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Corporate Governance Under State Control: The Chinese Experience

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Corporations controlled by the Chinese government originated as state-owned enterprises (SOEs) and still constitute the foundation of the Chinese economy. In addition to their profit-maximization goal, they are expected to contribute to the national welfare, maintain a harmonious society, and ensure sustainable economic development. They thus pursue both firm goals and national goals. This dual goal has shaped corporate governance under state control. While Chinese SOE performance has improved in recent years, certain problems remain. This Article suggests how the governance of these firms can be reformed in line with their dual goal.

Introduction

After over thirty years of market reform, China has succeeded in establishing a market-based economy to replace the previous centralized system. Most large Chinese corporations originated as state-owned enterprises (SOEs). While some continue to be wholly owned by the state, in others the state has a reduced its stake to a majority interest or has become a non-controlling shareholder. The governance of all of these firms is strikingly different from that of corporations in capitalist systems, which are based on private ownership. Thus, the governmental agencies continue to be extensively

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involved in the governance of these corporations as a controlling shareholder and have become the predominant force in the Chinese economy.

This Article provides an overview of the internal governance of SOEs in China today and suggests ways in which it can be improved. The central claim is that although these corporations have gone a long way from functioning as an extension of the government to resembling private businesses, they continue to pursue the often-conflicting goals of maximizing profits on the one hand and contributing to national welfare, on the other. With that difficult task in mind, this Article suggests ways to further modernize corporate governance in Chinese SOEs and tailor it to their current role in the economy.

Part I introduces the history of SOEs in China and the important part they still play in the economy. Part II describes the current governance of these corporations, which combines political elements remaining from their past with modern elements of corporate governance. Part III proposes reforms that would tighten both the external monitoring of SOE managers and the internal governance to keep their actions in check.

I. A Primer on Chinese State-Owned Enterprises

Under Article 6 of the Constitution of the People's Republic of China, "the basis of the socialist economic system of the People's Republic of China is socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people."[1] Article 7 further states that "the state economy is the sector of the socialist economy under ownership by the whole people; it is the leading force in the national economy. The state ensures the consolidation and growth of the state economy."[2] The state-owned sector, in the form of SOEs, has therefore played a predominant role in the Chinese economy, laying the foundation for institutions that ensure a harmonious society as well as sustainable development of China's economy.

Unlike private corporations, whose only goal is to maximize profits, Chinese SOEs have social responsibility as an additional goal. While still expected to be profitable, they also serve as an important vehicle for the state to advance economic stability, development, and sustainability at the national level.[3]

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1 Xianfa art. 6 (1982) (China) (English version is available at http://english.people.com.cn/constitution/constitution.html).

2 *Id.* art. 7.

3 *See* Bei Jin, *State-Owned Enterprises Are Special Enterprises*, 1999(3) Study & Exploration 11, 13 (China).

Against the backdrop of this dual goal, the Chinese economy has experienced four stages of reform since the 1970s. From 1978 to 1986, the government began to decentralize power and allow SOEs to retain profits. From 1987 to 1992, professional managers were brought in to the SOEs, and modern corporate governance was introduced into SOEs between from 1993 to 1998. Finally, since 1999, the government has been exiting industries of lesser national importance and the remaining SOEs have been consolidating. The first three stages of reform focused on making SOEs more efficient, whereas the final stage has concentrated on improving national economic capabilities and realizing general socioeconomic goals.

This reform provided the Chinese government with new tools for intervening in the economy. As the largest shareholder of a company, the government can appoint representatives to the board of directors and make key business decisions for the firm. This power can be used to advance both the goals of individual firms and national goals. According to a survey conducted by Xiaoxuan Liu in 2005, of more than a thousand reformed SOEs, sixty-nine percent were companies with majority state ownership.[4] Moreover, in 2010, of the top-500 Chinese enterprises, 65.8% were wholly owned or majority owned by the state. Finally, all Chinese firms on a recent Global 500 list of the British newspaper *Financial Times* are either wholly owned or majority owned by the state.[5] Consequently, the government now has parallel avenues for intervening in the economy: as regulator and as shareholder.

