a host of other objectives, such as

⁵⁴ See *infra* text at notes 57-61.

information sharing, marketing, and pooling of capital for capital-intensive projects. As shown in below, these linkages typically take two forms: equity joint ventures and contractual alliances.

One obvious concern these forms of collaboration would raise in most economies is anti-competitive conduct. China has an Anti-Trust Law, enacted in 2008, which as a formal matter would appear to subject these alliances, along with mergers and other combinations between SOEs, to anti-trust scrutiny. In practice, however, the national enterprises under SASAC supervision are exempt from anti-trust enforcement.⁵⁵

We illustrate a few of the inter-group networks in the national steel groups by way of example. The number of relationships involving companies in these groups is actually much greater than is pictured here.⁵⁶ The figures illustrate the use of both ownership and contract to construct inter-group networks. They also show how networks are constructed among both complementary groups and groups of erstwhile direct competitors.

[Insert Fig. 3 here]

[Insert Fig. 4 here]

2. *Central-Local Inter-group Networks:* National groups under SASAC control are sometimes linked to business groups under the control of local governments. (Figure 3 above provides an example from the steel industry: provincial group Hebei Iron & Steel has an equity ownership interest in national champion BaoSteel.) These linkages are the result of an evolving dynamic between the central and local governments. Initially, local governments sought investment from the national groups to rescue moribund local SOEs. As the national groups

⁵⁵ See, e.g., Wentong Zheng, China's Antimonopoly Law—One Year Down Part 5. A De Facto “Dual-Track” Competition Regime?, *Antitrust & Competition Policy Blog*, available at http://lawprofessors.typepad.com/antitrustprof_blog/2009/12/chinas-antimonopoly-lawone-year-down-part-5-a-de-facto-dualtrack-competition-regime-.html.

⁵⁶ Figures are based on data from SDC Platinum. This data base is focused on international deals, so purely domestic linkages may be significantly under-reported.

expanded, local governments began to view them as a competitive threat to local business. Local protectionism increased, and a push was made to create “provincial champions.” The relationship between national and local groups appears to be in flux again as a result of the global financial crisis, which prompted renewed cooperation. The local governments now view the national champions as sources of support for small and medium-sized enterprises, which suffered when they lost the backing of foreign and private companies.⁵⁷ For the national groups, which are under pressure from their governmental supervisors to grow, tie-ups with local groups are an avenue of expansion.

3. *Business Group-Government/Party Networks:* Of course, as “state owned” enterprises supervised by SASAC, all national champions are connected to the central government. But this simple syllogism masks the density of the networks which tie the leading business groups to institutions of the central government and the Communist Party. Multiple institutional bridges facilitate the network. The first is the China Group Companies Association, which is formally designed as an intermediary between the national business groups and the central government. Its board of directors is composed of senior government officials and top managers of the most important national business groups. The Association is a vehicle for conveying the concerns of top SOE managers to the State Council (cabinet).

A second bridge is the practice, with roots dating to the period prior to the establishment of SASAC, of granting substantive management rights over a nationally important SOE to the ministry with supervisory authority over the industry in which it operates. For example, the Ministry of Industry and Information Technology retains important management rights over China Mobile, including the power to nominate its top managers, even though China Mobile is

⁵⁷ As an example of the importance provincial governments are now placing on tie-ups with national groups, over a one-month period in 2011, the Guangdong government reached 249 collaboration agreements with 71 national groups, representing a total investment of \$40 million. Enterprise Observer. June 2011.

part of a national business group whose core company is 100% owned by SASAC. In some industries, high-level two-way personnel exchanges between ministries and national groups reinforce this link.⁵⁸

A third institutional bridge is the routine exchange of personnel between SASAC and the central SOEs it supervises. In a policy designed to promote “mutual adaptation in political and professional qualities,”⁵⁹ fifty to sixty SOE managers are seconded to SASAC annually for one year periods, and vice versa. Available data on this practice suggest that the corporate managers seconded to SASAC are fairly senior and are sent from leading enterprises. The SASAC officials are relatively junior. This suggests that the practice is not primarily designed to facilitate SASAC’s monitoring of the SOEs, but rather to build SASAC capacity and promote cooperation between the SOE sector and the government.

A fourth institutional bridge between the national champions and the government is the practice of reserving a number of positions in several elite (if functionally obscure) government and party bodies for leaders of the national SOEs. Chief among these are the National People’s Congress—the central government’s symbolic legislative body—the National People’s Political Consultative Conference, an advisory body composed of representatives of different social and political groups, and the National Congress of the Chinese Communist Party, the Party’s general assembly. For example, based on a pool of candidates recommended by the party committees of the 120 central enterprises extant at the time, SASAC nominated 22 managers as representatives to the current (11th) National People’s Congress, and 99 managers to the 11th National People’s Political Consultative Conference, both of which run from 2008 to 2013. In 2007, the Party

⁵⁸ A recent example is the virtually simultaneous move in 2011 by Vice Minister (Xi) of the Ministry of Industry and Information Technology to become Party Secretary of China Mobile, and the appointment of China Mobile Vice CEO (Bing) to the newly vacated Vice Minister position.

⁵⁹ Statement by Mr. Xiping Shi (Head of Bureau of Personnel of SASAC). Press Release by the Bureau of Personnel of SASAC, June 21, 2007.

Committee of SASAC and the party committees of the 120 central enterprises selected 47 members to the 17th National Congress of the Chinese Communist Party. The composition of the selected members was determined on instructions from the Central Organization Department of the Party, which specified that no more than 70% of the positions should go to top managers of the core companies, and no less than 30% to middle managers of core companies and top managers of their subsidiaries.⁶⁰

As explained in detail below, the Party also plays a major role in personnel appointments in the national business groups. One-third of the employees in the national SOEs are members of the Party,⁶¹ and Party organizations exist within each level of the business group hierarchy. At one time, there may have been ideological reasons for the Party's pervasive role in SOEs. But a compelling political economy explanation for the practice is also apparent. The Party constitutes a massive interest group that maintained extensive ties to economic enterprises in the central planning era. Indeed, in this era there was often little separation between governmental, economic, and social organizations, with party involvement pervasive across all three spheres of activity. Corporatization and other economic reforms could have posed a major threat to important dimensions of party rule. Institutionalized party involvement in the post-reform state-owned sector can be seen as a way of buying the support of the Party for reforms that it may have otherwise blocked. The Party is also functionally well situated to monitor personnel in the SOEs. As one commentator notes, “[t]he Party’s control over personnel was at the heart of its ability to overhaul state companies, without losing leverage over them at the same time.... The

⁶⁰ China's State-Owned Assets Supervision and Administration Yearbook 2008, at 81 & 93. Guanyu Zuohao Zhongyang Qiye Xitong (Zaijing) Shiqida Daibiao Houxuanren Tuijian Gongzuo de Tongzhi [Notice on the Work of Nominating the Party's National Congress Members Representing the Central Enterprise System (Beijing-Based)], issued by the Party Committee of SASAC, December 2006.

⁶¹ As of the end of 2009, 3.03 million of the 9.36 million employees of the central SOEs were party members. China's State-Owned Assets Supervision and Administration Yearbook (2010).

party body with ultimate power over personnel, the Central Organization Department, is without doubt the largest and most powerful human resources department in the world.”⁶²

D. Examples

For illustrative purposes, we describe the corporate structure and governance characteristics of two national champions—Chinalco, one of the world’s largest aluminum producers, and giant power producer China Datang. As the structure of national champions go, Chinalco is unusual; Datang is typical. We include Chinalco both by way of contrast and because its structure is a legacy of a form of business alliance prevalent in an earlier stage of China’s reform’s process. Contrasting Chinalco and Datang helps illustrate the dynamism of organizational forms in the state sector.

1. China National Nonferrous Metals Industry Group

The Aluminum Corporation of China (Chinalco) is a Fortune Global 500 company. Its origins can be traced to the Bureau of Nonferrous Metals, established in 1979, under the Ministry of Metallurgical Industry. The company was reincarnated several times before it came into its present form as the crown jewel of the Aluminum Group Corporation of China in 1999. The Chinalco group has retained some features of the business alliance concept prevalent in the 1980s, during the firm’s formative period. Thus, Chinalco is not only a group in its own right, it is also the centerpiece of a larger alliance of firms, the China National Nonferrous Metals Industry Group (CNNG by its English abbreviation).⁶³ CNNG has four levels of firms, organized to collaborate along the nonferrous metals production chain. The first three levels resemble the structure of the other national SOE groups. They consist of the core company,

⁶² Richard McGregor, *The Party: The Secret World of China’s Communist Rulers* 69 (2010).

⁶³ CNNG is the successor of the Aluminum Group of China (CHINALG), which formed in 2003. In April 2007, CHINALG was transformed into CNNG, although the basic governance structure was retained.

Chinalco, and wholly owned and uncontrolled downstream subsidiaries of the core company. What makes this group unusual is the huge fourth level, consisting of over 100 firms, comprised of companies in which Chinalco holds no shares, but with which it or other Chinalco group members have long-term trading relationships.⁶⁴ Some members of the fourth-level are also members of local corporate groups, acting as bridges to other business networks.⁶⁵ Because SASAC's supervisory authority is based on share ownership, the vast numbers of contractual members of CNNG are not within the SASAC governance system, and do not count toward the rankings of business groups by size. In essence, CNNG is an industry association with a vertically integrated national champion business group embedded in its core. Now consisting of 197 members,⁶⁶ CNNG is a hybrid between the 1980s contractual alliances and contemporary business groups, in which hierarchical equity relations prevail. Figure 5 illustrates the group structure. The dotted line delineates the group boundary. The triangle shows the jurisdiction of SASAC.

