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Political Control for China’s State-Owned Enterprises: Lessons from America’s Experience with Hybrid Organizations

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China’s reform of state-owned enterprises (SOEs) is intended to liberate the companies from bureaucratic control that hinders their management. Discussions of SOE reform, however, downplay the policy consequences. Can SOEs be “free” to succeed economically while some political control is maintained? Surprisingly, American experience with hybrid organizations—government-created companies that straddle the line between public and private—offers some precedent for managing the balance between political control and enterprise independence. Three strategies are derived for China. First, welfare functions must be stripped from SOEs and replaced by policy objectives compatible with commercial purposes. Second, reducing financial dependence on SOEs will remove a barrier to rational control. Third, and most importantly, a robust regulatory framework for control must be developed as a substitute for the weakened administrative linkages. The emerging control infrastructure rooted in state asset commissions is likely to prove ineffective for its blurring of ownership, administration, and regulation.

As China continues its transition to a market economy, the transformation of state-owned enterprises (SOEs) remains a formidable challenge. The national government, hoping to see these businesses replicate the growth of their private peers, has restructured SOE ownership and supervision. However, a fundamental obstacle remains. The government would like to see improved performance without sacrificing SOEs as instruments of state policy. Can profitability be reconciled with political control?

Insights may come from an improbable source: the United States. Hybrid organizations—companies with one foot in the private sector and the other in the public—have a long history in the United States. Key aspects of American economic development can be traced to the government’s direct participation in the market. Inexpensive power produced by federal power administrations in the South and in the West fueled American economic expansion in the post-WWII era (Selznick 1949). The huge boom in homeownership during the same period was financed by a series of federal loan guarantees and low-interest mortgages. The same can be said for the recent mortgage crisis. While China has moved far today, its actions today are likely to have implications for tomorrow’s orthodoxies.

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of government-sponsored financial intermediaries that helped provide capital to homebuyers (Fish 1979). Indeed, this secondary mortgage market—anchored by two government-sponsored enterprises—is studied in myriad countries, including China, interested in emulating the model.

Comparisons of Chinese SOE reform with similar programs in other countries have been offered but the American example has not been considered (Mako and Zhang 2002). To be sure, America’s “state-owned enterprises” are dramatically different from that of China’s. They are not nearly so central to the nation’s economy. They have never provided comprehensive social services. Moreover, the revenue generated by American hybrids does not sustain any state bureaucracy. Nevertheless, America’s experience with its own SOEs offers important lessons regarding the maintenance of policy control while administrative ties between the state and its commercial progeny are severed.

Hybrid Organizations: America’s SOEs

With the term “hybrid organizations” I refer to American government-created entities that operate through market transactions and generally cover the costs of their own operations through their revenues.¹ These American hybrids are created to accomplish some explicit policy goal. For example, the Federal Home Loan Banks are directed to expand the availability of credit to American homebuyers. The Overseas Private Investment Corporation (OPIC), a government-owned corporation, facilitates American investment in developing countries.

Many American hybrid organizations began as traditional government agencies before being transformed into enterprises. The most common explanation for the change in structure is the belief that a business-like organization would be more efficient and effective.² Additionally, the public administration code generally grants hybrid organizations greater latitude than government agencies. Thus, policymakers find it desirable to assign tasks to hybrids as a means of escaping public law.

The most important “governmental” characteristic of American hybrids is their access to inexpensive capital. Such enterprises pay the same (or almost the same) interest rate as the government itself when they borrow, a rate lower than that paid even by the most highly rated private companies. This is a tremendous business advantage.³

Hybrid organizations are frequently led by individuals appointed by elected officials. The president of the United States, for example, appoints the directors of the Export-Import Bank of the United States as well as the heads of government corporations, such as Unicor and OPIC.⁴ Government-sponsored enterprises, such as Farmer Mac, a financial intermediary in the agriculture area, are led by individuals selected by the board of directors but the president has the authority to appoint some directors.
The government oversees hybrid organizations differently than their private sector peers. On the one hand, American hybrids are frequently exempt from rules, regulations, and taxes that apply to private companies. For example, the Tennessee Valley Authority, a well-known American hybrid that produces much of southern United States’ power, is free from most state environmental regulations (Durant 1985). On the other hand, many hybrids are subject to performance requirements intended to ensure that they are achieving policy purposes (Koppell 2003; Stanton 2002). For example, many government-backed venture capital funds must meet distribution requirements, which stipulate that their investments are made in targeted areas (Koppell 2003).

Listing the public attributes of American hybrids only provides half the picture, of course. These hybrids are also market-driven organizations. In fact, some American hybrids are not even owned by the government. This is a big difference between U.S. hybrids and SOEs (in China and elsewhere). Although many SOEs around the world are owned by the government and private investors (sometimes in the form of stock or sometimes as joint-owned corporations), this model is quite uncommon in the United States. Generally, hybrids are either publicly or privately owned. For example, Fannie Mae is privately owned by shareholders.

Privately owned hybrids are profit-seeking companies and must provide a return to owners. Even government-owned enterprises seek revenue that at least covers the cost of operations (Koppell 2003). Historically, many SOEs outside the United States receive direct operating subsidies or loans through state-owned banks and are not self-sustaining (Mako and Zhang 2002).