Chinese corporations today can be categorized into four types according to the level of state ownership: corporations wholly owned by the state, corporations with majority state-ownership, corporations with minority state-ownership, and corporations with no state-ownership. State-controlled enterprises are a convenient tool for the Chinese government to advance macroeconomic goals. Chinese state-controlled enterprises (consisting of both state-wholly-owned corporations and corporations with majority state-ownership) tend to be very large and to cover collectively many industries. They thus can affect employment, price levels, and industrial structures nationwide through human resources policies, pricing, and business strategies such as investment and financing.

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4 Xiaoxuan Liu, The Reform and Reconstruction of Chinese SOEs, Lecture Given at the Unirule Institute (June 24, 2005) (China), *available at* http://doc.mbalib.com/view/46f2a037e259701a5b006a27f67d865d.html.

5 *See* Changan Li, The Position of State-Owned Enterprise in China, Lecture Given at the World Economic Forum in Tianjin (Sep. 15, 2010) (China), *available at* http://finance.jrj.com.cn/2010/09/1513218177020.shtm.

II. The Features of Corporate Governance Under State Control

Many publicly traded corporations are run by professional managers while being owned by others. This is the source of the familiar principal-agent problem between a corporation's investors and its managers. State corporate investments in China are managed by the State Owned Assets Supervision and Administration Commission (SASAC), which has branches in the various provinces, cities, and regions. Corporations under the control of this government agency have a typical organizational structure, described below.

A. The SOE's Governing Bodies: A Combination of the Party Committee and the Board of Directors

Ever since the economic reform that established modern corporations in China, state-controlled enterprises have been organized around so-called "three new committees" — a board of directors, a board of supervisors, and a shareholder general assembly — while maintaining their "three old committees" — a Chinese Communist Party (CPC) committee, an employee conference, and a trade union. In practice, the two sets of committees are staffed by the same people.

SASAC officers sit on both the board of directors and the board of supervisors. The secretary of the CPC committee normally is the chairperson of the board of directors or chief executive officer. He or she thus often functions as the corporation's leading figure. The CPC committee members on the board of directors are its most important members. A representative of the Party's Discipline Inspection Commission typically chairs the board of supervisors.[6] As a manager of state assets, the SASAC has the power to dismiss impeach the chairperson of the board of directors.

B. The SOEs' Objectives: A Combination of National Goals and Company Performance

As described above, the SOEs are the Chinese government's economic arm and, thus, are expected to advance the well-being of the entire Chinese nation

6 For a description of the Discipline Inspection Commission, see *Central Commission for Discipline Inspection of the Communist Party of China*, Wikipedia, http://en.wikipedia.org/wiki/Central_Commission_for_Discipline_Inspection_of_the_Communist_Party_of_China (last visited May 25, 2012).

in their governance and operation. From here derives their dual objective: improving the corporation's performance and advancing national goals.[7]

On the company level, as organizations with a socialist orientation, the SOEs are expected to set an example for businesses nationwide. Specifically, they are expected to pursue stable development, long-term competitiveness through research and development, and profitability. At the same time, they are expected to treat employees well. Furthermore, SOEs are expected to serve as a model of good compliance with the law and fair trade with suppliers and retailers. Thus, Chinese SOEs are expected to advance the interests of all of their stakeholders.

On a national level, the SOEs are regarded as an important vehicle for realizing the Chinese government's goals and facilitating government intervention in the economy. Due to their large size, the SOEs can impact entire market segments and thereby enable the government to intervene in resource allocation and prices in the economy. Additionally, Chinese SOEs can reduce unemployment rates through their hiring decisions. Some SOEs withdraw from certain industries of their own initiative, leaving those industries to corporations with no state ownership. In some cases, the Chinese government controls several SOEs within an industry in order to stimulate competition, as is the case with China Telecom, China Unicom, and China Mobile Communications Corporation.

C. A Complex System of Evaluating and Compensating Executives

The duality of the Chinese SOEs' purpose has led to the creation of a complex set of standards for evaluating corporate performance. On the one hand, profits lie at the foundation of the corporation's survival and success. On the other hand, the corporation's executives are also like local politicians and are therefore evaluated based on individual character and loyalty to the Party.

