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Article

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State-owned enterprises in China: A review of 40 years of research and practice



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ABSTRACT

State-owned enterprises (SOEs) are important components of the Chinese economy. Although SOEs are generally considered inefficient in operations, China's economy, which relies heavily on SOEs, has been highly successful over the last four decades. This indicates the importance of SOEs in China's past and future economic success. Therefore, in this study, we review the literature on economic theories and 40 years of practice of Chinese SOEs and discuss implications for future research. Our review consists of four parts: the theories of SOEs and their reform, the performance and financing strategies of SOEs, corporate governance in SOEs, and corporate social responsibility in SOEs.

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1. Introduction

State-owned enterprises (SOEs) play an increasingly important role in today's global economy. There were 27 SOEs in *Fortune Global 500* (FG500) in 2000, and this number increased to 102 in 2017, accounting for one fifth of the FG500 corporations. In 2017, the revenues of FG500 SOEs reached a total of \$6.1 trillion, amounting to 22% of the total revenues of all FG500 corporations (\$27.7 trillion). Chinese SOEs represent a significant portion of FG500 SOEs. In particular, in 2000, there were 27 FG500 SOEs, 9 were from China; in 2017, 75 of the 102 FG500 SOEs were from China. Fig. 1 shows the distribution of China's SOEs in relation to all SOEs in the FG500 list.

In addition to the 75 giant SOEs in FG500, there are more than 150,000 SOEs in China. China's SOE sector has grown significantly (in the number and total market capitalization of SOEs) since China's launch of

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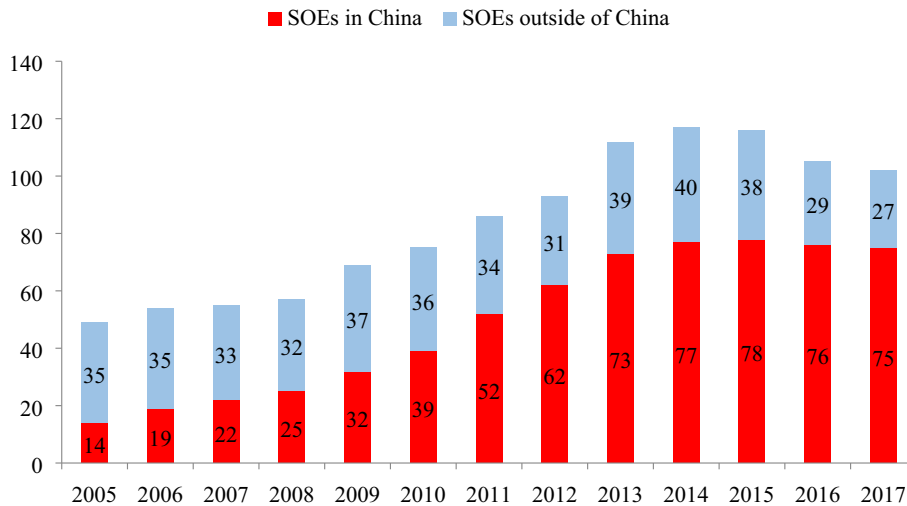


Fig. 1. SOEs in *Fortune Global 500*.

marketization reform in 1978. According to the disclosure of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), the assets of Chinese SOEs reached RMB151,711 billion (about US\$22,310), and they sold more than RMB52,200 billion (about US\$7,676) in goods and services in 2017.

These data suggest that China's SOEs are essential not only for the domestic market but also for the global market. In the field of academic research, voluminous studies on SOEs are based on a Chinese sample. According to Bruton et al. (2015), 39 papers on SOEs were published in the *Financial Times's* list of 45 journals between 2000 and 2014, among which 30 papers used Chinese SOEs as a research sample. Existing research sometimes provides mixed evidence on China SOEs, probably due to lack of consensus on theories regarding China SOEs. Most important, the literature didn't provide clear answer on the question: If China's SOEs perform poorly, why has China achieved the fastest economic growth of the last 40 years by relying on its SOEs? Attempting to address this question, our study first describes the historical development of China's SOEs over the last 40 years, then reviews previous studies on the theories and empirical findings of China's SOEs to provide suggestions for future research.

We review the literature on theories and practices by organizing prior studies into three parts. The first part (Sections 2, 3, 4) describes the status and evolution of Chinese SOEs. We first describe the current status of the Chinese economy, led by the phenomenon of the "Chinese Puzzle," i.e., China's economy has relied heavily on SOEs, an economic organization considered to have lower production efficiency, yet has achieved outstanding economic growth. Second, we explain SOEs' operational inefficiency by detailing the theoretical developments regarding SOEs. For example, economic theories indicate that SOEs are public goods that would be overconsumed and carry heavy policy burdens, that SOEs naturally face agency problems between their controlling shareholder (i.e., the state) and their minority shareholders, and that SOEs' hierarchical structure will lead to greater information asymmetry between the decision maker (the state) and the executors of daily operations (managers), all leading to the economic conclusion of reduced operational efficiency. However, the Chinese government has effectively launched its SOE reform to overcome inefficiency. Thus, we present factual evidence of how SOEs have evolved historically to adapt to the Chinese economic system and its reform. Finally, we discuss the financial burden and financing policies of SOEs.