[Insert Figure 5 here]

The formal governance documents of CNNG are a capsule summary of state capitalism, reflecting both political and business concerns. According to the Articles of Grouping, a major purpose of CNNG is to undertake important functions requested by the state, including the implementation of national economic development policies, advising the government in enacting industrial policies, and in implementing corporate, industrial, and national standards.⁶⁷ This is a

⁶⁴ An Overview of CHINALG, available at <http://www.chalco.com.cn/zl/html/40/2007/20071015154236016590199/20071015154258391709486.pdf> (last visited Aug. 26, 2011). CHINALG included four research institutes, nine state-private joint ventures, and twenty one private firms.

⁶⁵ See Council Member List of CHHG, available at <http://www.chalco.com.cn/zl/html/40/2007/20071015154208781539156/20071015154222828274339.pdf> (last visited Sept. 8, 2011).

⁶⁶ Information reported in the Third Meeting of the Third Management Council of CNNG, March 2011.

⁶⁷ CNNG Articles of Grouping, Article 7, Items 1-3.

formal recognition of the state's goal in establishing corporate groups as a mechanism for exerting control and implementing development policies through the networks organized around the core companies. The Articles also state a straightforward business rationale for the formation of CNNG: to coordinate resources among member companies. According to the Articles, CNNG was created to provide a platform for technological exchange, capital reorganization, and sales and marketing collaboration, to improve resource allocation among member companies, to support the internationalization of research, production and sales by member firms, to disseminate data within the group, and to coordinate relationships among member companies.⁶⁸

Policy and resource collaboration among a large number of firms requires coordination mechanisms within the group. Yet the lack of ownership ties among many firms in CNNG leaves the group without corporate law mechanisms to facilitate coordination. In place of organizational structures, CNNG uses contractual governance mechanisms featuring ostensibly democratic principles. Internal affairs are governed by a management council composed of one representative of each member and chaired by an appointee of the core company.⁶⁹ The management council has a large executive committee, comprised of three sub-committees, to implement the decisions of the management council. The executive committee is composed not only of representatives of the core company and its controlled subsidiaries, but also representatives of firms which only have contractual relationships with these companies. In both the management council and the executive committee, decisions are made by majority vote, with one vote per member.

⁶⁸ CNNG Articles of Grouping, Article 7, Items 4-8.

⁶⁹ CNNG Articles of Grouping, Article 8. The responsibilities of the management council include to coordinate the relationships among member companies in order to achieve synergy, to reflect the advice of member companies to the State Council, to research the domestic and international market trends and explore the international market, to approve the group's strategic plans, to approve and amend the group's governance rules, and to approve the group's annual reports and financial statements.

This group governance structure is reminiscent of the Presidents Councils in Japanese *keiretsu*. While some commentators placed considerable weight on the Presidents Council as a corporate governance institution, it is more likely that they were used mainly as an information sharing device, and to make decisions on non-core business issues in areas such as public relations. We do not have enough information about these intra-group governance mechanisms, which are fairly widespread, to know how important a role they play in practice.

2. *China Datang Group*

China Datang Group is a Fortune Global 500 company, and one of the five largest power generation companies in China. Figure 6 shows the ownership structure of the group, which is comprised of 143 companies. We have chosen this group because it is typical of national champion groups and nicely illustrates the networked hierarchy common in major Chinese SOEs today. Note the layered structure, with a core holding company at the top and layers of subsidiaries directly and indirectly controlled by the holding company below. Also note the top-down nature of the ownership structure, with a nearly complete absence of cross shareholding among group member companies. The group includes three publicly listed companies, all controlled by the holding company. These include Datang International Power Generation Corporation (publicly traded company # 1 in the Figure), whose shares are listed on the Hong Kong Stock Exchange and the London Stock Exchange. Another key member is the finance company, also controlled by the core company, with some shares held by the publicly listed companies.

But China Datang Group is not an island unto itself. As Figure 6 shows, the group has extensive linkages to companies outside the group: 84 non-member companies have equity relations with group members. These networks are highly strategic, comprised of firms

operating in related or complementary industries. For example, the group has equity joint ventures with the other major power generation companies in China, including Guodian Group, Huadian Group, and Hauneng Group.⁷⁰ Another joint venture is with Three Gorges Group, which is also active in power generation. Thus, the largest power generation companies not only share a common controlling shareholder in SASAC, but also have joint ownership of a number of companies. Although the parallel is far from perfect, in some ways, the Chinese national group structure resembles the Korean *chaebol* structure on a meta-level. That is, while individual corporate groups in China are vertically integrated along the production line and lack cross shareholding among member firms, the groups under SASAC supervision, taken as a whole, resemble a giant diversified conglomerate under a single controlling shareholder with extensive cross-ownership and other forms of collaboration among members.

[Insert Figure 6 here]

IV. The Party-State as Controlling Shareholder

Atop the national groups is SASAC, ostensibly “the world’s largest controlling shareholder.”⁷¹ Controlling shareholder regimes are prevalent throughout the world, and in this sense, China’s variety of capitalism shares an important trait with corporate capitalism in many other developing and recently developed countries, including for example Brazil, India, and Korea. Although in other countries, the controlling shareholder is typically the founding heir or members of his family, as one scholar has recently argued, “it is easy to overstate the extent to

⁷⁰ In 2002, the Chinese government reorganized the national power industry. National Power Corporation, which controlled half the power generators and all of the power grids in China, was dissolved and its assets divided into eleven business groups under SASAC supervision. Datang is one of the power generation companies created in the reorganization.

⁷¹ See supra note 5.

which the interests of the government as a controlling shareholder differ from those of private controlling shareholders.”⁷²

Macro-level generalizations and comparisons with other controlling shareholder regimes, however, are likely to mislead, because several aspects of China’s regime make it highly distinctive. For one, it is uniquely encompassing in scope. In no other developed or developing country is a single shareholder – private or public – so pervasively invested in the leading firms in the national economy.⁷³ More importantly, as we explain below, it is misleading to attribute to SASAC the same bundle of control rights associated with controlling shareholders in other regimes.

A. SASAC as Controller

The complex nature of SASAC’s control rights in the national champions cannot be understood without at least a thumbnail sketch of its origins. The national SOEs were carved out of central government ministries in the “corporatization” process, which transformed governmental organs into joint stock companies. Initially, control shares in the SOEs were held by the ministries from which they had been created, with predictably negative results.⁷⁴ In 1988, the State Council established the Bureau of State Assets Management, an agency supervised by the Ministry of Finance. Despite its name, the bureau did not actually centralize management rights over the SOEs; in reality, control remained dispersed among a range of ministries with jurisdiction over separate corporate activities such as investment and trade, as well the Communist Party, which was involved in labor and wage issues.⁷⁵ The bureau was eventually

⁷² Pargendler, *supra* note 12, at 5.

⁷³ A majority stake in virtually every leading firm in a critical industry in China, from telecom to energy, autos to steel, is held directly or indirectly by SASAC. Compare France, another country with extensive state involvement in the economy. See Jason Dean et al., China’s ‘State Capitalism’ Sparks a Global Backlash, *Wall St. Journal*, Nov. 16, 2010 (reporting that as of 2008, total assets of state enterprises in China were \$6 trillion (133% the size of the Chinese economy) versus \$686 billion (28%) for France). SOEs under SASAC supervision account for 62% of GDP. See *supra* note 11.

absorbed by the Ministry of Finance, effectively abolishing it, and control rights remained dispersed.

SASAC, established under the State Council in 2003, represents a second attempt to consolidate control rights over the national SOEs. But SASAC is a work in progress, and the legacy of shared control rights was not overcome by its mere establishment. This is particularly true given its location in the government organizational chart: although SASAC is a ministerial level agency, so are fifty-three of the most important SOEs under its supervision.⁷⁶ SASAC faces potential resistance not only from the firms it supervises but from the competing agendas being pursued by other important ministries such as the Ministry of Finance.⁷⁷ As one commentator notes, “In practice, SASAC has faced an uphill struggle to establish its authority over the SOEs that it supposedly controls as a representative of the state owner.”⁷⁸

Until recently, there was no overarching legal authority governing SASAC in its role as controlling shareholder. In 2008 – tellingly, after an arduous process of interest group balancing which began in 1993⁷⁹ – a Law of the PRC on State-Owned Assets of Enterprises (SOE Asset Law) was enacted to “safeguard[] the basic economic system of China..., giving full play to the

⁷⁴ For example, lack of central coordination mechanisms, weak oversight, and conflicts between the ministry’s role as regulator and economic actor.

⁷⁵ For example, capital management issues were supervised by the Ministry of Finance, investment projects were overseen by the National Planning Committee, ordinary business operations were supervised by the National Economic and Trade Commission, and labor and wage issues were handled by the Ministry of Labor. Authority over top managerial appointments at roughly 200 large national enterprises was lodged with two committees of the Party – one with appointment power over the largest enterprises, the other of which assumed appointment power for a number of ministries that were abolished in the late 1990s.

⁷⁶ Some argued that, consistent with ownership of state assets by “the people,” the National People’s Congress rather than the State Council was the proper entity to hold the SOEs. Carl E. Walter & Fraser J.T. Howie, *Red Capitalism: The Fragile Foundation of China’s Extraordinary Rise* 167 (2011).

⁷⁷ See Barry Naughton, *SASAC and Rising Corporate Power in China*, *China Leadership Monitor* No. 24.

⁷⁸ Mikael Martin, *Whose Money? The Tug-of-War over Chinese State Enterprise Profits*, FIIA Briefing Paper No. 79 (April 2011).

⁷⁹ A working group was established in 1993 to draft the law. One law professor we interviewed stated that he resigned from the working group when it became clear that the SOE Law would not be consistent with market-oriented principles of corporate governance or with the Corporate Law.

leading role of the State-owned economy in the national economy.”⁸⁰ In essence, the law formally recognizes SASAC as an *investor* – a shareholder in the national SOEs, with the ordinary rights and duties of a shareholder. Ostensibly, the law confines SASAC to this role⁸¹ and governs the agency’s performance of its functions as an investor.⁸² But there are no formal mechanisms in the law to enforce SASAC’s responsibilities, and in reality, the law grants SASAC powers *greater* than those available to it as a shareholder under China’s Corporate Law.