The main task for which SOE managers are responsible is maintaining and increasing the value of the state-owned assets. Under Section 5 of Interim Measures for Assessing the Operation Performance of Persons in Charge of Enterprises directly under the Central Government, issued by the SASAC in January 2010,[8] "the performance of Chinese SOEs' managers shall be

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7 *See* Qing Yu & Jiansu Huang, *The Nature, Objectives and Social Responsibility of State-Owned Enterprises*, 2006 J. China Indus. Econ. 68, 72 (China).

8 *See* State-Owned Assets Supervision & Admin. Comm'n (SASAC), Interim Measures for Assessing the Performance of Persons in Charge of Enterprises Directly Under the Central Government § 5 (2010) (China), *available at* http://www.gov.cn/flfg/2010-01/22/content_1517096.htm.

evaluated on the basis of success in maintaining and enhancing the value of state-owned assets, maximizing shareholder value, and achieving sustainable development."[9] Furthermore, "Chinese SOEs should evaluate and reward managers strictly based on performance."[10] Under Section 16, the performance of SOE managers must be evaluated relative to the market and to the industry. Market-adjusted performance is measured by the growth rate of asset value and of operating income. Industry-adjusted performance is evaluated according to standards set by the SASAC in its Corporation Responsibility Statement,[11] including innovation, energy saving, and competitiveness.

Due to the SOEs' historical roots and goals, their executives are corporate managers but have the same rank as state officers depending on the SOE's size and position in the national economy. In fact, the CPC Central Committee Organization Department can promote SOE executives to positions in the government based on their performance, providing a strong incentive for SOE managers to perform well. Based on an April 2011 Unirule Institute report, out of 183 administrative officers at or above the deputy minister level in nineteen ministries, fifty-six had experience at SOEs.[12] The report also looked at the resumes of executives from 123 SOEs, finding that 115 executives from forty-seven SOEs that disclosed information had experience as government officers. For example, of the current nine executives in the State Grid, seven used to be government officers, and eight of the fifteen members of the Sinopec Corporation's Board of Directors have served as government officers. Of the companies listed on the Shanghai Stock Exchange or the Shenzhen Stock Exchange (the so-called "A-Shares Market"), 1142 executives used to be government officers.[13] Promotion to an administrative position in the government represents an opportunity for SOE executives to enhance their political careers. Political position is the most important factor in social status in China.

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9 *See id.* § 5.1.

10 *See id.* § 5.2.

11 The Corporation Responsibility Statement is signed by the chairperson of the SASAC or by a person authorized by him to do so after negotiating with SOE managers. It contains a set of considerations for evaluating firm performance, state of the firm's assets, techniques, use of resources, and operation capacity over the previous year, as well as macroeconomic policies implemented.

12 *See* Unirule Inst. of Econ., The Nature, Performance, and Reform of State-Owned Enterprises 112-13 (Apr. 12, 2011) (China), *available at* www.unirule.org.cn/index.asp.

13 *See* Jun Zhou, *Officers in State-Owned Listed Companies*, "Investor News" Blog (July 5, 2010), http://blog.sina.com.cn/s/blog_5309085b0100jz1j.html (China).

D. A Complex Principal-Agent Relationship

With the reform of the Chinese SOEs, professional managers came to be in charge of operations, which gave rise to a new principal-agent problem within the SOEs: The SASAC is now represented on the board of directors as an investor, while professional managers are hired to manage the SOE. Due to their superior information regarding the corporation's affairs, managers can pursue personal benefits at investors' expense. To counteract this conflict of interests, the SASAC, as the principal, has to monitor SOE managers. This Section examines three aspects of this principal-agent relationship in Chinese SOEs.

1. Agents Watching Agents

Corporate governance in Chinese SOEs is characterized by a dual principal-agent relationship: between the government and the SASAC and between the SASAC and the SOE executives. Under the Constitution of the People's Republic of China, Chinese state-owned assets belong to the entire nation. Accordingly, the SASAC, a controlling shareholder in the SOEs, acts as the agent of the state. At the same time, the SASAC authorizes professional managers to run the corporations, giving rise to a second principal-agent relationship: between these managers and the SASAC.