The second part of the review (Section 4) focuses on corporate governance in SOEs. We discuss the agency problem of SOEs, detailing different layers of this problem; we analyze the effectiveness of the compensation system, the independent director mechanism, the outside blockholder monitoring, and the external M&A market; we then review the literature on SOEs' information transparency to outside investors.

The third part of the review (Section 5) surveys studies examining how Chinese SOEs meet the expectations of their stakeholders through the lens of corporate social responsibility. We discuss how SOEs create jobs to

meet the needs of the government from a social welfare standpoint, their environmental protection efforts, and their philanthropic commitments.

2. The “China Puzzle and the role of SOEs in China’s economy

2.1. Performance of China’s SOEs and the “China Puzzle”

SOEs are shown to have lower economic performance than non-SOEs (e.g., Lin et al., 1998; Allen et al., 2005), largely because of their lower production efficiency. Borensztein and Ostry (1996) analyze the pre- and post-reform Chinese economy and find an increase in the per-worker total factor productivity (TFP), although it is unlikely to be sustainable. They suggest that government interventions, especially in SOEs, have led to lower productivity and employment growth rates in SOEs compared with non-SOEs.

Table 1 describes the status of Chinese SOEs. In the 20 years between 1997 and 2016, the number of SOEs first decreased and then increased after 2008, but overall decreased. However, the total assets managed by SOEs increased 11.39 times $((154,912-12,497)/12,497)$ in these two decades. Similarly, we can calculate the trends of other variables. Table 1 shows that SOEs’ liabilities increased at the same pace as their assets (about 11 times), sales increased by 5.6 times, and net income increased by 31.34 times. These statistics demonstrate a significant improvement in SOEs’ operational efficiency. Fig. 2 presents the ratio changes over time.

The “China Puzzle” refers to the fact that China lacks market-supporting institutions and is characterized by many government interventions, but its growth ranks among the top in the world. In other words, China’s economic growth presents contradictory evidence against the law-finance-growth predictions that when the legal system does not support financial markets, economic growth is impeded. There are many factors contributing to the “China Puzzle,” including the fact that China’s economy relies heavily on the public sector. In the following sections, we discuss theoretical and empirical evidence of the advantages and disadvantages of SOEs.

2.2. Advantages of SOEs

Why are SOEs important for China’s economy? If SOEs typically operate with low production efficiency (Lin et al., 1998; Firth et al., 2006), how can they help the Chinese economy rank at the top in terms of economic growth? The literature proposes three reasons why SOEs are advantageous to the extent that the government uses them to solve externalities that cannot be solved by the market.

First, government interventions in the market can benefit the economy by maximizing resource mobility to create capital-intensive industries. These industries are essential for the economy, but investing in them requires long gestation, imported equipment, and large lump-sum investments that cannot be achieved by the market alone (Lin et al., 1998; Lin and Tan, 1999). In other words, government interventions make functional operations possible in these capital-intensive industries and move the economy by providing infrastructure construction.

Second, the government sees SOEs as the second-best way to maintain social stability, without which the economy cannot function properly. Bai et al. (2000) show that SOEs are valuable for tasks other than profitability. For example, when social stability is low, SOEs are useful for hiring excess labor and bear people’s retirement benefits, although they have reduced incentives for production (Shleifer and Vishny, 1994). Bai et al. (2009) also show that privatized firms have a reduced number of employees as a result of privatization and that the ratio of debt and financial expenses to sales decreases with non-state ownership. This result suggests that only SOEs are used to achieve social goals.

Finally, the government uses SOEs to maintain control over key elements of society, the “commanding heights” of state control advocated by Vladimir Lenin. Controlling a set of firms and outputs are consistent with the government’s interests.

Table 1

SOE performance in China. This table presents the basic performance measures for SOEs and different ratios for the 1997–2016 period. The data come from the Ministry of Finance of China. Lev is measured as the ratio of total liabilities to total assets; ROA is the ratio of net income to total assets; ROE is the ratio of net income to shareholders' equity; ROS is the ratio of net income to sales.