Unlike traditional government agencies, American hybrids generally face less constrictive regulation. For example, many contracting and personnel rules do not apply to hybrid organizations. Some hybrids, including the United States Postal Service and Amtrak, have bureaucratic systems that are distinct from the rest of the federal government (Perl and Dunn 1997; Tierney 1984). Such exemptions are intended to make hybrids more efficient and provide flexibility required to participate in a competitive marketplace.

**Differentiating Chinese and American SOEs**

SOEs in the United States and China are obviously quite different. It is important to be precise about the key distinctions before moving forward with the analysis. These differences are summarized in Table 1.

**Origins**

As noted in the previous section, American hybrids are generally substitutes for government agencies rather than businesses. That is, they neither supplant nor directly compete with private sector entities. The common
The justification for creating hybrid organizations in the United States is that they are more efficient than traditional government agencies.8

In China, SOEs were never conceived as an improvement upon state agencies. Many Chinese SOEs are similar to their European cousins, formerly private companies that were nationalized following the Communist revolution (World Bank 1997). Other SOEs were created by national, provincial, or local governments (Bian 2005).

In contemporary China, SOEs are increasingly facing competition from privately owned businesses (Fan and Nolan 1994). Observers generally find the dynamism of the Chinese economy in the nonstate sector (Steinfeld 1998). Thus, one goal of SOE reform is to restructure the companies such that they might better emulate private firms (Garnaut et al. 2005; Pan 2003; World Bank 1997).

**Purpose**

Chinese SOEs have historically been a vital instrument for provision of social services and an instrument of state policy (Bian 2005; Steinfeld 1998). Chinese workers’ lives and interactions with the government were generally mediated by the SOE for which he or she worked. SOE employees received their housing, their medical care, their children’s education, and their pension through their workplace. Indeed, one’s work affiliation (danwei) was more than a job; it was an integral part of one’s identity (Bian 2005). Aside from the material aspects of one’s life, political “participation” was also structured through the danwei (Bian 2005; Wang 2004b). This model is fading.

It would be misleading to argue that SOEs are not substitutes for government. Indeed, the “public” burdens of the SOE in China are an important point of similarity with American hybrids. The nature of the public function is, however, quite different. The public policy purpose of the American SOE is generally embodied in its business purpose: produce electricity, finance housing, build schools, invest in fledgling businesses,

### TABLE 1: Key Differences between American and Chinese State Enterprises

<table>
<thead>
<tr>
<th>American Hybrids</th>
<th>Chinese State-Owned Enterprises</th>
</tr>
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<tbody>
<tr>
<td>Substitute for government agency</td>
<td>Substitute for private company</td>
</tr>
<tr>
<td>Business objective relates to core public policy objective</td>
<td>Social services provision is core public policy objective</td>
</tr>
<tr>
<td>Does not compete with private firms performing similar function</td>
<td>Does compete with private firms performing similar function</td>
</tr>
<tr>
<td>Revenue produced by firm is not vital government resource</td>
<td>Government relies on revenue as source of general funds</td>
</tr>
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258 JONATHAN G. S. KOPPELL
and so on. Unlike Chinese SOEs, American hybrids do not produce commodities that are widely available through private sector competition (such as consumer goods).

**Revenue Source**

SOEs historically provided an important source of revenue for governments in China because income, property, and sales taxes are minimal compared with that of the United States (Steinfeld 1998). As noted earlier, American SOEs do not fund government bureaucracy and only shareholder-owned hybrids must earn an economic *surplus* sufficient to satisfy owners. The need for Chinese SOEs to generate revenues sufficient to support the government, particularly local and provincial governments, will obviously generate a distinctive pressure.

There is some evidence that state reliance on SOE revenue is in decline. The SOE’s share of value-added tax (VAT) revenue, for example, is illustrative. In the last three years, the portion of total VAT payable from SOEs has dropped from 58% to 54%, while government’s dependence on VAT revenues generally also continues to decline (China, National Bureau of Statistics 2005).

Still, such indicators provide only part of the picture. The net profits of all SOEs combined are increasing, rising from 283.4 billion Yuan in 2000 to 476.9 billion Yuan in 2003 (China, National Bureau of Statistics 2004; State-Owned Assets Supervision and Administration Council [SASAC] 2003). This revenue is likely more valuable at the provincial and local levels. Moreover, the state reports of revenue derived from SOEs have undergone significant accounting changes in the last several years (Holz and Lin 2001). SOE revenue totaling 300–500 million Yuan annually is now reported in categories that were not recorded five years ago, thus, creating uncertainty regarding the true level of dependence (China, National Bureau of Statistics 2004). Although there is compelling evidence that China continues to subsidize some money-losing SOEs for strategic reasons, such as export promotion, the aggregate numbers also suggest that the SOE sector remains an important source of revenue (Eckhaus 2006).

Moreover, aggregate revenue numbers do not capture the value of indirect revenues associated with SOEs such as payments derived from SOE employment, nor does it indicate the cash flow which may have value locally even if the balance sheet reflects losses. One indicator of the value of this cash flow is the rising aggregate sales revenue reported in the last three years (China, National Bureau of Statistics 2004). Revenue is often realized at a local or provincial level while losses are experienced elsewhere. Finally, government officials have openly urged for SOEs to produce greater revenues for the state making the pressure on SOEs to perform for purposes of sustaining the public sector rather plain (*People’s Daily* September 9, 2004).
Competition

Generally, American hybrids do not face direct competition. In fact, critics argue that enterprises with government-endowed advantages sometimes crowd out private businesses. This has two important implications in the U.S. context. First, American hybrids cannot be presumed to be more efficient by virtue of a need to outperform their competitors because they rarely have competitors (Walsh 1978). Second, we may be worried that government-owned businesses hurt private firms by undercutting them, using government-granted advantages. Both points are relevant to Chinese SOEs.