2. The SASAC's Limited Control over SOE Managers

The SASAC's authority is constrained by the power structure within SOEs. As an agent of the state, the SASAC monitors the performance of SOE managers and implements a punishment-and-reward mechanism based on this performance. However, the SASAC is limited in its ability use compensation to motivate managers because the compensation of directors and officers of SOEs is largely determined by regulation. The SASAC also lacks the power to appoint or dismiss managers because the political status of SOE managers is similar to that of the SASAC staff. Thus, only the CPC Central Committee Organization Department can terminate SOE directors and officers.

3. Implicit and Explicit Contracts Between the Principal and the Agent

SOE regulation requires that the SASAC and SOE executives sign a contract articulating the executives' duty to maintain and enhance the value of the SOE and providing that the SASAC will evaluate and reward the executives based on performance. This explicit contract is characteristic of modern commercial relations.

Since Chinese SOEs are expected to produce certain socially beneficial outcomes, the evaluation of their executives by the SASAC is not merely a matter of evaluating profitability. Other factors also come into play, such as the extent to which the corporation fosters social stability and sustained development, implements national strategies, promotes innovation, energy conservation, and environmental protection, and uses its resources efficiently. The optimal balance between these factors varies over time. Therefore, the contract between the SASAC and SOE executives has to be modified annually to reflect changes in state policy. Normally, the SASAC will initiate one-on-one negotiations with SOE managers at the beginning of each year based on current state policy on SOEs. Because the relevant regulations do not set specific guidelines for medium- or long-term incentive compensation, SOEs that wish to use stock-based compensation must negotiate the terms with the SASAC on a case-by-case basis.[14]

Alongside the explicit contract between the SASAC and SOE executives, there is an implicit agreement that successful executives will be rewarded with an appointment to a position in government. A variety of factors come into play with such promotions, including the executive's moral character, personality, responsibilities, capability, and performance, the availability of a position in government, the balance of power between political factions, and the executive's personal connections.[15] Because these factors change over time and are hard to specify, they are never spelled out in any explicit agreement.

III. SOE Performance

Given the characteristics of Chinese SOEs and their role in the economy, their performance is evaluated by two measures: firm performance and contribution to the national economy.[16]

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14 *See* Jingxiang Li, *Contractual Arrangements with Top Executive in State-Owned Enterprises in Current Institutional Perspective*, 2010(9) Reform 112, 112-14 (China).

15 *See* Youmin Xi & Jianqi Zhang, *Unequal Contractual Relationship and Reform of State-Owned Enterprises*, 1998(1) J. Mgm't Sci. 43, 47 (China).

16 *See* Ruiming Liu & Lei Shi, *The Double Loss of Efficiency in State-Owned Enterprises and Economic Growth*, 2010(1) J. Econ. Res. 127, 136 (China); Han Zong, *A Correct Understanding of the Role and the Efficiency of State-Owned Enterprises*, 2011(2) J. Contemp. Econ. Res. 39, 42; Gongxiang Hong, *Is There a Double Efficiency Loss in SOEs?*, 2010(11) J. Econ. Theory & Econ. Mgm't 24, 26 (China).

A. Firm Performance

The performance of Chinese SOEs over the last thirty years can be divided into two periods: poor performance between 1985 and 1995, and improved performance, particularly for the larger SOEs, between 1996 and 2008.[17] Since the end of the twentieth century, SOEs have been part of a property rights reform directed at establishing a modern enterprise system in China. Throughout the transition process, most SOEs have been transformed into corporations with majority state-ownership or corporations with minority state-ownership, and subsequently their performance has improved significantly. The total amount of SOE profits has increased annually, from about 50,000,000,000 Yuan in 1998 (about $6,000,000,000), to over 200,000,000,000 Yuan in 2000 (about $24,000,000,000), to over 500,000,000,000 Yuan in 2004 (about $60,000,000,000), to over one trillion Yuan in 2007 (about $140,000,000,000). According to current Ministry of Finance data, Chinese SOEs made an overall profit of about two trillion Yuan in 2010 (about $300,000,000,000), representing an increase of about thirty-eight percent relative to the same period in the preceding year. In industries such as chemicals, electric power, nonferrous metals, and transportation, SOE profits more than doubled during that period.[18]