In short, SASAC has both less and more power as a controlling shareholder than meets the eye.

1. Control Rights in Management: As with controlling shareholders everywhere, one of SASAC’s main powers with respect to the national champions is the selection and compensation of top managers. But SASAC exercises this power in the shadow of Party control. As just noted, various party organs held appointment power in the central SOEs prior to the establishment of SASAC, and this practice was retained even after its establishment. “Political qualities,” including party membership, are one of the major criteria against which managerial performance in the national champions is evaluated.⁸³

There are two parallel personnel systems in all Chinese SOEs: the regular corporate management system and the party system.⁸⁴ In the corporate management system, positions are similar to those commonly found in firms elsewhere, such as CEO, vice CEO, chief accountant, and if the company has a board of directors, a chairman and independent board members. A

⁸⁰ SOE Asset Law, Art. 1.

⁸¹ SOE Asset Law, Arts 11-14.

⁸² See e.g., SOE Asset Law, Art. 69 provides for unspecified disciplinary measures against SASAC staff who neglect their duties as investor. Art. 70 subjects a shareholder representative appointed by SASAC to personal liability for loss caused by failure to carry out SASAC’s instructions.

⁸³ Measures Concerning the Integrated Evaluation of the Top Management Teams and Managers of the Central Enterprises (Provisional), CPC Organization Dept. Doc. No. 17 (2009).

⁸⁴ On the party personnel system generally, see John P. Burns, Strengthening Central CCP Control of Leadership Selection: The 1990 Nomenklatura, 138 China Q. 458 (2004); Hon Chen, Cadre Personnel Management in China: The Nomenklatura System 1990-1998, 179 China Q. 703 (2004). See also Howson, *supra* note 18.

leadership team in the party system includes the Secretary of the Party Committee, several Deputy Secretaries, and a Secretary of the Discipline Inspection Commission (an anti-corruption office), along with other members of the Party Committee. Institutionalizing party penetration of corporate roles is formal policy, and overlaps between the two systems appear rather uniform, such that a corporate manager of a given rank typically holds a position of equivalent rank in the party system.⁸⁵

Party and corporate leadership appointments take place in a highly institutionalized sharing arrangement between the Party and SASAC. The top positions in fifty-three central enterprises, including board chairmen, CEOs, and Party Secretaries, are appointed and evaluated by the Organization Department of the CPC. This is a legacy of appointments practice prior to the establishment of SASAC. Some of these positions hold ministerial rank equivalent to provincial governors and members of the State Council; others hold vice-ministerial rank. Deputy positions in these enterprises are appointed by the Party Building Bureau of SASAC (the Party's organization department within SASAC). A separate division of SASAC, the First Bureau for the Administration of Corporate Executives, assists in this appointment process. Appointments and evaluations of top executives in the remaining central enterprises are made by yet another division of SASAC, the Second Bureau for the Administration of Corporate Executives. While appointments power formally resides with SASAC, appointments decisions

⁸⁵ In 2004, the Organization Department of the Chinese Communist Party and the Party Committee of SASAC released Opinions Concerning Strengthening and Improving the Party Construction Work in the Central Enterprises. A key principle of the Opinions is the policy of "bilateral entries and cross appointments." Bilateral entries means that members of the Party Committee can serve on the board of directors, the supervisory board and the top management team, while board members and top managers who are party members can enter the Party Committee. Cross-appointments means if the company has a board of directors, the Secretary of the Party Committee and the board chair can be assumed to be the same person. If the company does not have a board of directors, then the Secretary of the Party Committee can be assumed to be the CEO, and the vice CEO can be assumed to be the Deputy Secretary of the Party Committee.

are made with inputs from various party organs and ministries supervising relevant business operations, and are subject to approval by the State Council.

The appointments and evaluation process for top managers of the national SOEs is supported in two ways: ministry recommendations and Party leadership training. The Party's Organization Department and SASAC compensate for information asymmetries about talent and suitability of individual SOE managers by obtaining input from the ministries that supervise the industry in which a national SOE operates. Moreover, SOE managers are trained in the Party school system, which serves as a think tank and mid-career training center for cadres. The Central Party School in Beijing, the most important and prestigious of these schools, offers specialized training classes for SOE managers.⁸⁶ While little information is available about the content of this training, the Party school system would appear to provide an excellent opportunity for Party leadership to evaluate the intelligence, skills, and commitment of those who pass through its programs.

Note that the standard corporate mechanism for the appointment and evaluation of senior executives – the board of directors – is missing entirely from this process. Indeed, only thirty-five of the core companies of the national business groups even have boards of directors as of this writing. Although SASAC and the Party have begun taking steps to bring boards of directors into the appointments process and to create boards for those core companies which do not yet have them, the steps taken thus far leave little doubt that the Party does not intend to relinquish appointment authority with respect to the most important enterprises and the highest level appointments.⁸⁷

⁸⁶ See David Shambaugh, *Training China's Political Elite: The Party School System*, 196 *China Q.* 827, 837 (2008).

⁸⁷ In 2008, SASAC and the Organization Department of the Communist Party promulgated *Guidance Opinions on Top Manager Appointments by the Board of Directors of Central Enterprises*. These Opinions for the first time gave some appointment power to boards. However, the CEOs of the top 53 central enterprises are not covered by the

In order to understand how the party-state manages executives in the national champions, we hand collected data on appointments and removals of “leaders” of the enterprises under SASAC supervision from 2003-2009. The term “leaders” is used by SASAC to refer to holders of top positions in both corporations and the Party. These data include a limited number of high-level corporate appointments for which SASAC runs a public recruitment process.⁸⁸

[Insert Table 2 here]

Table 2 shows that from one-third to three-quarters of the national SOEs experienced at least one appointment or removal of a leader by SASAC in the covered years. SASAC does not explain why the number of appointments systematically exceeds the number of removals. But the most likely explanations are that (1) some appointments are actually reappointments of incumbents without any corresponding removal, and (2) some enterprises established a board of directors during the covered period, creating new positions for appointment.

SASAC also rotates senior corporate and party leaders among business groups. Table 3 shows that rotations are fairly common. Our analysis of the data suggests that most of the corporate rotations reflected in the table are of directors or vice CEOs, and the party rotations are for positions below Secretary of the Party Committee. However, from time to time SASAC has rotated top executives in key industries. For example, in April 2011, SASAC rotated CEOs of

Opinion. Even with respect to other enterprises, the nomination committee of the board is required to “fully consult” with the Party Committee and SASAC before nominating a CEO. The preliminary appointment must be filed with SASAC before the appointment becomes final.

⁸⁸ Since 2003, SASAC has publicly solicited applications for some top corporate leadership positions. From 2003 to 2008, this process resulted in the appointment of 8 CEOs, 54 vice CEOs, 50 chief accountants and 26 chief legal counsels. Although the recruitment process is open to the public and attracts large numbers of applications, perhaps unsurprisingly, the process often (in about 40% of the cases) results in the appointment of an existing employee at the firm, and in most of the remaining cases, the appointment of an employee of another firm under SASAC supervision. Finer grained data from this process provide some insight into the type of manager viewed as attractive by SASAC. The average age of the 115 managers appointed through the open recruitment process is 41. Almost 90% of those appointed are members of the Party. The majority have graduate-level education, and over half of those appointed as CEO or vice CEO are trained as engineers. Data collected from recruiting advertisements and decisions posted on SASAC’s website.

the three central petroleum enterprises, each of which is a Fortune 500 Company.⁸⁹ SASAC made similar rotations among top executives in the energy sector in 2008 and telecom in 2007 and 2004. Such rotations obviously ignore the separate identity of the corporate groups and flout standard corporate law concepts. But the practice is less jarring conceptually if, as we argued above, all the national SOEs are viewed as one diversified meta-group under common (if somewhat attenuated) control of SASAC. Our interviews suggest that the rotations are viewed, or at least explained, by Chinese actors within the system as a monitoring device in groups without boards of directors. Rotations are said to reduce concentration of authority in a single individual in firms where institutionalized corporate oversight organs have yet to be developed.

As Table 3 shows, leaders are also rotated across the spheres of business, government, and the Party. These data, together with the data on appointment of business leaders to various government and party positions presented in Part III, are another powerful illustration of institutional bridging at work in China's system of state capitalism.

[Insert Table 3 here]

Unfortunately, available data on appointments/removals and rotations do not allow us to make more fine-grained assessments about a number of important issues such as the specific enterprises involved, the reasons for removals (e.g. firings versus promotions), and distinctions between corporate and party personnel management. But taken as a whole, the available data suggest, contrary to some assertions,⁹⁰ that SASAC exercises fairly extensive control rights over top managers in the central SOEs (or at least is the mechanism through which the Party exercises such control rights), albeit in ways that pay little obeisance to ordinary corporate law norms.

⁸⁹ China National Petroleum Corporation (CNPC), China Petrochemical Corporation (Sinopec) and China National Offshore Oil Corporation (CNOOC).

⁹⁰ See, e.g., Walter & Howie, *supra* note 75, at 167-71 (arguing that SASAC is weak and akin to a department of compliance vis-à-vis the enterprises it ostensibly supervises).