Because Chinese SOEs operate to generate revenue and provide social services rather than to fill a vacuum in the economy, the “competition problem” is essentially reversed. For example, Chinese SOEs produce a wide range of consumer products in direct competition with private firms not burdened by social responsibilities. Indeed, Huang and Woo (1998) report that 90% of SOE products face market competition. With the liberalization of laws regulating entrance into the markets (prompted in part by China’s entry into the World Trade Organization [WTO]), SOEs are facing greater competition from private firms everyday.

At present, it is uncertain how much assistance (if any) should be extended to the SOEs to level the playing field. This is a key policy matter striking at the core of financial sector reform. The government has used banks to prop up failing SOEs for reasons of social policy and politics (Chang 2004; Gregory and Tenev 2001). Although this approach is not sustainable, it begs the question over the extent of public burdens that can be imposed on SOEs without rendering them incapable of competition (Holz 2003).

Common Ground: The Control Challenge

The issue of “control” is most transcendent for SOEs in China in the United States. This makes perfect sense. The challenge of delegation —often referred to as a principal–agent problem—confronts organizations across sectors. In both countries, the heart of the control challenge is the same: What happens when the structural tools used by government officials to ensure that SOEs meet public needs are removed in order to promote business efficiency?

In Western political discourse, there is a long-standing concern that government bureaucracies can be an unaccountable, unrestrained force. As a result, structural mechanisms have been incorporated into the design of government agencies, such as legislative oversight, executive appointment of leadership, yearly budget review, opportunities for public review and comment, and so on (Aberbach and Rockman 1988; Gruber 1987; McCubbins, Noll, and Weingast 1987; Wilson 1989). These structures are intended to inhibit bureaucratic discretion and keep control in the hands of political leaders.
Ambivalence about control is new to the Chinese political culture. Historically, political control has been prized even at the expense of efficiency. SOEs are in the midst of transition from centralized state management to something as yet undefined but modeled on companies in the Western mold. In order for SOEs to function as effective enterprises, it has been concluded, the state’s grip on the reins must be loosened. However, it is questionable whether or not policymakers are truly willing to surrender SOEs as state instruments. One senior SOE executive noted that what is said publicly differs from the true attitudes of senior officials; they are not ready to let go (Author interview, October 25, 2005).

In *The Politics of Quasi-Government*, I compared American hybrid organizations with traditional U.S. government agencies as they responded to the demands of their political masters, Congress and the President. This was the first study attempting to determine what structural tools actually provided elected officials with political control over hybrid organizations. The core finding supported the working hypothesis that hybrid organizations are more difficult to control than traditional agencies as a result of the removal of structural mechanisms normally available to steer the bureaucracy (Koppell 2003). This finding is not shocking although policymakers are always flummoxed when hybrids resist control. More subtle findings yielded by the research illuminate the situation of China’s SOEs, most importantly in relation to which tools of control are most effective with respect to SOEs.

**Why Control Is Difficult**

There are three core reasons why the hybrid model is inherently resistant to political control. First, hybrid organizations, including Chinese SOEs, have multiple objectives that are often in conflict with each other. Second, hybrid organizations rely upon market participants to carry out their objectives. As a result, they are constrained by market forces. Finally, and most fundamentally, political leaders must utilize regulatory control tools instead of traditional administrative mechanisms to bureaucratic compliance. Essentially, regulation is substituted for administration.

**Competing Objectives**

The term “hybrid organization” conveys the mixed character of SOEs but not the intrinsic tension in their design. Although the hybrid model would be untenable if policy and business objectives were always at odds with each other, hybrid organizations are often pushed to pursue one set of goals at the expense of another. When Congress and the president pressed the Export-Import Bank to increase exports from small business, for example, the government-owned corporation resisted because it was
costly and negatively affected the bottom line (Koppell 2003). Ultimately, pressing hybrids to carry out activities that adversely affect financial performance is likely to fail.

Reliance on the Market

Hybrids harness the power of the marketplace by altering the calculus of market participants. Consider some examples. Government-backed venture capital funds use guaranteed loans to increase the return for private investors. OPIC provides insurance to encourage investment in riskier countries in need of development capital. In each case, the hybrid relies upon private market participants. Investment funds need entrepreneurs who are starting businesses. Companies cannot send capital abroad if the targeted recipients are not interested. As a result, efforts at control can be stymied by the lack of partners in the marketplace notwithstanding the inducement offered by the hybrid.

An example clarifies the point. Through its venture capital program, OPIC created a fund targeting the West Bank and Gaza strip. Despite the guarantee of capital coinvestment offered through the program, the fund had a difficult time raising funds. Moreover, when fully funded, the managers of the fund could not identify companies suitable for investment. Given the violence and instability in the area, no one was starting any new companies. Thus, the fund was unable to follow orders simply because the market would not cooperate (Koppell 2003).