Corporations under SASAC control, which tend to be larger than corporations under local government control, have performed even better. In 2010, for example, Sinopec's profit totaled 70,700,000,000 Yuan (about $11,000,000,000), a twelve percent increase over the previous year and a new high in the company's history. China National Petroleum Corporation performed even better in that year, with about 140,000,000,000 Yuan (about $21,000,000,000) in profits, while China National Offshore Oil Corporation showed profits of about 54,000,000,000 Yuan (about $8,000,000,000).[19] As of January 2011, the revenue of all central corporations under SASAC control amounted to 1.4 trillion Yuan (about $217,000,000,000), a twenty-three percent increase from the previous year, and they paid about 180,000,000,000 Yuan (about $28,000,000,000) in taxes, a thirty percent increase from the preceding year. The corporations' net profits in January 2011 were about 70,000,000,000 Yuan (about $11,000,000,000), representing a twenty-four percent increase from the previous year. 47,000,000,000 Yuan (about $7,000,000,000) of these

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17 *See* Chen Zhang & Yu Zhang, *Are State-Owned Enterprises Inefficient?*, 2011(2) J. Economist 16, 24 (China).

18 *See* Liping Sun, *"Secret" in a Poor-Rich World*, Outlook Wkly., Dec. 3, 2011, http://www.chinavalue.net/Finance/Article/2011-12-3/198072.html (China).

19 *See* Jingjing Zhong, *Sinopec Got New High Net Profit of 70.7 Billion Last Year*, New Beijing Daily, Mar. 28, 2011, at A26 (China).

profits belonged to the parent corporations, which was a twenty-six percent increase relative to the same period the previous year.[20] State backing has enabled technological innovation for Chinese SOEs in industries such as steel, telecommunications, railways, defense, and aerospace.

In recent years, the Chinese economy has transformed from being dependent on investment and resources to relying mainly on technology for reducing waste and pollution, to achieve sustainable development. In March 2010, the SASAC released its Interim Supervision Regulations on Energy Saving and Pollution Reduction for Central Corporations, which explicitly provide that central corporations must incorporate "energy saving and pollution reduction" into their development strategy and invest in developing the necessary technology to this end.[21] These regulations require managers of central corporations to save energy and reduce pollution and set an incentive scheme to ensure compliance with this requirement. As a result, Chinese SOEs have stepped up investment in energy saving and pollution reduction technologies, leading to a 15.61% drop in the ratio of energy consumption to the GDP between 2006 and 2010. For example, in 2009, state-owned coal mines in Shanxi Province were required by the provincial government to acquire 2840 private coal mines, thereby reducing the number of legal entities operating mines from over 2200 to 130 and the number of mines from 2600 to 1053. All coal mines producing less than 300,000 tons annually were closed in the province, and the output of the remaining mines was increased to one million tons. The consolidation left large state-owned mines to account for over seventy percent of coal production in the province. Moreover, there was a forty-six percent drop in mine accidents during the nine-month period following the consolidation.

B. Contribution to the National Economy

Chinese SOEs also performed significantly in terms of advancing national economic goals, for example, by keeping prices in check, streamlining production, enhancing industrial safety, and developing infrastructure. During the reform of the Chinese economy, SOEs exited certain industries in order

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20 *See The SASAC Detailed 168,600,000,000 Central Enterprises Bonus Five Flow*, State-Owned Assets Supervision & Admin. Comm'n, http://vod.sasac.gov.cn/play.jspa?indexid=709&streamid=438 (last visited May 25, 2012) (China).