Concomitant to its appointment power, SASAC also supervises executive compensation at the central SOEs. Prior to SASAC's establishment, managerial compensation was determined by the SOEs themselves, which led to a series of problems as well as major inequalities in pay across firms. In 2004, SASAC introduced a system to supervise compensation at the central enterprises. Under this system, the basic structure of managerial compensation consists of base salary, performance bonuses, and mid- to long-term incentive compensation.⁹¹ Again, note that the standard corporate law organ for determining executive compensation – the board, or perhaps the board in cooperation with the shareholders – is bypassed by this process. Indeed, there is evidence that the compensation paid to executives of listed national champions which has been approved by the board and disclosed to shareholders is something of a fiction – the actual compensation received by the executive is the one set by SASAC.⁹²

Comprehensive data on executive compensation in China are difficult to obtain, but the broad contours of pay practices can be gleaned from existing data. The highest paid executive in 2007 was the chairman of China Mobile Group, at 1.3 million RMB (about \$182,000). The average compensation for the CEOs of the central enterprises supervised by SASAC in 2009 was 600,000 RMB (about \$88,000).⁹³ While these salaries are obviously very low on an international scale, they must be understood in context. The figures do not include a host of perquisites and privileges enjoyed by corporate executives and their families, such as free or nominal charges for

⁹¹ SASAC employs complex personnel evaluation systems in order to determine managerial compensation and appointments/removals. Top managers enter into binding annual performance agreements with SASAC specifying evaluation criteria and benchmarks, and applicable rewards and punishments. Annual performance scores are transformed into letter grades from A to E, and bonuses are determined according to these grades.

⁹² Both news reports and our own interviews suggest that at the time of listing shares on the Hong Kong and New York Stock Exchanges in 2001, the executives of CNOOC, Inc., the major subsidiary of national champion oil company CNOOC, reached an internal agreement whereby they would “donate” the compensation approved by the board to the parent company (the core company in the group). Thus, the compensation approved and reported in compliance with corporate and securities law norms is not actually received by the executives. Actual compensation is determined outside the corporate law process by SASAC. Our preliminary research suggests that this practice is common.

⁹³ About one-third was base pay and two-thirds was performance-based. Speech by Chairman of SASAC at Peking University Business School, Jan. 9, 2010.

housing, education, and medical care. Side payments for nominal additional service provided to the firm by top managers are also commonplace. And in contemporary Chinese society, leadership positions in any sphere attract other remunerative opportunities, a reality succinctly summarized by the phrase “money for power,” which we heard often in our interviews.

2. *Control Rights in State Enterprise Assets:* SASAC’s central mission is to preserve and increase the value of state assets while transforming SOEs into public companies. Since its establishment, SASAC has pursued a policy of building several large enterprises in each key industry. In recent years, SASAC has consolidated smaller and weaker SOEs into larger business groups. In the process, the number of SOEs under SASAC supervision has declined to 121 in 2010, from 198 in 2003. SASAC’s goal is to bring the number under one hundred. Simultaneously, as the Fortune 500 list attests, SASAC has successfully pursued a goal of building globally competitive conglomerates.

This central mission makes SASAC a gatekeeper with respect to transfers of state enterprise assets. With passage of the SOE Asset Law, SASAC now has solid legal backing for this role. Under the SOE Asset Law, share transfers involving national SOEs require SASAC’s approval, even with respect to transactions over which it does not have veto power as a shareholder under the Company Law.⁹⁴ Some Chinese courts have upheld SASAC’s superior control rights under the SOE Asset Law, holding that contracts for transfer of shares entered into without SASAC’s approval are unenforceable or invalid, even where they are consistent with the Company Law.⁹⁵ SASAC has super-control rights in the transfer of state-owned enterprises.

⁹⁴ For example, SASAC’s approval is required to transfer shares of a subsidiary of a company under its direct control. Under corporate law principles, only the board of directors of the company directly under its control has authority to approve such a transaction.

⁹⁵ See e.g., *Zhang Buo v. Beijing Jing Gong Garments Group Co.Ltd.*, Civil Case No. [2985] (Beijing Intermediate People’s Court, May 20, 2009); *Hunan Zheqin Group Co. Ltd. v. Chendu Yinghua Investment Co. Ltd.*, Civil Case No. [6] (Huaihua City Intermediate Court People’s Court, May 27, 2009).

3. *Cash Flow Rights*: As a large amount of corporate governance literature attests, the separation of cash flow rights from control rights is a central problem in controlling shareholder regimes. Where a shareholder's control rights exceed its rights to cash flows, the agency problem between the controller and minority shareholders is magnified, with the scale of the problem growing as the wedge increases. As Ronald Gilson puts it, "conditional on maintaining control, the less equity a controller has, the greater the incentive to extract private benefits of control [benefits to the controller not provided to the minority shareholders]; increased productivity accrues to shareholders in proportion to their equity, while private benefits of control are allocated based on governance power."⁹⁶

In controlling shareholder regimes outside the SOE context, the separation of control rights from cash flow rights, and the ensuing potential to extract private benefits, arises because controllers are able to magnify equity's voting power through pyramiding and circular stock ownership arrangements among corporations in the group. In the SOE context, regulators and politicians acting as "owners" on behalf of the state may reap private benefits of control not shared with ordinary financial investors, in the form of political influence, opportunities for patronage or corruption, and national prestige. These types of pecuniary and nonpecuniary private benefits of control over the national champions are clearly available to the Chinese party-state managerial elite, and SASAC is a major vehicle through which such control is exercised. Beyond its role as a vehicle for party-state governance of the central SOE sector, the organizational incentives of SASAC as the formal "owner" of the national SOEs are affected by a peculiar historical circumstance: its control rights exceed its right to cash flows because until

⁹⁶ Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 Harv. L. Rev. 1642, 1651 (2006).

recently, the state collected no dividends from wholly state-owned enterprises.⁹⁷ This decision was reversed in 2007, with the wholly owned subsidiaries of SASAC now paying dividends to the state, but still at rates below those of the publicly traded SOEs. Moreover, SASAC receives only a portion of the dividends collected by the state, which it uses for asset acquisitions, restructurings, and emergency support for failing enterprises.⁹⁸ Thus, SASAC does not fully internalize the financial consequences of its control rights over the national champion groups, and it cross-subsidizes the firms under its supervision with the cash flow rights that it does hold.

These realities suggest that the central SOE sector collectively, rather than individual firms, are of greatest concern to SASAC in carrying out its governance responsibilities, and they may account for several outwardly puzzling aspects of national champion governance in China. For example, the practice of rotating top management among firms in the same industry makes a good deal of sense if maximizing shareholder wealth at individual firms is less important to the controlling shareholder than building up a number of globally competitive firms in critical industries. Another example is SASAC's heavy emphasis on the "corporate social responsibility" (CSR) of the enterprises under its supervision.⁹⁹ CSR is a theme typically trumpeted by non-shareholder corporate constituencies or NGOs, not large investors. But the CSR campaign by SASAC might be a means of building support for state capitalism domestically, improving its image abroad, and justifying management of the SOEs in ways that are not explicable solely from the standpoint of profitability and efficiency.

⁹⁷ Publicly listed subsidiaries paid dividends to their parent (core) companies, but the core companies paid no dividends to the state.

⁹⁸ See Barry Naughton, *SASAC and Rising Corporate Power in China*, China Leadership Monitor No. 14, available at <http://www.chinaleadershipmonitor.org/20052/bn.pdf>.

⁹⁹ Li-Wen Lin, *Corporate Social Responsibility in China: Window Dressing or Structural Change?*, 28 Berkeley J. Int'l L. 64 (2010); Li-Wen Lin, *Legal Transplants through Private Contracting: Codes of Vendor Conduct in Global Supply Chains as an Example*, 57 Am. J. Comp. L. 711 (2009); Li-Wen Lin, *Corporate Social Accountability Standards in the Global Supply Chain: Resistance, Reconsideration, and Resolution in China*, 15 Cardozo J. Int'l & Comp L. 321 (2007).

B. Consequences

SASAC is not only the largest controlling shareholder in the world, it is also quite possibly the most idiosyncratic. Deconstructing SASAC's control rights in the firms it ostensibly owns reveals that it is simultaneously weaker and more powerful than a typical controlling shareholder in other regimes. It is weaker, because it lacks appointments power with respect to top management of the most important enterprises, and defers to other agencies – and even to the SOEs themselves – on substantive issues outside its realm of expertise. It is more powerful, due to the vast scope of its holdings over the most important firms in the national economy, and as a result of its super-control rights in state enterprise assets, which trump standard corporate law norms. Even beyond this disjuncture in its formal status and powers, SASAC is unique as the focal point for state capitalism in a rapidly rising economic superpower. SASAC appears, by design, to be yet another institutional bridge in the networked hierarchy – a high-level link between the national SOEs and other major components of the party-state. To be sure, many questions remain about SASAC's internal operations, relationships with the firms it ostensibly controls, and its oversight by party and governmental organs.¹⁰⁰

One major consequence of this arrangement is clear, even if all of its implications are not: the national champions represent much more than a purely financial investment for the party-state. SASAC, as the organizational manifestation of the party-state in its role as controlling shareholder, seeks to maximize a range of benefits extending from state revenues to technological prowess, and from soft power abroad to regime survival at home. As one of us recently put it in a separate co-authored work, in state capitalism, “the government attempts to ensure that company-level behavior results in country-level maximization of economic, social,

¹⁰⁰ We attempted to learn the number of people employed by SASAC as a very rough measure of the scope of its work, but we were told by SASAC's public information office that the data are “confidential.”

and political benefits.”¹⁰¹ Of course, the “country’s” interests are defined by and consistent with the interests of the managerial elite who play key roles in the operation and evolution of the system.

V. Implications and Questions

A. Implications for Comparative Corporate Governance Scholarship

The last decade of comparative corporate governance scholarship has been dominated by two big, related questions: whether and how law influences corporate ownership structures around the world, and whether global systems of corporate governance are converging, particularly on a shareholder-centered, market-oriented model. In these debates, particularly the seminal works that set the terms of the inquiry, China is conspicuous by its absence, raising something of a “China Problem” for both bodies of literature.

1. Law and Finance: The by-now familiar “law and finance” literature asserts that the quality of legal protections for investors determines the degree to which share ownership in a given country is dispersed. “Bad” law which protects investors poorly leads to concentration of corporate ownership; “good” law results in dispersed ownership. Legal systems of common law “origin” appear to systematically provide superior protections than systems of civil law origin, explaining pronounced differences in ownership structures around the world.¹⁰²

Critiques of this literature are legion, and we simply note that China’s experience, like that of many other countries, seems consistent with the hypothesis on a surface level but far less so upon careful examination.¹⁰³ Rather than asking whether China’s experience supports the

¹⁰¹ Gilson & Milhaupt, *supra* note 22, at 1346.