Tools of Control

The tools utilized by government officials to control hybrids present challenges. American hybrid enterprises are subject to two very different control mechanisms. The entities are part of the state and, as such, some tools utilized by political leaders to control bureaucracies are applied to hybrid organizations. At the same time, hybrids are subject to two species of regulation. First, they are regulated like other companies carrying out similar tasks. For example, the power-producing companies that are owned and operated by the government are regulated for worker safety. We might think of this as “normal” regulation. Second, American SOEs are subject to “special” regulation, unique to each organization. For example, Fannie Mae and Freddie Mac are compelled by the government to achieve certain levels of business in low-income areas where home loans are more difficult to obtain. This special regulation is, in effect, a substitute for the eliminated administrative connections. Thus, I refer to the management of hybrids as “administration by regulation” (Koppell 1999). (Table 2 summarizes the distinction between “normal” and “special” regulation.)

Although I found that regulation is more effective for controlling hybrids than the remaining administrative ties, regulation is a difficult
tool to wield. Crafting regulations is demanding and slow. Translating general policy goals into specific, measurable targets is not easy. Certain objectives are more easily pursued by regulatory means than others. Specifically, it is easier to impose a prohibition on a hybrid than a requirement. For example, the U.S. government forbids any publicly supported venture capital funds from investing in companies that produce armaments or pornography. Fannie Mae and Freddie Mac cannot purchase loans over a certain dollar value. OPIC cannot guarantee investment in countries that sponsor terrorism. Such prohibitions are more likely to be followed than commands requiring a hybrid organization to undertake some new activity. Examples of such demands include directing the Export-Import Bank to increase assistance to businesses owned by women or requiring a venture capital fund to invest in telecommunications companies.

Part of the explanation lies with the “control tool.” Regulation is better suited to prohibition. It is far more straightforward to frame a prohibition in regulatory language than an inducement and it is easier to assess compliance. Also, the “market dependence” problem does not affect a hybrid’s ability to comply with a prohibition. A hybrid can reject certain
customers—for example, firms that discriminate based on race—if so ordered. However, a hybrid directed to do business with a certain type of person can comply only if such person exists and is willing to do so. Finally, prohibitions are less likely to threaten the companies’ finances than requirements to take on new goals. There are costs associated with embarking on a new endeavor that will prove on a drain on the company’s performance. At worst, prohibitions present foregone opportunities.

The Control Challenge: Applications to Chinese SOEs

Chinese policymakers concluded some time ago that economic progress depends upon the revitalization of SOEs. The first phase of this transformation (gaizhi) included the decision to essentially privatize the smaller enterprises while retaining the larger companies (Garnaut et al. 2005; Green and Liu 2005). Under the motto “Seize the large” while “letting go and enlivening” the others (zhuada fangxiao), many SOEs have seen their ownership restructured (Garnaut et al. 2005; Organization for Economic Co-operation and Development [OECD] 2000). For the large SOEs that are the focus of this article, it is more appropriate to characterize the reform as corporatization rather than privatization; the “new owners” are, in fact, state entities including holding companies and other SOEs (Broadman 1999; Lin and Zhu 2000; OECD 2000). Along with changes in the ownership structure, hierarchical command that government ministries had over the management of these companies was weakened (Green and Ming 2005; Wang 2004a; Xiao 1998; Xu, Zhu, and Lin 2005).

SOEs now face higher expectations for financial performance. Firms operating joint enterprises feel this especially keenly. At the same time, most SOEs—especially the largest—have not been fully relieved of burdens that are considered public sector’s responsibilities in the West (Gu 2001). For example, the companies often provide the entire range of social services to their employees including housing, education, health care, and pensions (OECD 2000; Steinfeld 1998). This is changing (slowly) as the government builds capacity (Garnaut et al. 2005; Gu 2001). Levels of employment remain a public issue with layoffs unpalatable even when bloated payrolls hinder financial performance (Bui et al. 2003; Li and Lui 2001; Xu, Zhu, and Lin 2005). These public responsibilities obviously cut against the bottom line for SOEs.

Such clashes between the SOEs’ public and private objectives are analogous to the conflicting objectives faced by American hybrids. On the one hand, the SOE is charged with performing like a profit-seeking company, maximizing revenue and reducing costs. On the other hand, the company has policy responsibilities. In the United States, the policy responsibilities are generally tied to the firm’s business activities. In China, provision of social benefits to employees is the greatest burden (Chen and Jones 2003; OECD 2000; Steinfeld 1998; World Bank 1996).
The additional layer of complexity in China stems from the revenue point raised earlier. Unlike American hybrids, SOEs generate revenue important to support government bureaucracies, particularly at the provincial and local government levels (OECD 2000; Steinfeld 1998; World Bank 1996). Thus, placing burdens on the corporation that will, in turn, diminish the cash flow to the government is counterproductive. One analysis of Town and Village Enterprises (TVEs) concluded that the importance of revenue created by these companies effectively insulated them from some interference; politicians literally could not afford to burden them with political objectives (Perotti, Sun, and Zou 1998). Although the operations of TVEs are significantly different from the large SOEs on which this article is focused (including declining public ownership), such research illustrates the dynamic being described (Sun 2002).

This dynamic is highlighted when the central government is pursuing a policy objective contrary to the financial interests of SOEs. Regulation of industrial pollution is a prime example. Toughening air pollution standards is a central government priority but all mandated solutions have negative financial implications. Low-sulfur coal, for example, would be an improvement over the dirty coal currently consumed by industrial companies and power-generating plants. Alternatively, scrubbers could be installed to eliminate some of the pollution at its source. Either approach is costly, cutting into the SOE’s revenues and hurting the local and/or provincial government. Thus, even when faced with orders from Beijing, many SOEs have simply ignored them and local governments are actively disinterested in enforcement (Bolande 1998; Fan and Nolan 1994). This may help explain the finding that SOEs perform worse than privately owned companies on environmental measures (Wang and Jin 2002).