21 *See* State-Owned Assets Supervision & Admin. Comm'n (SASAC), Release No. 23, Interim Measures for Energy Conservation in the Supervision and Management of the Central Business (2010) (China), *available at* http://www.gov.cn/flfg/2010-04/12/content_1578699.htm.

to assist in building a market that would replace central planning and make better use of resources. The private sector thus increased its market share and took the lead in certain industries. By 2008, for example, SOEs constituted only 3.8% of the 1,400,000 corporations in the wholesale and retail industry and accounted for 32.9% of all sales and 29.6% of all assets in the industry. In the same year, SOEs constituted only 8.1% of the 145,000 corporations in the food and hospitality industry, with sales and assets representing 16.6% percent and 28.1%, respectively, of the industry total.

Roughly during the same time, the Chinese government split up certain SOEs in order to stimulate competition. For example, the government allowed non-SOEs into certain areas of telecommunications in order to foster a competitive environment that would replace the existing SOE monopoly. In 1993, China Unicom was founded;[22] in 2000, China Mobile was founded and China Telecom split up into two SOEs — China Telecom and the new China Netcom Corporation. The market now had four major telecom corporations instead of the single corporation that had monopolized the market previously.

SOEs also played a significant role in stabilizing the prices of resources of national priority. When oil prices increased dramatically worldwide in 2008, China National Petroleum Corporation, Sinopec Corporation, and China National Offshore Oil Corporation set the domestic price below the international level and wrote off 160,000,000,000 Yuan (about $24,000,000,000) due to the price difference. This stabilization activity made the oil SOEs a dominant force in Chinese macroeconomic control.

Chinese SOEs also played a major role in building transportation infrastructure. In 2010, the Chinese government invested 7.7 trillion Yuan (about $1.2 trillion) in constructing 16,000 kilometers of railway and 30,000 kilometers of highway. SOEs won many of these construction contracts.

Lastly, in 2009, the Chinese government increased domestic expenditures to ameliorate the external pressure caused by the international financial crisis. Moreover, it engaged in extensive mergers and acquisitions in various industries, notably, steel, coal, and nonferrous metals.

C. Difficulties in Evaluating Overall Effectiveness

If only financial indicators are taken into consideration, SOEs' performance trails that of private corporations. According to data released by the Unirule Institute, SOEs' return on assets averaged 8.18% in 2009, whereas the

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22 *See* Yanbo Li, *Creating a Better Future: In Celebration of the 14th Anniversary of China Unicom*, News (July 18, 2008), http://news.xinhuanet.com/tech/2008-07/18/content_8569360.htm (China).

corresponding figure for non-SOEs was 15.59%. If government subsidies and the cost of accounts payable (such as rent and resource tax) are deducted from income, SOEs' real return on assets becomes only 1.47%.[23] To be sure, it is hard to compare the returns on assets between SOEs and non-SOEs since only SOEs are expected to perform for the common good. Only SOEs, for example, bear the costs associated with stabilizing prices and with restructuring to increase competition. These costs obviously affect returns.[24]

Yet even taking into account the additional costs they bear, some SOEs appear to be less efficiently run than non-SOEs. Indications of SOE inefficiency can be found, for example, in the large losses associated with some investments they have made and the high salaries they pay. Additionally, some SOEs monopolize their industries and likely earn rents that allow them a certain extent of slack.[25] In the absence of hard data, however, it is difficult to estimate the costs imposed on SOEs by their public duties, and accordingly, it is difficult to compare their performance to that of non-SOEs.

Pay levels at SOEs enjoying monopoly positions in their industries are significantly higher than the national average. This is largely the result of the authority granted to SOEs in 2000 to set their own compensation plans. Data show that while employees of SOEs in uncompetitive industries (such as electric power, telecommunications, oil, and finance) account for less than eight percent of the workforce in China, they earn sixty percent of the total wages.[26] A significant wage disparity exists also within SOEs, between the executives and other employees. Indeed, in 2008, the average annual pay of central SOE executives ranged between forty to one hundred times higher than the national average.[27] In 2008, for example, seven executives at the Ping An Group earned more than 10,000,000 Yuan (about $1,500,000) each, while

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23 *See* Unirule Inst. Of Econ., The Nature, Performance, and Reform of the State-Owned Enterprises (Apr. 2, 2011) (China), *available at* www.unirule.org.cn/index.asp.