Year	No. of SOEs (Thousand)	Total Assets (Billion)	Total Liabilities (Billion)	Sales (Billion)	Net Income (Billion)	Lev %	ROA %	ROE %	ROS %
1997	262	12,497.5	7881.06	6813.20	79.12	67.10	2.30	1.70	1.20
1998	238	13,478.0	8440.93	6468.51	21.37	65.50	2.10	0.40	0.30
1999	217	14,528.8	9147.49	6913.66	114.58	65.40	2.70	2.10	1.70
2000	191	16,006.8	10,209.24	7508.19	283.38	66.00	3.30	4.90	3.80
2001	174	16,671.0	10,527.33	7635.55	281.12	65.00	3.30	4.60	3.70
2002	159	18,021.9	11,367.58	8532.60	378.63	64.80	3.60	5.70	4.40
2003	146	19,971.0	12,871.89	10,016.09	476.94	65.90	3.50	6.70	3.00
2004	136	21,560.2	13,883.91	12,072.20	736.88	65.70	4.50	9.60	6.10
2005	126	24,256.0	15,517.32	14,072.66	957.99	65.10	5.00	11.00	6.80
2006	117	27,730.8	17,929.37	16,239.03	1219.35	67.40	5.50	12.40	7.50
2007	112	34,706.8	20,247.25	19,483.53	1744.18	68.70	6.40	12.10	9.00
2008	110	41,621.9	25,000.84	22,939.79	1333.52	61.60	4.60	8.00	6.00
2009	111	51,413.7	31,541.69	24,301.54	1560.68	62.80	4.20	7.90	6.60
2010	113	64,021.4	40,604.32	31,499.39	2142.82	63.40	4.60	9.20	7.00
2011	135	75,908.2	48,609.08	38,634.14	2466.98	64.00	4.60	9.00	6.60
2012	147	89,489.0	57,513.54	42,535.65	2427.73	64.30	4.10	7.60	5.90
2013	156	104,094.7	67,097.46	47,112.51	2557.39	64.50	3.80	6.90	5.60
2014	160	118,471.5	76,595.59	48,909.91	2644.40	64.70	3.50	6.30	5.50
2015	167	140,683.2	92,441.72	45,735.20	2497.04	65.70	2.90	5.20	5.60
2016	173	154,914.2	101,521.49	47,439.16	2555.87	65.50	2.70	4.80	5.50

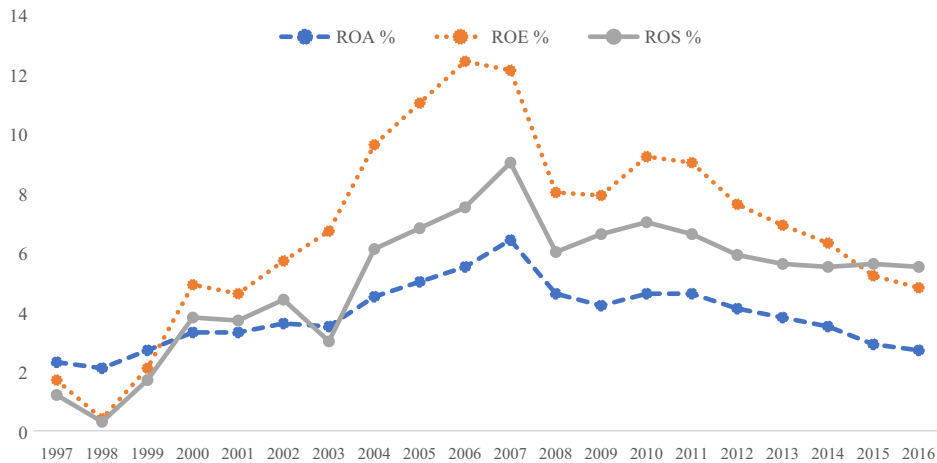


Fig. 2. Performance of SOEs.

2.3. Problems with SOEs that result in lower performance

The cost of SOEs undertaking multiple tasks is that their economic performance is lower than that of non-SOEs. Theories explaining this inferior performance are discussed below.

2.3.1. SOEs as public goods

A prominent issue causing SOEs' underperformance is the inherent defect of SOEs. SOEs are public goods subject to various externalities, impairing their operational efficiency. We will illustrate these externalities in two aspects: excludability and non-diminishability (Jefferson, 1998).

Excludability is a feature of public goods resulting from their undefined property rights, i.e., all parties accessible to public goods can consume them. The famous “tragedy of the commons” is a case in point – a common land is overconsumed by unregulated grazing. When resources are shared and have no defined ownership, anyone who has access to them will act independently according to their own interests (e.g., Tornell and Velasco, 1992). Conceptually, SOEs are “owned by the people”, and such ambiguously defined property rights lead to the overconsumption of their assets by various parties, including the state, managers, and workers. The state extracts rents from SOEs with predatory taxes and other burdens, managers consume on-the-job perks, and workers shirk, leading to lower performance.