Emerging Control Infrastructure for SOEs

Although the structure of the relationship between SOEs and the government is quite different, the American experience suggests likely vulnerabilities in the emerging system of SOE governance. The alteration of the administrative connections has been accomplished through a shift in the ownership structure, particularly of the largest SOEs. The government has created SASAC to assume ownership responsibility (Green and Ming 2005; Wen 2005; Xinhua 2003c). Previously authority was vested in the ministries with direct responsibility for the policy area of interest. Provincial governments have established (or are establishing) their own commissions (Green and Ming 2005; Sun 2005; Xinhua 2003b).

The purpose of changing the structure of ownership is, in the words of the government, to separate “ownership from control” (Cook, Yao, and Zhuang 2000). The animating principle is that the government’s ownership of SOEs is desirable but government officials’ involvement limits the SOEs’ ability to function effectively. Placing asset supervision commissions and holding companies as intervening layers between the SOEs and
the government is intended to free the SOE managers to run their companies (World Bank 1997). Holz (2003) has, in fact, reported that SOE executives already do not regard interference as their principal management challenge.

Still, even the official descriptions of SASAC’s role suggest a bureaucratic insinuation into the management of SOEs. Part regulator and part owner, the SASAC retains the ability to hire and fire all SOE leaders including senior managers and board members (Wen 2005). Although SASAC has stated repeatedly that it should not be involved in the administration of SOEs, its chairman Li Rongrong speaks of a need for SOEs to exercise control in the greater economy (Green and Ming 2005). While questioning its likely efficacy, Green and Ming (2005) conclude that “the SASAC is the institutional embodiment of the socialist government’s ambition to retain both ownership and control of its economy’s largest, most important enterprises.”

Finally, one cannot underestimate the strong SOE link to the state through the Chinese Communist Party which has an official presence in most SOEs and retains significant influence in decisions ("State-Owned Enterprises to Have New Rules" 2003; Garnaut et al. 2005; McNally 2000; Opper, Wong, and Hu 2001; FieldNet.com 2003). Additionally, company leadership is still chosen with government’s (party) participation or authorization (Lin and Zhu 2000; McNally 2002).

Drawing an analogy to the analysis of the American situation in which I differentiated “administrative tools” from “regulatory tools,” one could argue that the “administrative” linkages between SOEs and the Chinese government have been weakened but not severed. The formal and informal connections exist to keep SOEs within the public sphere, maintaining their adherence to state policies such as high employment and allowing for government monitoring (Li 2000). As shall be discussed later, the regulatory tools remain primitive.

As if the transition to “arm’s-length” supervision of the SOEs was not complicated enough, a simultaneous effort to improve “corporate governance” is under way. Improving corporate governance in China will require recognizing shareholder rights, formalizing reporting and accounting requirements, and creating boards of directors with representation for shareholders and authority over management (OECD/ADB/DRC 2000; Tenev, Zhang, and Brefort 2002). Moreover, the entire legal infrastructure must be developed to provide aggrieved owners a mechanism for redress (DRC/ERI-OECD 2005). This effort, being led by the China Securities Reform Commission, affects SOEs by, for example, altering the selection of directors and shareholder conference members (Garnaut et al. 2005).

Thus, the “control infrastructure” for SOEs is actually undergoing two distinct but interrelated simultaneous transformations. First, administrative direction of the companies is being reshaped to emphasize state asset administration commissions. Second, corporate governance is being
reformed to bring greater market discipline to the management of the firms and define the parameters of owner rights.

These overarching reforms are being pursued concomitantly with more specific policy objectives. Government faces challenges in the areas of employment (particularly in the growing cities), housing (and its rapidly increasing cost), education, health care, pensions, environmental protection, and economic development to name only a few pressing matters. SOEs remain tools to address these issues even as reforms are under way to free state-owned firms from nonmarket responsibilities.

Three strategies derived from my research on the American experience with hybrids are offered to allow the government to utilize SOEs as policy instruments while enhancing their financial performance: (1) diminish conflict between public and private goals, (2) lessen financial dependence on SOEs, and (3) pursue control through regulation rather than administration. The final point shall be emphasized because the first two strategies are essentially being pursued already by the Chinese government (albeit for reasons different than those offered here).

Relieving the Tension: The Need for a Chinese Welfare State

The root cause of control challenges associated with hybrids is the incompatibility among organizational objectives. SOEs are not only expected to be profitable but also are expected to carry out functions that sap profitability! To make SOEs functional as businesses, the burden on SOEs to provide comprehensive social benefits to all employees must be lightened (Bui et al. 2003; Steinfeld 1998) This not only relieves tension between the policy and fiscal sides of the SOE, but it also actually makes SOEs more effective policy instruments.

Essentially, China needs to develop a true welfare state in order for its SOEs to both thrive and remain effective instruments of state policy. This effort is already under way but the task is monumental. Service organizations within SOEs, for example, are increasingly independent or under the wings of local administrative agencies (Lam 2001). This is a transition model. Government is moving to assume responsibility for pensions, health care, and housing outside the SOE structure (Garnaut et al. 2005; Gu 2001).