24 *See* Yuan Chun Liu, *Analysis of the Macro-Efficiency of State-Owned Enterprises*, 2001(5) J. China Soc. Sci. 69, 74 (China).

25 *See* Qijun Ding, *The Source of High Profits in Monopoly Industries*, 2010(5) J. China Indus. Econ. 36, 39 (China); Liangchun Ding & Wei Zhang, *The Extent of Administrative Monopoly in the Chinese Industry and the Related Efficiency Losses*, 2010(3) J. Econ. Res. 16, 25 (China).

26 *See* Ran Zhou, *Central Enterprises Should Increase the Distribution of Dividends to Financial*, New Beijing Daily, Jan. 2, 2011, http://www.donews.com/media/201101/325110.shtm (China).

27 *See* Yanzeng Shen, *The Internal Income Gap in the Monopoly Enterprise*, China Daily, Jan. 21, 2008, http://www.chinadaily.com.cn/hqcj/2008-01/21/content_6408274.htm (China).

the general manager and his deputy earned about 48,000,000 Yuan (about $7,000,000) each and the chairperson of the board of directors earned about 46,000,000 Yuan (about $6,700,000 million). Similarly, in 2010, the chairmen of the boards of directors at Guangfa Security and Vanke Group were paid 8,700,000 Yuan and 7,600,000 Yuan (about $1,300,000 and $1,100,000), respectively.

Chinese SOEs have been instrumental in advancing the government's national goals. This is apparent in the role they have played in industry restructurings, infrastructure development, provision of public services, and investment in economic growth, job creation, and scientific research. However, SOEs have been far less prominent in keeping prices low and ensuring social equality. For example, some entered the real estate market purely for the purpose of reaping excessive profits. Taking advantage of their relationship with the government, they acquired large amounts of land and played a key role in creating a real estate bubble. Similarly, SOEs in uncompetitive industries such as railways, oil, and natural gas regularly charge consumers monopoly rates.

IV. How to Reform Corporate Governance in Chinese SOEs

As the above analysis suggests, Chinese SOEs are inefficiently run and have yet to realize their performance goals or national goals. However, they do have a vital role in the Chinese economy and cannot be disregarded. The discussion below proposes corporate governance mechanisms that could contend with the agency problems that arise in these SOEs.

A. Innate Conflicts of Interests in SOE Governance

Corporate governance in Chinese SOEs suffers from several shortcomings, all of which reflect conflicts of interests among the various groups involved in management and control. First, there is a conflict of interests between shareholders and managers. As a representative of the state, the SASAC authorizes SOE executives to run the business in a way that increases the value of state-owned assets and advances national goals. However, managers have access to inside corporate information and tend to pursue their own personal interests. The reform of Chinese SOEs has endowed their managers with almost unfettered discretion in running the corporation free of any supervision of investment decisions, use of profits, or compensation policy. This latitude has increased managers' ability to manage the state-owned assets under their control for personal benefit.

Second, there is a conflict of interests between SOE executives and the general staff. Under China's previously centralized economic system, all SOE employees could regard themselves as the owners of the corporations. However, following the economic reform and shift to a market-oriented system, SOE executives were granted the right to operate the corporations, while the majority of the workers were now hired as ordinary employees. This has created an employer-employee relationship between the executives and general staff and has given rise to a continuously growing imbalance between them.

Third, there is a conflict of interests between the state and the representative of investors. Because the Chinese government cannot directly supervise SOEs, the SASAC is authorized to perform this duty. Accordingly, a core component in an effective governance mechanism for SOEs would be the prevention of any dereliction of duty or corruption on the part of SASAC officers in supervising SOEs.

The objective of Chinese SOE governance reform should thus be to implement a mechanism that balances the conflicts of interests among these three groups while protecting the interests of the Chinese nation.

B. Internal Governance Reform

To effectively reform SOE governance so that SOEs can realize both firm goals and national goals, three governance changes are necessary.

1. Make the SASAC Accountable

The main source of the principal-agent problem in Chinese SOEs is that they are not subject to any external monitoring. The people of China, who are the putative owners of the SOEs, obviously cannot oversee management. The current governance mechanism is a multilevel agent system under the ultimate control of the chairperson of the SOE's board of directors, who is regarded as the agent of the shareholders. This gives rise to a series of problems.