Non-diminishability indicates that the overconsumption of one person does not seriously affect the ability of others to extract value from public goods. In other words, although the state, managers, and workers consume assets from SOEs, they will not be constrained by other parties' consumption. This reduces the operational efficiency of SOEs. Even worse, the overconsumption of SOEs leads the state to control prices and tighten monetary policies, which reduces the productivity of the non-state sector, thereby undermining economic growth.

2.3.2. Policy burdens and soft budget constraint

The heavy policy burdens and the soft budget constraint also lead to lower performance among SOEs. Because of their special role in the economy, such as the need to maintain social stability, Chinese SOEs bear heavy policy burdens, including (a) high capital intensity (especially in strategically important industries), suggesting high financing costs, and (b) the costs related to retirement pensions, social welfare, and the hiring of redundant workers (Lin et al., 1998; Lin and Tan, 1999; Dong and Putterman, 2003). The soft budget constraint aggravates the problem of policy burdens (Lin et al., 1998; Lin and Tan, 1999). SOE managers often attribute their losses to the policy burdens imposed by the state, and the state cannot distinguish between the lack of effort or competence of SOE managers and the effect of policy burdens on firm performance. In turn, the state will bail out financially distressed SOEs through fiscal subsidies and tax cuts, effectively creating the

soft budget constraint. Therefore, the capital of SOEs is not constrained by a solid budgeting process. The soft budget constraint separates the incentives of SOE managers from firm performance, exacerbating the agency problem.

2.3.3. *The agency problem in SOEs*

The agency problem refers to the fact that when ownership and control are separated and the incentives of the economic agents operating the company deviate from those of the agents owning the company, firm value maximization is achieved in the first-best solution. In the Anglo-Saxon setting, the agency problem usually stems from the conflict of interest between managers and shareholders, while in the setting of Chinese SOEs, the agency problem refers to two layers of conflict of interest.

The first layer of the agency problem results from the conflict between the controlling shareholder and the minority shareholders. The presence of a controlling shareholder holding a dominant percentage of shares is a characteristic of Asian firms (Claessens et al., 2002). The controlling shareholder has well-entrenched incentives because it pays less than 100% of the company's ownership but controls it through voting rights. Therefore, the first level of the agency problem exists between the controlling shareholder and the minority shareholders (Claessens et al., 2000; Claessens et al., 2002). In the context of SOEs, the controlling shareholder is the government, which pursues multiple objectives other than value maximization, such as maintaining social stability by reducing unemployment and income polarization (Lin et al., 1998; Lin and Tan, 1999; Dong and Putterman, 2003).

The second layer of the agency problem exists between the managers and the controlling shareholder, as the literature shows in the Anglo-Saxon setting. In a market economy, the agency problem is solved through an efficient labor market (Fama, 1980),¹ which does not exist in China. More importantly, personnel decisions in SOEs are made by the state or local governments, resulting in labor contracts without an effective mechanism encouraging managers to pursue profitability (Bai and Xu, 2005; Chang and Wong, 2009). Instead, managers are incentivized to solve social problems, such as unemployment and social instability (Bai et al., 2000). Under this weak incentive structure encouraging CEOs to multitask, CEO compensation and turnover respond weakly to firm performance (Firth et al., 2006; Chang and Wong, 2009). Weak pay-for-performance and turnover-performance sensitivity are also seen as evidence of collusion between CEOs and the government (i.e., the controlling shareholder) (Wang and Xiao, 2011; Zhang et al., 2014).

2.3.4. *Information asymmetry and the cost of hierarchy*

Finally, SOEs are featured by its hierarchical structure, which hinders efficient information transfer between them and the government, resulting in lower operational efficiency. That is, information comes from the production floor and is used by top executives or the state, while agents in possession of information will use it to negotiate their benefits. Information asymmetry and the agent's tendency to conceal information to obtain private benefits (i.e., the moral hazard problem) generate costs for the state, especially when information has to be transmitted to the state (Groves et al., 1994; Huang et al., 2017). The greater the distance between the SOE and the overseeing government, the costlier the information transmission and the less effective the decision-making process.

3. The history of SOE reform in China

The Chinese government is aware of the advantages and disadvantages of SOEs in economic development. In this section, we discuss the historical development of SOEs in China and how the government has reformed SOEs to solve the disadvantages described in Section 2.

Before 1978, as in all socialist countries, China's economic system was a centralized socialist planning system. Each SOE was a production unit that responded to the production plans of the central government or local governments. Before the opening-up reform in 1978, China's SOEs had the following characteristics:

¹ In an efficient labor market, employers can directly design pay for performance contracts to motivate managers. Indirectly, the labor market valuation of the performance of managers can inform firms about the competence of their managers.