¹⁰² See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishney, *Law and Finance*, 106 *J. Pol. Econ.* 1113 (1998).

¹⁰³ At first blush, China’s experience comfortably fits the hypothesis. China’s legal system, ostensibly of civil law origin, is weak in the formal protections it provides to investors. The stock market is underdeveloped, corporate

predictions of the law and finance literature, we use the big questions in that body of work to motivate inquiries about the role of law and legalism in the growth of large, globally active Chinese firms, and at least by plausible extension, the development of the Chinese economy.

The law and finance literature emphasizes the sticky effects of a country's "legal origin" on the structure of firms. Putting aside the thorny question of how to properly code legal families that bedevils attempts to support this assertion empirically, let's consider whether the approach of Chinese economic strategists in building national champions has been heavily influenced (or bounded) by a particular tradition of legalism inherited from the civil law system. The Chinese approach certainly shares with the French civil law tradition a high degree of comfort with state involvement in the economy and regulatory paternalism. Moreover, contrary to the distrust of bigness that has animated U.S. corporate law, governance and institutional design over the course of the past century, bigness has not only been tolerated but celebrated in the Chinese economic reform period. Generalizing to a high degree, it is thus possible to say that China's approach to corporate law and governance resonates with attitudes prevalent in the civil law tradition.

But ending with this generalization would not capture the full story of how the legal order has influenced China's approach to corporate governance. Chinese institutional designers have been highly eclectic in the foreign models they have used in building the state sector. In early phases, consistent with the sentiments just discussed, Japanese and Korean corporate groupism

ownership structures are highly concentrated, and the economy is populated by corporate groups. But as our paper has shown, large elements of the structure of contemporary Chinese corporate capitalism are products of conscious policy design, or at least governmentally structured experimentation. Corporate groupism may have partially been a response to institutional voids in the early reform period, but production concerns and the desire to transmit industrial policy played major roles in motivating the assembly of business groups. Where the state chose to use corporate law and other legal concepts such as contract-based alliances and business group registration in assembling its firms, it had the required capacity. Thus, it is hard to identify specific corporate law defects, let alone any negative effects that could be generally attributed to China's civil law "origin," that promoted formation of corporate groups under the control of the party-state.

and its institutional accouterments held a high degree of attraction. More recently, the rights-based, shareholder-oriented approach of the U.S., with its emphasis (if less than perfect track record) on accountability and transparency has held sway on the drafters of Chinese corporate law, policy makers, and regulators. SASAC's rather schizophrenic role in national champion governance may result from the amalgam of these two sentiments—the quest for size and state control alongside an emphasis on independent accountability mechanisms and at least outward adherence to global corporate governance standards. Importantly, the absence of a firmly developed and entrenched legal order in reform-era China may have freed the hands of economic strategists to select forms of organization that were believed to best promote Chinese corporate development at a given moment in time.

The law and finance literature also raises the important question of precisely *what* matters in corporate law—which of its features are key to the growth of firms? For the authors of this literature, of course, the answer is legally enforceable investor protections. The law and finance literature emphasizes investor protections because capital is scarce, so that governance rights should be allocated to attract investment. But China's experience (along with those of Korea and Japan during their formative periods of development) suggests that where capital is available, at least to firms favored by the state, investor protections are not a first order priority.¹⁰⁴ Yet China's experience simultaneously appears to confirm the importance of the corporate *form* to firm growth and perhaps by extension, economic development. We have seen how central the corporatization process has been to the hydraulics of industrial organization in China's state sector: separating the regulatory from the operational aspects of enterprise in the corporatization process was a crucial first step in the development of a functional SOE sector. We have also

¹⁰⁴ External constraints, such as competitive product markets, may also be a necessary condition for the success of this model.

seen how important the rearrangement of assets within, and creation of linkages among, corporate entities has been to the formation of industries deemed critical by the party-state. Unlike the early contractual business alliances, the corporate form has proven to be an extraordinarily useful device for the transmission of information and control. Indeed, the utility of the corporate form in providing an enduring, highly adaptable, and anonymous vehicle for investment and economic activity has been recognized by Chinese economic strategists. Throughout the reform period, they have selectively chosen from among the menu of corporate attributes, making extensive use of the corporation's hierarchical governance structure and separate legal existence in building networks of firms responsive to direction from the party-state, while largely sidelining its collegial decisionmaking and oversight organ, the board of directors, and downplaying shareholder rights enforcement mechanisms. China's state capitalism is thus powerful confirmation of the genius of the corporate *form* as a vehicle for promoting investment and productive enterprise. Corporate *law*, however, in the narrow sense of an effective menu of readily enforceable legal protections for investors, has played little role in the emergence of globally active Chinese firms.

Indirectly, the law and finance literature raises an existential question about the linkage between corporate ownership structures and economic growth. The unstated assumption in the literature is that such a linkage does exist, and that dispersed ownership structures produce better economic outcomes than concentrated ones. Yet business groups, the form of corporate structure prevalent in “bad” law jurisdictions around the world,¹⁰⁵ have been the engine of development in countries pursuing a diverse range of economic strategies over the past half century. These countries now prominently include China, pursuing a strategy of state capitalism. Thus, while

¹⁰⁵ And some “good” law jurisdictions as well. See Ronald J. Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harv. L. Rev. 1641 (2006).

the genius of the corporate form is present in all economic miracles, “good” corporate law is not an essential contributor to its genius; and dispersed corporate ownership is not a necessary condition for transformative economic development.¹⁰⁶ In this respect, China’s recent history confirms the lessons provided by the experience of the United States in the late nineteenth and early twentieth centuries.

2. *Convergence*: Law and finance scholarship added fuel to the convergence debate, which considers whether corporate governance systems around the world are converging on a single shareholder-centered, market-oriented model. In the decade since the debate flowered and then promptly reached a theoretical stalemate,¹⁰⁷ China has emerged as one of the world’s major economic powers. With the benefit of hindsight, the turn-of-the-century convergence debate now seems rather quaint. Scholars never seriously considered the possibility that domestic political legitimacy and international influence could be a major goal of a corporate governance regime.¹⁰⁸ The concept of “nonpecuniary private benefits of control” was developed to help explain the persistence of controlling shareholder regimes, but this concept was used to describe social standing and influence of private founding entrepreneurs within the domestic political economy.¹⁰⁹ State capitalism as practiced in China blurs the distinction between pecuniary and nonpecuniary benefits of corporate control, and highlights major international soft power

¹⁰⁶ A “law first” approach to investment and development might be preferable on the grounds of predictability, transparency, and accountability. But it may simply be too time consuming – and thus politically impossible -- for countries at early stages of development to pursue this approach. An authoritarian state, and developing democracies displaying imaginative pragmatism in institutional design, can credibly commit to development and encourage investment without resort to frictionless legal enforcement. See Gilson & Milhaupt, *supra* note __.

¹⁰⁷ The stalemate is between path dependence theories predicting persistence of national institutions which protect vested interests versus market imperative theories predicting global internalization of shareholder wealth maximization norms.

¹⁰⁸ The only literature of which we are aware that even begins to grapple with this dimension of the issue is Jeffrey N. Gordon, *The International Relations Wedge in the Corporate Convergence Debate*, in *Convergence and Persistence in Corporate Governance* 161 (Jeffrey N. Gordon & Mark J. Roe eds, 2004). (considering Germany’s interest in promoting integration of the EU when privatizing Deutsche Telecom).

¹⁰⁹ See Gilson, *supra* note 95.

ramifications of corporate governance structures, at least in a world where “state capitalism” is posing challenges to “market capitalism.”

We noted at the outset that Chinese corporate governance is often defined by what it lacks in comparison to other systems, and hopefully the previous sections of the article have made some headway in understanding its features other than by reference to negative space. In regard to the convergence debate, however, it bears emphasizing that, regardless of where the Chinese system may be headed, it presently does not fit neatly into any of the standard taxonomies.¹¹⁰ Chinese corporate governance for the national champions is not bank-based or stock-market based. It is not shareholder-oriented or stakeholder-oriented, unless the concept of a corporate “stakeholder” is stretched to include the ruling political party and the government in its policy making, regulatory, and enforcement capacities. Nor is it a liberal market economy (LME) or a coordinated market economy (CME) per the “varieties of capitalism” literature.¹¹¹ None of these taxonomies provides much analytical leverage on a system of national champion capitalism in which a party-state is residual claimant, controlling shareholder, financier, and chief engineer of an Olsonian encompassing coalition that ties the economic and political fortunes of a vast array of actors to national economic growth.

Of course, each country’s governance structures are unique. The point is that the map used by comparative corporate governance scholars in recent decades to understand the world

¹¹⁰ The following comment from over a decade ago, by observers focused on the same aspects of the Chinese system that we have addressed, is prescient: “Neither the term ‘developmental state’ nor ‘entrepreneurial state’ is adequate to capture the complex web of interests that now connect government and emerging big businesses in China. Whatever the name one chooses to give it, it is clear that a new institutional form is being born.” Peter Nolan & Wang Xiaoqiang, *Beyond Privatization: Institutional Innovation and Growth in China’s Large State-Owned Enterprises*, 27 *World Development* 169, 191 (1999).