By making it difficult for the SOEs to thrive as enterprises, the current arrangement is self-defeating. It is like adding more and more weight onto the back of a mule. Ultimately, less cargo will be conveyed because the mule will drop dead (or move very slowly). By relieving some of the burden, the SOEs will be more effective and more useful. The American case suggests that the Chinese government will have more effective control of SOEs as policy instruments after current welfare responsibilities are assumed by the state. For example, once the cost per employee is reduced for SOEs, maintaining artificially high levels of employment will
be less burdensome. This is a key consideration because Chinese political leaders fear the instability that may arise from high urban unemployment (Li 2000; Weston 2002).

The old burdens on SOEs cannot be replaced with any new public objectives. The lesson of the American case is that some public goals are more compatible with the reality of SOEs than others. Thus, the key to control is the emphasis of objectives that are not orthogonal to business goals. The charters for Fannie Mae and Freddie Mac specify that no activity can be required of them that loses money. A similar requirement should be applicable to SOEs. This would still leave a wide range of public purposes to be pursued by SOEs:

- Bank regulations could require a mixed portfolio that sets a baseline share of loans to small- and medium-sized enterprises. Such loans are somewhat more costly but a skilled management team can make such activity fit within a broader portfolio of activity and maintain positive net financial performance. This would be a means of stimulating economic growth in lagging communities.

- Industrial SOEs can be given targets that compel them to locate or maintain facilities in strategically selected regions such as those experiencing higher unemployment or a net loss of population. This approach could even soften the blow of lost provincial government revenue that will accompany SOE reform (more on this in the succeeding discussions).

- Companies could face distribution requirements with respect to purchase of raw materials or other inputs from companies or enterprises in particular regions.

All of these regulatory burdens might have some negative financial implications but may not be completely at odds with corporate objectives. They must be sustainable. Note that this is not suggesting a return to central planning. The crafting of regulation to drive programmatic performance must create measurable performance targets but leave management in the hands of SOE executives. Developing the bureaucratic capacity to make such a regulatory regime effective is the key element of the approach suggested in this paper. This point is elaborated upon below.

**Reducing SOE Leverage: The Need for Tax Reform**

It is very difficult to control someone with whom you are dependent. As discussed previously, the government’s reliance on revenues generated by SOEs may be fading but these revenue streams remain critical, particularly at the provincial and local levels (Traustadottir, Mariggio, and Sasse 2001; Tseo, Zhang, and Zhang n.d.). This has two implications.

First, policy demands that cut into that revenue stream will be opposed not only by the SOE but by the local and provincial governments as well.
When the central (national) government seeks to move SOEs in a policy direction that will have negative financial implications, support from the local government will not be forthcoming. This has already proven to be an obstacle toward improving the environmental impact of Chinese industry (Hills and Man 1998; Lo et al. 2000). Dictates from Beijing go unheeded because the financial implications of carrying out the central governments’ orders would be unmanageable (Lo et al. 2000; Steinfeld 1998).

Second, the revenue dependence on SOEs means that local and provincial governments will have a strong interest in maintaining SOEs despite other deleterious consequences. The current tax code imposes a 30% corporate income tax rate on SOEs as opposed to 22% for domestic enterprises and 11% for foreign-funded enterprises (China Economic Net 2005; Tam and Ko 2002). Holz (2003) has argued that differential tax treatment largely explains the apparent wide disparity in performance of SOEs and private firms. Until a tax system that treats all enterprises uniformly is adopted, governments that rely upon revenues produced by SOEs simply cannot afford to see nonstate companies siphon any income. Sheltering SOEs from private competition, of course, may be harmful to the province in the long term but some governments have little alternative (OECD 2000).

China must accelerate the adoption of a tax system that is uniform, nondiscriminatory, and growth-enhancing. At present, there is too great an incentive to squeeze as much revenue as possible from the SOEs (e.g., Dabla-Norris 2005). More tax change is already promised as part of reform necessitated by China’s entry into the WTO. This change will enhance SOE performance and, more importantly, reduce the incentive for government officials to shield SOEs from any burden that imposes additional costs. Thus, it will enhance control.

Give Regulation a Chance: Defining the Goals of SOEs

Keeping SOE ownership in state hands serves two purposes for the Chinese government: (1) it prevents a Russian-style landgrab that privatization might create; and (2) it keeps SOEs from ignoring governmental priorities as they pursue profitability. Assuming that the government will always want to retain some influence over key SOEs for policy purposes, the challenge is creating conditions that permit efficient business operations and preservation of the state’s ability to steer the SOEs toward public objectives. The solution was the creation of two intermediate institutions—holding companies and asset administration commissions—that keep ownership of the largest, most important SOEs in government’s hands. The holding company and commission arrangement may prevent the type of corrupt wealth transfer that Chinese officials fear but reforms have muddied administrative control without developing an effective, noncorrupt regulatory infrastructure. The SOEs’ public objectives remain ambiguous and difficult to measure.
Earlier in this essay, I defined two types of regulation to which American hybrids are subject: (1) “normal” regulation that is applied to all firms in the sector in which the hybrid is participating, and (2) “special” regulation that serves as a substitute for the administrative linkages used to give elected officials policy control over the bureaucracy. The American system is far from perfect but its two-pronged approach is appropriate to the Chinese situation with SOEs.