First, the chairperson of the board can seek to promote executives' interests at the expense of the owners' interests. Second, the large number of SOEs under SASAC supervision (including 123 central corporations) makes it challenging to monitor them all. The desire to give SOEs wide latitude to operate with minimal administrative supervision comes at the cost of insufficient oversight by the representatives of the corporations' owners. Moreover, SASAC officers may collude with SOE executives, resulting in ineffective supervision and excessive pay practices.

The Standing Committee of the National People's Congress, as the ultimate body in charge of the state-owned assets, could supervise the SASAC. With the addition of this new level of supervision, the SASAC would serve as an agent of the Standing Committee, and the chairperson of the board of directors would serve as the SASAC's agent. The SASAC would thus become accountable to the Standing Committee and would report to it.

2. Enhance Board Independence

Outside directors should constitute the majority of directors on SOE boards. It is important to select directors who understand business, government policy, and their role as the representatives of the Chinese people, who own the SOE. The SASAC could nominate candidates for the outside director positions, while the Standing Committee of the People's Congress would be charged with vetting and approving the nominees. The chairperson of the SOE board of directors could be nominated by the Chinese government and approved by the board, and vice presidents could be recruited from the market and approved by the Standing Committee.

3. Treat Employees as Owners

In Chinese SOEs, employees are also owners, and as such, they owe duties to their SOE. Thus, SOE employees should be encouraged to participate in the corporation's governance, including by sitting on the board of directors. This would be achieved if the general meeting were to protect employees' right to be represented on the board of directors.

C. External Monitoring Reform

The distribution of SOE profits among shareholders, managers, and employees affects not only the SOE itself, but also society as a whole. As the representative of the SOEs' owners, the government should regulate the distribution of profits rather than leave the matter to the discretion of managers. Distribution decisions cannot turn on profitability alone. In some cases, high profits for SOEs may reflect their monopoly power, while low profits in other cases may reflect costs they bear in implementing national policies. Accordingly, distribution decisions should factor in also fiscal considerations, SOE development, income disparity, and the social gains that strong SOEs generate by leading the nation's industrialization process.

An effective financial auditing system is crucial for constructing a solid foundation to SOE payout practices.[28]

First, the implicit subsidies given to SOEs should be replaced with explicit subsidies. To compensate SOEs for the social burden they bear, the government currently subsidizes them in a variety of implicit ways, including tax exemptions, reinvestment of dividends, free transfer of land, low taxation of natural resources, and inexpensive loans. This array of subsidies should be replaced with a transparent arrangement whereby SOEs are treated like non-SOEs. Under this arrangement, SOEs will be subject to objective standards for evaluating performance, calculating profit and loss based on market prices, and identifying profits and losses associated with their relationship with the government.

Second, a system of financial reporting to the People's Congress should be instituted. Moreover, the SOEs' financial state and related information (such as profits and losses) should be audited by experts reporting to the People's Congress. Given the dual goals of Chinese SOEs, the government should set a standard protocol for approving the annual payout plan and compensation for SOE executives.

Third, the People's Congress should adopt laws to regulate in detail SOEs' operation in areas such as investment decisions, dividend policy, executive and employee compensation, and accounting.

Conclusion

It is vital that a mechanism be established to regulate Chinese SOEs and subject them to public scrutiny. This will ensure that they fulfill their duties: to compete in the marketplace and serve as a model for other businesses, while advancing national macroeconomic goals.

This Article has proposed several reforms to achieve this end. First, it has made a case for improving the internal governance of SOEs, calling, in particular, for making the SASAC more accountable to the political branch, increasing board independence, and strengthening the power of employees within the firm. Second, it has called for improving the external monitoring of SOEs. Specifically, it has advocated steps for increasing transparency and regulating key management decisions.

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28 *See* Qing Yu, *Seeking a Common Ground While Reserving Differences To Make a Steady Change in Corporate Governance*, Chinese Soc. Sci. Today, Jan. 6, 2011 (China).