(1) they were state-owned and state-operated, which means that the state held both the ownership and the operating rights of SOEs (to better reflect this feature, these firms were named State-operated Enterprises at the time); (2) their production plans are developed by national planning agencies, and SOEs can only execute these plans; and (3) their strategic decisions, such as personnel, finance, production, and sales, were made by the government. Specifically, the Chinese government appointed SOE managers and developed salary standards for different industries and positions. The state also provided funds that SOEs needed for costs that are close to zero. SOEs planned their production according to predetermined plans issued by the government, without considering about setting product price and the demand of customers. All profits made by SOEs were remitted to the state and losses were covered by the state. Under this planned economic system, managers and workers had little incentive to promote production, thus SOEs had low operational efficiency.

It was apparent to the Chinese government that such inefficient SOE system could not help the government to overcome the economic distress caused by the Cultural Revolution between 1966 and 1976. Thus, China implemented its reform and opening-up in the late 1970s, which became a vital component of the national reform process. Over the last 40 years, the reform of SOEs has gone through stages illustrated as follows.

3.1. Stage 1: Expanding SOEs' operating rights under the planned economic system (1978–1984)

China's reform and opening-up was a tentative attempt to improve SOE performance in the late 1970s. During this period, the government first attempted to address SOEs' lack of enthusiasm for production. The most distinctive feature of this stage was to increase SOEs' decision-making rights in operations. This stage of reform started from October 1978, when the local government of the Sichuan Province chose six SOEs to conduct an experiment to increase their autonomy, letting them keep part of their profits and giving workers bonuses if they achieved their annual production goals. As a result, SOEs were allowed to engage in production beyond the state's mandatory plans and exporting SOEs started to retain some of their foreign exchanges. In 1983, the pilot reform was advanced to allow SOEs to pay taxes instead of remitting all profits to the state (*li gai shui*). Although the income tax rate was 55%, SOEs got to keep the rest of the profits.

At this stage of the reform, the state started to recognize SOEs as independent entities. Due to the growing autocracy, SOE managers became residual claimants, which greatly improved SOEs' enthusiasm for production and partially reduced the agency problem. The reform of the expansion of the autonomy of SOEs culminated in the publication of "Interim Ordinances on State-operated Enterprises" by the State Council in April 1983. The Ordinances defined for the first time an enterprise as a legal person with the right of independent production and operations. However, China's SOE reform at the time only expanded to a limited degree of operating autonomy, leaving the planned economy largely intact.

3.2. Stage 2: The contract responsibility system (CRS): Separation of ownership and operating rights based on public ownership (1984–1992)

In the early 1980s, the state took almost all important decisions, from personnel to production decisions, for SOEs. The integration of ownership and operations was accompanied by inefficient decisions; that is, the state did not have enough information and expertise to make good decisions.

In 1984, the third plenary session of the 12th Central Committee of the Communist Party of China (CPC) started to reform the urban economic system and clearly expressed the need to separate ownership and operating rights in SOEs. The policy was implemented with the Contract Responsibility System (*Cheng Bao Zhi*, hereinafter CRS) as the primary means. The CRS was a system in which managers were assigned the operating rights of SOEs by the government through employment contracts. In turn, they paid a predetermined amount of profits to the government and retained excess profits. At the end of 1988, 93% of the enterprises used the CRS system, and the duration of the government-manager contract was generally three to five years.

The CRS was the most striking feature of China's SOE reform in the 1980s. The system was considered to have improved the operating performance of the SOEs that used it. However, the CRS had obvious shortcomings. First, it created short-termism among managers. Because most contracts lasted three to five years, managers had little motivation to maintain fixed assets, invest in new projects, and upgrade production facilities. Second, it triggered tunneling behaviors. The initial intention of the CRS was to motivate managers by giving

them rights to residual profits, but they obtained more benefits by extracting resources from SOEs, resulting in significant erosion of state-owned assets. Third, the CRS was not a market mechanism in essence, which led to unsalable products produced by SOEs. Eventually, about 40% of the SOEs were losing money in the early 1990s.

3.3. Stage 3: Establishing a modern enterprise system based on the market economy (1992–2002)

China deepened its SOE reform after Deng Xiaoping, the chief architect of China's reform and opening-up, delivered a series of important speeches in 1992, promoting the role of the market in economic development. In the same year, the 14th National Congress of the CPC clearly stated that “*the goal of China's economic reform is to establish a socialist market economy.*”

Although the CRS reform was seemingly successful, SOEs still suffered from the agency problem and a lack of market-supporting institutions to facilitate the separation of ownership and operations. This leads to vague property rights of SOEs. Consequently, the state launched a new round of reforms to establish a modern enterprise system, or corporatization. Corporatization entailed restructuring the internal governance system of SOEs while preserving state ownership (Aivazian et al., 2005). Unlike the previous two stages, which focused on the reform of operating rights, the corporatization of SOEs emphasized the reform of ownership rights. From then on, state-operated enterprises were called SOEs (state-owned enterprises).