¹¹¹ For an attempt to analyze China using the varieties of capitalism rubric, see Michael A. Witt, *China: What Variety of Capitalism*, INSEAD Working Paper 2010/88/EPS (2010). The utility of the varieties of capitalism framework as applied to China is questionable: the author concludes that some aspects of Chinese capitalism resemble an LME, others resemble a CME, and still others are either LME or CME depending on how broadly one defines the subject.

may lead observers of China astray, or at least cause them to overlook fertile areas for further investigation. To take an example relevant to the convergence question, most scholars have assumed that state capitalism in China is transitional, with the speed of the transition a function of state capacity and political will to make improvements in the formal institutional environment. Relatedly, many observers have emphasized the vast divergence between formal law and actual practice in Chinese corporate governance.¹¹² The gulf, some commentators imply, will close up when China becomes more “law abiding.”¹¹³

Our analysis points in a different direction. There is certainly a yawning gap between law and practice in Chinese state capitalism if one focuses on the *corporate law* and related institutions. Direct involvement of the Communist Party in high-level executive appointments, SASAC’s practice of bypassing the board of directors in the appointments and remuneration processes, and its veto power over downstream corporate transactions are all inconsistent with basic corporate law principles. (They also violate soft law norms on SOE governance promoted by international organizations such as the OECD.)¹¹⁴ But if one focuses on the regulations governing business group formation and governance, and the SOE Asset Law governing SASAC in its formal role as controlling shareholder over the national champions, the gap between law and practice in China’s SOE sector narrows substantially. The existing legal environment is actually quite complementary to the current economic system, in which the state sector is advancing over the private sector.

¹¹² Donald C. Clarke, “Nothing but Wind”? The Past and Future of Comparative Corporate Governance, 59 Am J. Comp. L. 75, 101-102 (2010) (“the reality of corporate governance in China remains very different from what appears in the statute books, and indeed is so opaque that it is difficult to measure reliably where it is, let alone to know in what direction it is moving.”); Michael A. Witt, China: What Variety of Capitalism?, INSEAD Working Paper 2010/88/EPS.

¹¹³ See Witt, *supra* note 109, at 12.

¹¹⁴ For example, the OECD Guidelines on Corporate Governance of State-Owned Enterprises (2005) provide that SOEs should not be exempt from anti-trust regulations, should face competitive conditions regarding access to finance, and should establish transparent board nomination processes and allow boards to exercise responsibilities independently, including the power to appoint and remove the CEO.

Whatever its disadvantages, and they are likely substantial, state capitalism as it has evolved in China over the past thirty years represents a form of industrial organization that produces substantial benefits to members of the encompassing coalition – the managerial elite within the party-state system. The national champions themselves are now forceful players in the Chinese political economy. We need look no further than the U.S. historical experience to see that large corporations – even ones not linked to the state – can exert tremendous influence on the design of national institutions and the nature of social relations. It is therefore quite possible that China’s formal legal institutions may “improve” in ways that reinforce the current system of industrial organization rather than prompt a transition to different forms of corporate organization. State capitalism may prove to be a durable institutional arrangement as a result of interest group politics, public policy, and path dependence.

Thus, for the convergence debate, China raises the possibility of a new, durable, and possibly influential variety of capitalism. The Chinese system has already garnered attention as a model of political intervention in the economy among countries with authoritarian political traditions, most prominently Russia.¹¹⁵ Of course, imitating the Chinese model may prove difficult for a host of reasons. But as we have shown, Chinese firms have entered the global economy through a path that bears almost no resemblance to the standard institutionalist account of how firms grow and large-scale commercial economies develop. Thus, even short of replication elsewhere, China’s variety of capitalism may prove influential to countries lacking the formal institutional foundations of growth.¹¹⁶ Quite apart from these forms of influence, it is apparent that China’s rise is a significant disruptive force in global capitalism. It has disrupted

¹¹⁵ See, e.g., Clifford Levy, In Chinese Communist Party, Russia’s Rulers See a Role Model for Governing, NY Times, Oct. 18, 2009, at 8.

¹¹⁶ See Gilson & Milhaupt, *supra* note 22.

previously settled notions about the nature of capitalism,¹¹⁷ and sparked a predictable backlash in some realms.¹¹⁸ The competitive challenges posed by an economic system in which, for the largest and most globally active firms, the *country* is the unit of maximization are profound. At a minimum, China's global economic rise, like that of Japan two decades ago, will likely encourage reconsideration of cooperative links between the state and the private sector, and refocus attention on networked varieties of corporate capitalism. In corporate governance, as in politics, the "End of History" is nowhere in sight.

B. Questions for the Future

If the current system may represent a relatively stable equilibrium as opposed to a transitional device, what forces, short of political regime change, might prove destabilizing to it? We survey some possibilities below. As the plethora of question marks suggests, the discussion is intended to identify possible pathways of change and to highlight areas for further research, not to offer predictions.

1. Legal reform? As noted, the current structure of corporate capitalism in China is a policy choice enshrined in law – to date, a highly successful one as measured against the primary goals of the regime, which include sustained economic growth, international influence, and regime survival and legitimacy. In which direction will future corporate and securities law reforms lead China's state capitalism? Our narrative at least suggests the possibility that ensuing reforms will further enhance and legitimize state control over important corporate assets rather than impel a transition to dispersed ownership structures and diminished political involvement in

¹¹⁷ For insightful commentary, see the series of articles in 7 *Org. & Management Rev.* (2010)

¹¹⁸ See, e.g., Jason Dean et al., China's 'State Capitalism' Sparks a Global Backlash, *Wall St. Journal*, Nov. 16, 2010, at 1; Ian Bremmer, *The End of the Free Market: Who Wins the War between States and Corporations?* (2010).

corporate governance.¹¹⁹ As we have shown, presently in respect of the national champion groups, there are overrides of corporate law principles at key points to ensure continued party-state control. In the future, more boards of directors may be established for the parent companies of the national champion groups, SOE boards may take on somewhat more power, and independent directors may become more prevalent. (These are reforms that have preoccupied many corporate law commentators.) But they will hardly alter the fundamental governance norms of Chinese SOEs, which are determined by the party-state in its role as controlling shareholder.

Of course, this does not mean that reforms to corporate and securities laws and the surrounding enforcement environment are of no consequence. Incremental improvements in the institutional environment for corporate governance are taking place in China, and they have the potential to improve corporate governance in the SOEs. But the most important long-term impact of legal reform may lie not in bringing a greater market orientation to the state sector, but in creating an institutional environment in which firms without access to the party-state network can raise capital and grow, ultimately diminishing the importance of the national champions in the Chinese economy.

2. *Temasek-ization of SASAC?* Another possible pathway of change is a reorientation of the party-state in its role as a controlling shareholder. The foreign economic models that China has sought to emulate have changed over time. As noted, Japan and Korea were once major role models for the construction of corporate groups under state control. Today, Singapore's state holding company Temasek is a favorite of Chinese economic strategists. Temasek, wholly

¹¹⁹ Anti-trust law and enforcement is a different matter. If the anti-trust regime were to be applied to the national champions, the present structure of state capitalism would be virtually impossible. For that very reason, it is almost inconceivable that the anti-trust law will be enforced in the state sector without a major change in the political system.

owned by Singapore's Ministry of Finance, holds major equity stakes in numerous Singapore corporations. It has a constitutional responsibility to safeguard the country's critical assets and reserves.¹²⁰ Its board of directors is appointed by the Ministry of Finance with the concurrence of the President, and is comprised of a majority of non-executive directors, uniformly consisting of business people, currently including one foreign businessman. No government officials serve on the board, although the CEO and executive director of Temasek is the wife of the Prime Minister. Publicly, Temasek claims to exercise only the rights of an investor and leaves management of its portfolio companies to their respective boards of directors. But Temasek maintains strong ties to the ruling Peoples Action Party, which has presided over the country's economic development.

A reorientation of SASAC toward the Temasek model would require a relaxation of party involvement in key managerial appointments and further devolution of control over the national champions to outside investors and independent directors. It may improve the transparency and "rule of law" quality of China's state capitalism, but it would not necessitate a fundamental alteration of the present system. Of course, this is precisely the attraction of the Singapore model to Chinese economic strategists.

3. *Great Reversal?* China's encompassing coalition has thus far agreed on financial repression. The financial system serves the interests of the national champions quite well, even if it serves private firms very poorly.¹²¹ But history shows that countries can undergo dramatic reversals in financial structure based on shifting political alignments.¹²² As Raghuram Rajan and Luigi Zingales have shown, over the twentieth century such reversals often led to repression of

¹²⁰ See Temasek Review, at www.temasekreview.com.sg/governance/governance_framework.html.

¹²¹ Franklin Allen, et al., Law, Institutions, and Finance in China and India, in *Emerging Giants: China and India in the World Economy* (Barry Eichengreen et al. eds, 2009).

¹²² Raghuram G. Rajan and Luigi Zingales, The Great Reversals: The Politics of Financial Development in the Twentieth Century, 69 *J. Fin. Econ.* 5 (2003).

the financial system, as incumbents blocked reforms that would have provided access to finance for potential competitors. But the reversals did not always go in one direction. As they point out, in Japan, the government brought the financial system under its control in wartime, to the great benefit of large Japanese banks for much of the postwar period. But the system broke down in the 1980s, as quality firms deserted the highly regulated domestic financial sector in favor of the international financial markets.

To date, relatively little attention has been paid to the Chinese financial system as it may impact corporate structures and governance. Might some managers of the national champions seek greater financial autonomy from the state-owned banks, particularly if accumulated non-performing loan problems and misallocation of capital by the banking sector lead to more arm's length lending relationships with SOEs? (This was essentially the spark for Japan's great reversal in the 1990s.) Might innovative private companies, which often list on foreign stock exchanges due to restrictions in the domestic equity market, generate pressure on Chinese regulators to liberalize the capital markets in ways that diminish the role of the banks? Alternatively, will growing equity links between nationally important SOEs and state-owned banks cement the existing coalition in favor of financial repression? Any of these potential developments in the financial sector could have profound consequences for Chinese state capitalism. Of course, history suggests that a crash or other unexpected shock may also intervene, precipitating a realignment of the coalition or triggering reforms that fundamentally change the orientation of the Chinese system of corporate finance and governance.¹²³

¹²³ This was essentially Korea's experience after the Asian financial crisis. Japan's economic problems, which started with weaknesses in the banking sector, are also potentially instructive for China. See Michael Shuman, *Is China Facing a Japanese Future?*, available at <http://www.curiouscapitalist.blogs.time.com/2011/02/14/is-china-facing-a-japanese-future/>.