Normal Regulation for SOEs

In contemporary China, all regulation is undermined by the weakly defined regulatory apparatus, its limited history, and the vagaries of a legal system riddled with corruption and inconsistency (Andrews-Speed et al. 2003). In most Western countries, “normal” regulation is seen as a vital state mechanism to prevent firms from engaging in behavior that has negative externalities. Under this model, a government bureaucracy generates rules in accordance with objectives laid out by the legislature. These rules carefully define the nature of the objective, the manner in which compliance will be evaluated, and the consequences of failure to abide by regulations. The regulations generally provide opportunities for affected firms to challenge the judgment of enforcement agencies and appeal decisions to a judicial body.

Unlike this Western approach, Chinese control of negative externalities has historically been carried out by administrative means. Directives from the ministries were a perfectly natural instrument to “regulate” corporate behavior when the economy was dominated by SOEs enmeshed within the administrative apparatus of Chinese government. As a result, regulatory capacity has never really developed. With the state explicitly removing the administrative mechanisms to control SOEs and the ascension of private industry, the robust regulatory substitute is now required. The “normal” regulation of SOEs should be carried out by regulatory bodies overseeing all firms regardless of ownership. The transfer of administrative responsibilities for SOEs away from the ministries charged with carrying out “normal” regulation of the same industries is a sensible move that clarifies the ministerial regulatory function (Green and Ming 2005).

Special Regulation for SOEs

Developing “normal” regulation is only the first required step. The weakness of administrative tools with respect to hybrid organizations that was observed in the United States is typical in China as well. The transfer of SOE responsibility to the SASAC does not solve the problem. Although the SASAC arrangement is intended to place greater distance between the bureaucracy and the SOE management, providing greater latitude to SOE executives, the bodies are still connected to the ministries and party appa-
ratus (Green and Ming 2005). Indeed, many of the staff responsible for running SOEs through the ministries were simply transferred over to holding companies and asset commissions (Green and Ming 2005; McNally 2000). The net result is opacity in SOE-government relations and (in all probability) less reliability (McNally 2002). This deterioration comes at a time when great demands will be placed on SOEs.

As pressure on SOEs to perform profitably increases, the policy direction provided by this arrangement will decay and weaken. Increased foreign investment in SOEs is being pursued more aggressively (Asia Pulse 2003; Business Daily Update 2003). Open trading of SOE shares is also being proposed (Xinhua 2003a). SOEs may even be allowed to fail rather than being propped up through state banks (Asia in Focus 2003). All these developments make clashes between business and policy needs inevitable.

The signs are already apparent. Provincial governments that own and operate the SOEs are unwilling to reduce operating margins to advance national policy goals because they need the revenue to support their bureaucracies. In northern provinces, SOEs began charging workers for heat in their company-owned residences as a way of offsetting this major expense. When pressed by the government to keep people from freezing in their apartments, the company again refused citing the return demands of foreign investors (Economist 2004).

A comprehensive specification of the roles and public responsibilities of all parties connected with SOEs is required. This “special” regulatory approach will allow the government to go beyond corporatization of SOEs. The asset holding companies should be regarded as transitional, a stepping stone to gradual privatization. This would truly force separation of ownership and control by eliminating the tempting crutch of the ownership infrastructure for conveying policy preferences. For this reason, it is a formidable goal.

In the interim, the nature of control being vested in the asset holding corporations must be clarified. The reform rhetoric raises as many questions as it answers. Indeed, it leads directly to the greater issue of corporate governance for all companies. All owners, including the state asset managers, should retain some “control” under any normal understanding of good corporate governance. Specifying the extent of control to be retained by the new ownership bodies is as vital to corporate governance reform as setting its limits. Establishing the rights of corporate owners—including the state—to exercise the type of oversight that is expected in Western economies is the second required piece of regulatory reform. This frees the state from the responsibility of evaluating management performance, something it is ill-suited to do.

With the ownership crutch removed, the government must dramatically improve the infrastructure for “special” regulation. The “special” regulatory approach requires formalization of the public policy goals being sought by SOEs, establishment of benchmarks and performance
metrics. There is no blueprint for such regulation and it can take multiple forms. Indeed, the existing asset commissions could theoretically assume this role, but at present, they are too vested in ownership as the mechanism for control.

In the United States, some “special” regulation resembles “normal” regulation. An independent regulatory body is established to write formal, detailed rules based upon the general instructions written into law by the legislature. The regulatory agency requires regular reports from the hybrid organization regarding its financial status and programmatic activities. The regulator has the power to carry out audits and examinations to ensure the veracity of the reported figures. Finally, the performance of the hybrid organizations is compared with targets established in law and regulation to determine whether or not the company is compliant. Implementing such an approach in China seems feasible. Regulatory bodies could be established at the central and/or provincial level with potential division by economic sector.

In other American cases, special regulation of hybrid organizations resembles a contractual arrangement. The public policy requirements with which the hybrid organization must comply are specified in terms of an agreement with the supervisory agency. This approach has been used with venture capital funds created through another U.S. governmental entity (Koppell 1999; 2003). As a condition of participation in the program, the venture capital fund accepts the contractual conditions. These include the powers of the supervising government agency to review the activities of the hybrid and verify compliance. This arrangement has been referred to as “performance contracting” and utilized with state enterprises in other contexts (Ramamurti 1991). A similar approach could be incorporated into any sale of state-owned shares in Chinese SOEs. “Golden shares” could be retained by the government stipulating a requirement for such a contract.13

Thus responsibility for guiding SOEs should be formalized in three spheres: (1) “normal” regulatory oversight ensuring SOE compliance with all laws applicable to companies doing business in China, (2) management oversight by owners (i.e., corporate governance) to ensure performance in accordance with fiduciary responsibilities, and (3) “special” regulation designed to craft and implement regulations defining the unique public policy obligations of SOEs.