Three milestones of the stage greatly promoted China's SOE reform. The first milestone was the establishment of the Shanghai and Shenzhen Stock Exchanges. The two exchanges provided platforms for listing and financing SOEs in the capital market. Today, more than 1000 SOEs are listed on both stock markets. The second milestone was the codification of Company Law, which came into effect in 1994 and laid a legal foundation for the establishment of a sound corporate governance structure for Chinese SOEs. Since then, the general meeting of shareholders, the board of directors, and the board of supervisors have become the three main bodies of Chinese companies. The third milestone was the codification of Securities Law (1999), the first economic law drafted by the supreme legislature of the state and not by a government department, which further boosted the development of China's securities market.

Although listed SOEs benefited from the corporatization reform, non-listed SOEs could not keep pace with this economic transition. When SOEs were in the spotlight, their operational inefficiency became visible. By the end of 1997, of the 16,784 large and medium-sized SOEs, 6599 reported negative earnings, with losses of RMB66.6 billion. To deal with this problem, Zhu Rongji, the newly appointed Prime Minister in 1998, stated that the government would spend three years helping most large and medium-sized unprofitable SOEs solve their problems and establishing a modern enterprise system. An important measure to eliminate redundant SOE workers resulted in 21 million workers being laid off throughout China, which largely solved the employee redundancy problem of SOEs. In 2000, the Chinese government stated that the three-year goal of SOE reform had been largely completed. In the same year, the profits generated by SOEs reached RMB230 billion. This achievement was noticeable in the public economy.

The enterprise reform was successful in that SOEs had improved their operational efficiency. However, during the reform where SOEs span off redundant assets, quality assets were captured by the non-state sector due to weak law enforcement. Such entrenchment activities became an increasingly prominent problem, causing social dissatisfaction. To address this issue, the Chinese government launched the fourth stage of its SOE reform, which began in 2002.

3.4. Stage 4: The reform of the state-owned assets management system (2003–2012)

After 2003, China's SOE reform entered a stage focusing on the reform of large and important SOEs. This round of the reform sought to solve the problem of undefined property rights. In other words, who are the owners of the SOEs? The report of the 16th National Congress of the CPC issued on November 2002 pointed out that the government needed to establish a state-owned assets management system, with which the central and local governments could assume the responsibilities of shareholders on behalf of the state, in terms of interests, rights, duties, and obligations. The report also clearly defined the roles of the central and local governments in managing different types of SOEs. For example, the central government should act as the owner

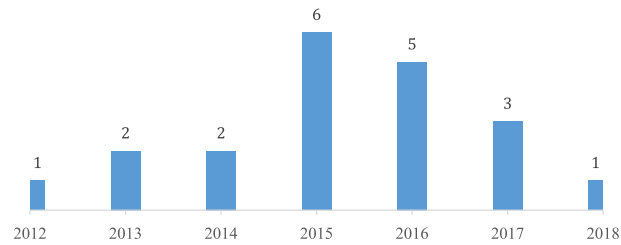


Fig. 3. Mergers of Central SOEs between 2012 and 2018.

for large SOEs in industries perceived to be the lifeline of the nation's economy and homeland security (such as industries in infrastructure constructions or natural resources productions), whereas local governments should act as the owners of smaller and less important SOEs.

Following this decision, in March 2003, China established the State-owned Assets Supervision and Administration Commission (SASAC) to fulfill the role of shareholder for large and important SOEs on behalf of the central government. SASAC is an agency reporting directly to the State Council acting as a shareholder of SOEs on behalf of the state. However, unlike the executive branch of the government, SASAC does not assume any public administrative function. At the time of its establishment, SASAC supervised 189 SOEs, called "central SOEs," which held RMB6.9 trillion (about US\$1 trillion) in assets at the end of 2002.

SASAC launched the board reform of central SOEs in 2003 to increase the number of outside directors and improve their monitoring role in corporate operations. Before the board reform, the board of directors of central SOEs overlapped with their top management, which weakened its role in monitoring and advising the management team. The board reform requires all central SOEs' parent companies to hire outside directors to serve on corporate boards. According to the guidelines issued by SASAC,² outside directors must participate in strategy, funding, and investment decisions and select and evaluate SOE managers. By the end of 2018, 90% of the central SOEs had completed or were in the process of completing this board reform.

3.5. Stage 5: Extensive SOE reform (2012-present)

In November 2012, the 18th Congress of the CPC was convened. It was followed by an unprecedented anti-corruption campaign and the launch by the government of an increasingly comprehensive and thorough reform of SOEs. The core document guiding the reform, entitled "Guiding Opinions on Deepening the Reform of State-owned Enterprises," was published in 2015, along 22 supplementary files. The idea that SOE reform should be guided by one core policy document (the "one"), supplemented by supporting policies (the "N") is called the "one plus N" ("1 + N") policy system.