4. *Dis-Integration of the national champion groups?* Recent scholarship has highlighted the way rapid technological change has led to corporate “vertical disintegration.” Where a single firm cannot maintain state-of-the-art capacity in all of the technologies required to produce advanced products, contract-based inter-firm collaboration may emerge as an alternative to vertical integration.¹²⁴ This phenomenon has interesting potential implications for the Chinese national champion groups. As currently constructed, the groups are vertically integrated, although as we have shown, through contract and ownership-based alliances, the groups appear to achieve the benefits of collaborative production.

The future structure of national champion capitalism may depend on how well the current networks of Chinese state-linked firms, including their international collaborations, promote innovation and diffusion of knowledge. Can the state sector in its present configuration generate state-of-the-art technology in all the domains required to produce globally competitive products, and to move out along the technological frontier in the face of rising domestic labor costs? Changes in inter-firm governance structures driven by global business imperatives could produce new firm-level structures and inter-firm collaborations that disrupt the current networked hierarchy and strain the bridges between business leaders and their party-state overseers. Cross-border collaborations may be particularly potent devices for change in this regard.

Conclusion

In this Article, we have tried to unpack the black box of “state capitalism” in China by exposing the mechanisms connecting the party-state to the national champions. Our focus has been on the relational ecology of industrial organization in China’s most important state-owned enterprises. Shifting the focus from agency problems in individual listed firms to networks of

¹²⁴ Ronald J. Gilson, Charles Sabel & Robert Scott, Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration, 109 Colum. L. Rev. 431 (2009).

firms enmeshed in organs of the party-state has advanced several important objectives. It has provided a richer understanding of China's state sector and the architecture supporting a central component of the state's economic development model. It has brought the corporate dimension of China's developmental experience to bear on important recent debates in scholarly literature. And it has provided new perspectives on China's future path of institutional development.

Fig. 1 National Champions as Networked Hierarchy

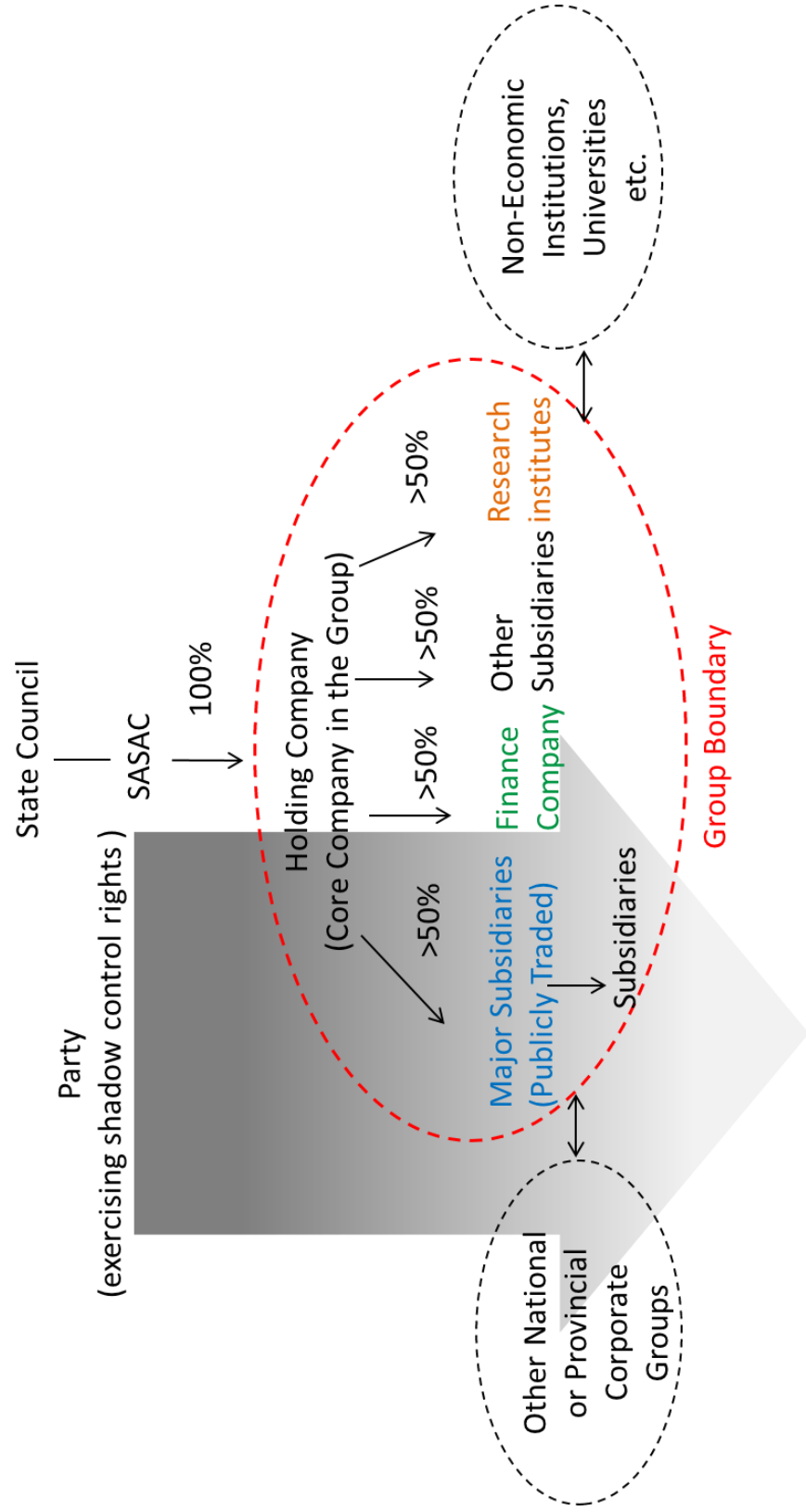


Fig. 2 Basic Structure of Registered Business Groups

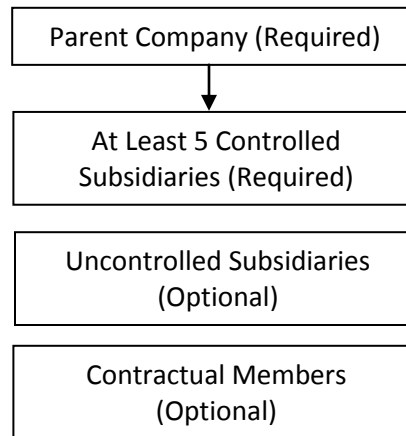
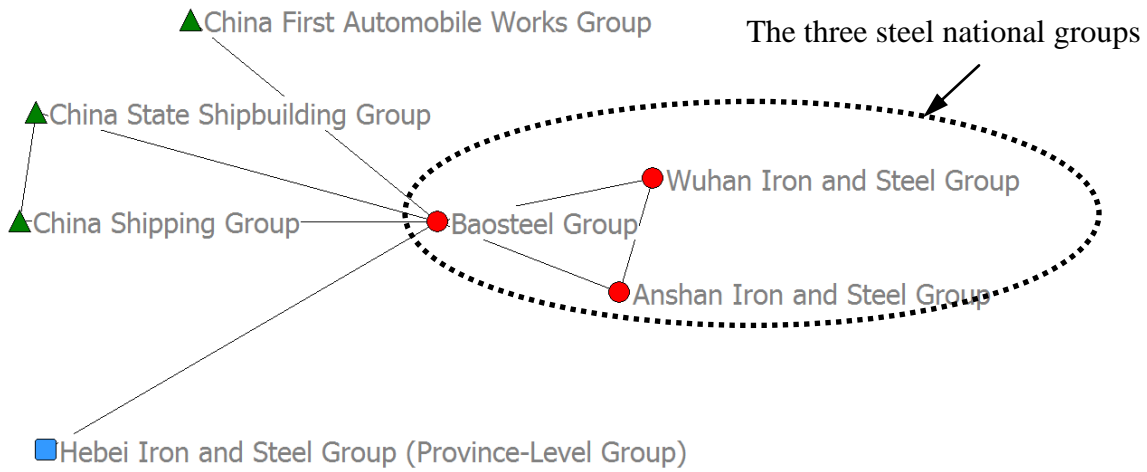


Table 1 Top 10 Finance Companies in China, by Asset Size, 2009

Rank	Company Name	Year Est.	Assets (USD billion)	Affiliated Group's Industry	Bank with Comparable Assets Size (National Rank)	Controlling Owner (State/Nonstate)
1	China Petroleum Finance Co.	1995	40.87	Oil	Beijing Rural Commercial Bank (20)	State-Controlled
2	China Power Finance Co.	2000	16.46	Electricity	Shengjing Bank (36)	State-Controlled
3	Sinopec Finance Co.	1988	8.31	Oil	Bank of Hebei (52)	State-Controlled
4	China Shipbuilding Industry Finance Co.	2001	6.85	Shipbuilding	Bank of Nanchang (57)	State-Controlled
5	SAIC Finance Co.	1994	6.43	Automobile	Bank of Qingdao (58)	State-Controlled
6	China Aerospace Science & Tech. Finance Co.	2001	4.56	Aerospace	Bank of Weifang (79)	State-Controlled
7	CNOOC Finance Co.	2002	4.44	Oil	Qishang Bank (82)	State-Controlled
8	Haier Group Finance Co.	2002	3.64	Home Appliances	Kushan Rural Commercial Bank (93)	Nonstate-Controlled
9	China Power Investment Financial Co.	2005	3.55	Electricity	Chang'An Bank (95)	State-Controlled
10	WISCO Finance Co.	1993	3.27	Steel	Bank of Jujiang (96)	State-Controlled

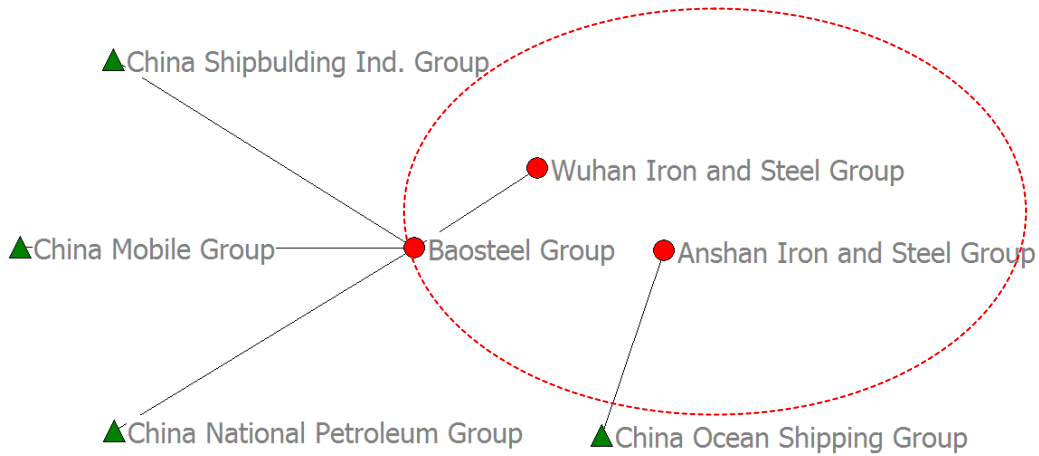
Data Source: Raw data from Almanac of Finance Companies of Chinese Business Groups (2010 Edition). The exchange ratio of RMB to USD is 6.83:1.