Conclusion

In both the United States and China, policymakers have incorrectly assumed that the best way to maintain political control of SOEs as they move into the marketplace is to retain some weakened administrative ties between SOEs, government bureaucracies, and political leaders. This intuitively appealing approach ignores the basic differences between SOEs and government bureaucracies. SOEs have objectives that compete with
their public goals, notably the need to perform economically, and they rely upon the markets to produce desired outcomes. My research has concluded that the presence of sound regulatory infrastructure is a better predictor of bureaucratic control over SOEs than the presence (or lack thereof) of administrative ties between SOE and the political leadership. While application of the American lesson is complicated by the simultaneous transformations being carried out in contemporary China, achieving the twin goals of improved SOE performance and retained control requires a three-pronged approach. First, the tension among SOE goals must be relieved through the ongoing development of a comprehensive Chinese welfare state. As this burden is assumed by the government, SOEs will perform better and can be used to pursue more specific policy goals. Second, dependence on SOE revenue needs to be reduced. Continuing tax reform speaks of this goal. Third, regulation must be developed as a workable approach to SOE control. This means giving up on administrative linkages through the asset commissions and development of a sound “special” regulatory infrastructure. These changes will clarify the management task facing SOE executives. Balancing competing objectives is more feasible when they are explicit and certain. The current situation generates ambiguity and ad hoc assignment of responsibilities. This hinders performance and serves as a barrier to capital investment. Investors prefer certainty and transparency in the form of explicit regulatory targets and standards. Finally, by clarifying what burdens will—and will not—be borne by SOEs, the central government will send strong signals to all government bodies regarding their own responsibilities in a post-privatization China.

Notes

1. The primary challenge in describing American hybrid organizations is that there is no standard model. Each institution is unique, distinctively combining elements of private and public sector organizations. Thus, one can only identify a set of features often associated with American hybrids while acknowledging that in a particular institution, this feature may or may not be present.
2. This explanation is often entwined with government budgetary rules. By changing government agencies into hybrids, policymakers can often move debt and expenses “off budget,” thus, decreasing the apparent expenditures of the government.
3. This is always true at the national level and frequently applicable at the state and local level.
4. Unicor is the tradename for Federal Prison Industries, an interesting government corporation to mention in an article concerning China. It markets office products to U.S. government agencies that are produced by federal prisoners.
5. There can be some confusion regarding terminology. Shareholder-owned companies are often referred to as “public” or “publicly held” companies. These terms distinguish such companies from those that do not have stock that is traded in markets. In our discussion of companies that are owned by
the government or “the public”; however, we would still think of these publicly traded companies as “privately owned.”

6. Some of these are stockholder-owned companies with shares traded on open exchanges. In other cases, hybrids invest funds pooled by private individuals and institutions along with public dollars.

7. There are exceptions, of course. Amtrak, one of the best-known government corporations in the United States, took over several failed private rail companies. The federal government took over passenger and freight-rail operations but later sold reprivatized rail freight, leaving the Amtrak as a government-owned passenger rail corporation.

8. This remains a very difficult contention to assess. Although many hybrids carry out tasks that are similar to those performed by agencies, they are never tackling exactly the same tasks. For example, the housing agencies that perform functions similar to those carried out by Fannie Mae and Freddie Mac are dealing with a more difficult universe of clients (generally those not good enough to qualify for products offered by the two government-sponsored enterprises). Thus, we would expect slightly higher rates of loss for the agencies.

9. The need to satisfy investors who could withdraw their capital would provide this type of motivation although the inherent strengths of hybrids (i.e., access to cheap capital) should keep shareholders interested regardless of management prowess. Moreover, very few hybrids are owned by shareholders.

10. One might argue that the answer is, by definition, “no” because the hybrid’s creation was because of the absence of private firms. For example, government-backed venture capital funds that invest in underserved communities are unlikely to be poaching investments from private firms. If such firms existed, then it is unlikely that the government program would exist (or so the argument goes). On the other hand, it may be argued that the need for a subsidized enterprise may have existed at one time but this need dissipated once the hybrid created a market. The suggestion that hybrid organizations have a limited lifespan is intended to avoid the difficulties in dismantling the companies once they entrenched and become politically powerful.

11. Among the hybrids I studied, for example, many had directors appointed by the president. All government-owned corporations in the United States are subject to the Government Corporation Control Act, a law setting limits on the hybrids albeit ones different than those applicable to other government agencies.

12. More accurately, the reform of SOEs creates multiple categories of enterprises: limited liability stock company, limited liability company, employee shareholding company, and private enterprise. The latter two categories were primarily restricted to smaller SOEs (Lin and Zhu 2000). Firms in converted companies are classified into five bins: state-owned, legal-person-owned (i.e., owned by an organization with the legal status of a person), individual owned, collectively owned, and foreign owned (Xu, Zhu, and Lin 2005). Most of the shares of large SOEs (the focus of this article) that have been corporatized are state-owned or legal-person-owned. Essentially, they remain state-owned but now this is formally expressed through stock shares.

13. Note that this approach differs from China’s experiment with contract management of SOEs. The “contract responsibility system” set targets for financial performance and required SOEs to make up shortfalls and reduce executive compensation when goals were not achieved (World Bank 1997).
References