First, the "1 + N" policy system promotes the reform of SOEs based on their classification. SOEs are classified as commercial SOEs and public service SOEs. Commercial SOEs are further divided into perfect competitive sectors and strategic sectors (i.e., key industries related to national security and national economic lifelines). In this new classification system, the government can discriminatively allocate resources between different types of SOEs. In other words, the government can reduce its support to commercial SOEs and allow them to compete freely with the private sector while providing more resources to public service SOEs.

Second, the "1 + N" policy system aims at strengthening the leadership of the CPC in SOEs. After the 18th National Congress of the CPC, SOEs were mandated to incorporate the CPC's leadership role into their Articles of Association. For example, in an official document, the CPC mandated the board of directors to hear the opinions of the CPC committee of the company before deciding on important issues.

Third, the "1 + N" policy system seeks to reorganize central SOEs. SASAC facilitated the merger of 20 central SOEs during the 2012–2018 period (Fig. 3). China's goals for these mergers ranged from promoting the competitiveness of SOEs to fulfill the "One Belt, One Road" initiative to reducing surplus capacity and advancing

² In July 2004, SASAC published "On Establishing and Improving the Board of Director Trial in Central SOEs," clearly outlining the purpose of the board reform.

“supply-side reform” at home. During this dramatic wave of mergers, the number of central SOEs in China dropped from 189 in 2002 to 96 at the end of 2018.

4. Financing and payout policies of China’s SOEs

4.1. Financing policies

Chinese companies can obtain financing from the financial market, the banking sector, and alternative financing channels (Allen et al., 2005). Overall, stock markets (i.e., the Shenzhen and Shanghai Stock Exchanges) are inefficient in resource allocation because stock prices cannot reflect firm-specific fundamentals. The banking sector is controlled by the government, so SOEs can obtain long-term loans with low creditworthiness requirements, resulting in a large number of non-performing loans. Alternative financing channels include the state budget, informal financing intermediaries, internal funds, foreign investments, corporate bonds, and trade credits (see Fig. 4).

4.1.1. State budget

For a while, China relied on a central planning system, in which the State allocated funds to most companies in the country. Since the reform, the state budget has become a small part of the funds obtained by SOEs. In the end of 2017, about 6% of the funds used by SOEs to finance their fixed asset investments came from the state.

4.1.2. Financial market

In 1993, the CPC Congress approved the “Decision of the CCP Central Committee on Issues Concerning the Establishment of a Socialist Market Economic Structure,” which emphasized the reform of SOEs to restructure their ownership. As part of this plan, two stock exchanges were created in Shenzhen and Shanghai. Today, 1047 SOEs are listed on the Shanghai and Shenzhen Stock Exchanges, and they represent 52% of the market capitalization of these two stock exchanges.

SOEs list their stocks on the stock market through initial public offerings (IPOs) and increase their future equity through seasoned equity offerings (SEOs). SOEs have two types of stocks: non-tradable stocks held by the central or local governments and tradable stocks held by public investors. The IPO process followed a

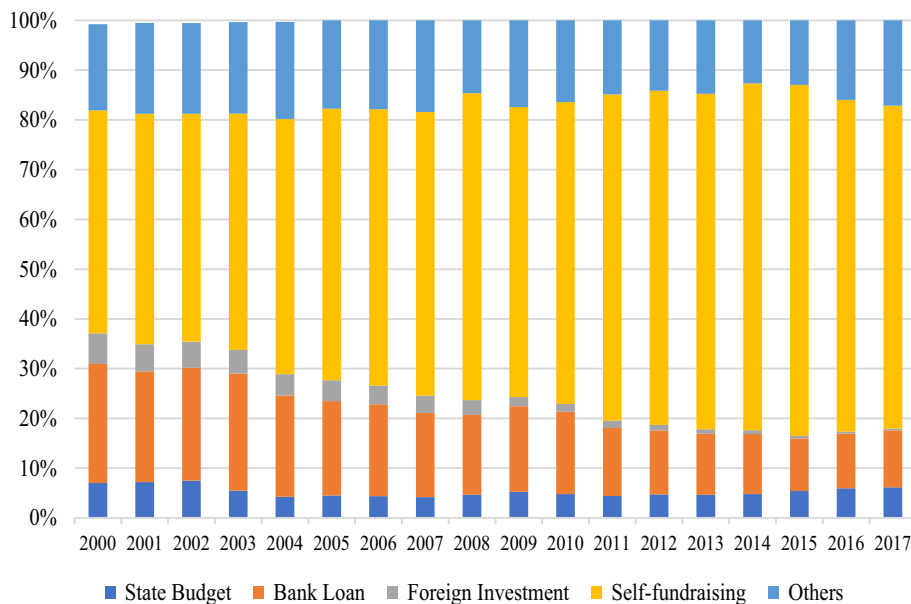


Fig. 4. SOE Financing Channels.

quota system between 1993 and 2000, in which the number of new shares to be issued was decided by the State Planning Committee, the Central Bank, and the CSRC (the China Securities Regulatory Commission). Then, quotas were allocated to each province or bureau with SOEs, which in turn recommended their SOEs for IPOs. The CSRC was responsible for screening SOE applicants for IPOs. The government favored SOEs for approval of rights offering (Green, 2003).