Fig. 3 Joint Ventures (Equity Linkages) Across Steel National Groups, 2000-2010



Note: triangle nodes indicate other national business groups supervised by SASAC.

Fig. 4 Strategic Alliances (Contractual Linkages) Across Steel National Groups, 2000-2010



Note: triangle nodes indicate other national business groups supervised by SASAC.

Fig. 5 CNNG Group Structure

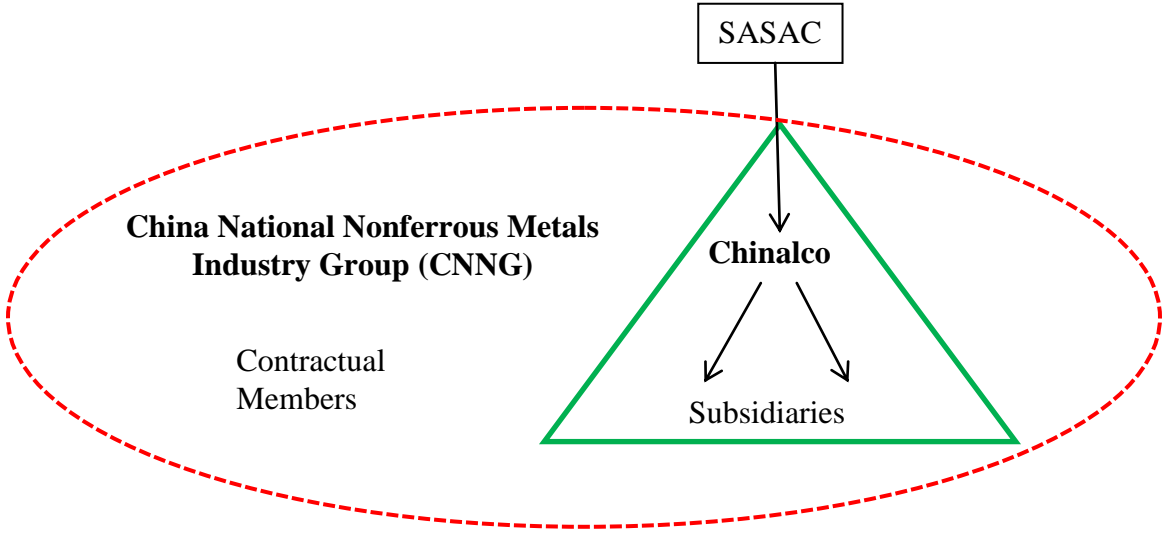
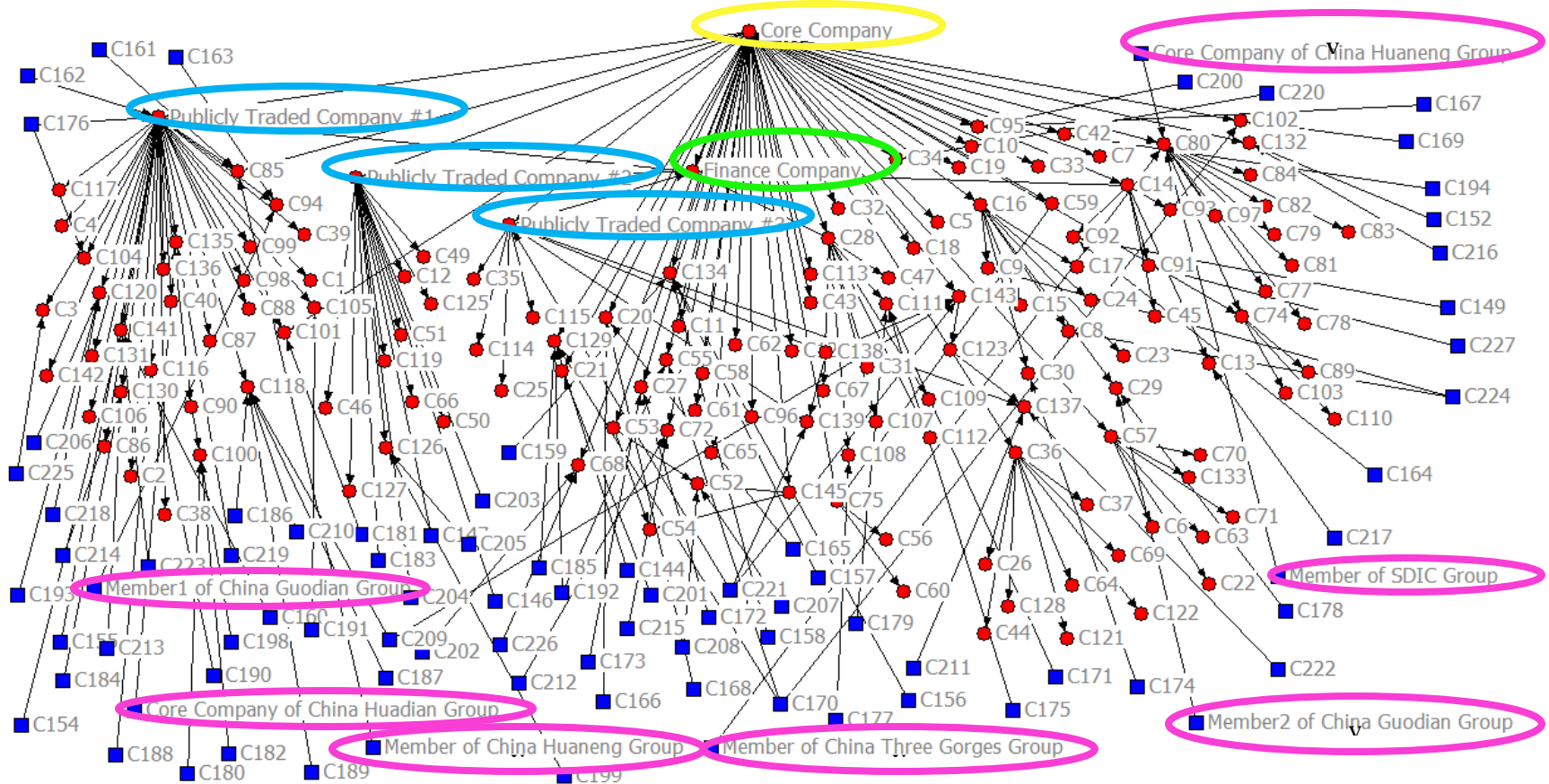


Fig. 6 Ownership Network of China Datang Group



- Source: raw ownership data hand collected from Yearbook of China Datang Group (2009 Edition).
- Note: The red circles indicate member companies in China Datang Group; the blue squares indicate non-member companies. There are 143 member companies and 84 non-member companies in the figure. The black ties with arrows indicate ownership direction. For example, $X \rightarrow Y$ means X Company has an ownership stake in Y Company. There are 248 ownership connections in this graph.

Table 2 Appointments and Removals of the Leaders of the Chinese Central Enterprises

Year	Number of Central Enterprises	Number of Central Enterprises with Appointments or Removals	Percentage of Central Enterprises with Appointments or Removals	Number of Appointments	Number of Removals
2003	196	65	33.16%	150	79
2004	178	77	43.26%	224	155
2005	169	113	66.86%	237	158
2006	159	101	63.52%	323	136
2007	155	90	58.06%	317	113
2008	148	95	64.19%	358	146
2009	129	97	75.19%	312	145

*Leaders including members of board of directors, CEOs, vice CEOs, chief accountants, secretaries of Party Committee, deputy secretaries of Party Committee, and secretaries of the Party's Discipline Inspection Committee.

** Data Source: China State-owned Assets Supervision and Administration Yearbooks 2004, 2005, 2006, 2007, 2008, 2009, 2010.

Table 3 Leader Rotations in the Chinese Central Enterprises

Year	Leader Rotations:				
	Between Central Enterprises	From Central Enterprises to Government/Party	From Government/Party to Central Enterprises	From Local SOEs to Central SOEs	Total Rotations
2004	27	6	13	0	46
2005	27	5	14	0	46
2006	20	3	10	1	34
2007	33	7	16	0	56
2008	NA	NA	NA	NA	50
2009	NA	NA	NA	NA	27

*Leaders including members of board of directors, CEOs, vice CEOs, chief accountants, secretaries of Party Committee, deputy secretaries of Party Committee, and secretaries of the Party's Discipline Inspection Committee.

** Data Source: China's State-owned Assets Supervision and Administration Yearbooks 2005, 2006, 2007, 2008, 2009, 2010.