Market regulation policies affect SOEs' decisions to become public. Piotroski and Zhang (2014) show that the imminent political promotion of politicians accelerates the IPO process of SOEs under their jurisdiction because these politicians can be rewarded by the development of the market in the region.

To obtain equity financing, SOEs engage in earnings management activities. Aharony et al. (2000) show that depending on their relationship with the central government and where their stocks are listed, SOEs engage in earnings management ("financial packaging") during IPOs. These authors find that in general, firms with weaker ties to the central government engage in more financial packaging during their IPOs and experience a greater decline in earnings after their IPOs.

In terms of IPO performance, it appears that government involvement in the IPO process leads to IPO underpricing. Jones et al. (1999) show that because the government does not care about IPO returns and uses IPOs for political purposes, SOEs are usually more underpriced than non-SOEs. Chen et al. (2015) confirm that SOEs, especially central-government-owned SOEs, face greater IPO underpricing than non-SOEs.

4.1.3. Corporate bonds

The Chinese bond market has gradually grown. In the mid-1980s, non-governmental bonds were issued, but a third-party debt guarantee was required, and the coupon rate was set by the government. In 2006, a real credit market developed with the first bonds issued without a loan guarantor, indicating the development of a modern corporate bond market in China. At the end of 2017, outstanding bonds reached US\$11 trillion (IMF, 2018).

Livingston et al. (2018) find that bonds issued by non-SOEs receive lower credit ratings, on average one-third of a notch lower, compared with those issued by central-government-owned SOEs. In addition, yields on non-SOE bonds are about 57 basis points higher than those issued by central-government-owned SOEs and 41 basis points higher than those issued by local-government-owned SOEs.

4.1.4. Bank loans

Bank loans are an important financing source for SOEs, largely because the big four banks are controlled by the state. The government owned 67% of the four largest commercial banks in China in 2017.³ State-owned banks prefer to lend to SOEs and discriminate against private firms. Cull and Xu (2000) show that bank loans are more efficient than government transfers in terms of allocating resources to increase productivity. Brandt and Li (2003) argue that SOEs have preferential access to bank loans for several reasons. First, although non-SOEs are more profitable and grow faster, banks may sacrifice profitability and lend to SOEs because of their ideological preferences and the perks generated by loans. Second, state-owned banks may have better information about SOEs and are therefore more willing to lend to them. Third, SOEs are deemed less risky because they will be bailed out by the government in the event of exogenous economic shocks. Using survey data obtained from two Chinese banks, these authors separate these explanations and conclude that SOEs have easier access to long-term bank loans, mainly because bank managers enjoy private benefits from lending to SOEs, namely, building connections with local government officials and obtaining benefits from these political ties. Liu et al. (2018) also find that the Chinese government does not allocate resources equally between SOEs and non-SOEs in the economic stimulus package during a financial crisis. Instead, SOEs have easier access to bank loans.

4.2. Payout policies of China's SOEs

Investigating the dividend policy of SOEs and comparing it with that of non-SOEs, the literature illustrates that ownership is important in terms of dividend payout strategies. Bradford et al. (2013) show that SOEs pay

³ LLS (2002) find that the government owns 99.45% of the 10 largest banks (Allen, 2005).

Table 2
SOE payout policies. This table presents the dividend policies of SOEs and non-SOEs, including cash dividends, stock dividends, and *Zhuanzeng*.

	Mean		
	SOEs	Non-SOEs	T-test
Cash Dividend to Earnings	0.3031	0.3218	-1.21
Stock Dividend Per Share	0.0132	0.0130	0.19
<i>Zhuanzeng</i> Per Share	0.0586	0.2038	-35.84***
Dividend Yield	0.0091	0.0063	18.24***

*, **, *** denote significance at the 10%, 5%, and 1% level, respectively.

more cash dividends than non-SOEs and that the dividend payment increases with the length of the chains of control. In other words, the higher the number of layers between the SOE and the controlling shareholder, the more dividends the firm will pay.

There are several theories about the determinants of dividend payout. The first explanation is tunneling. Chen et al. (2009) propose that cash dividends are a way for the controlling shareholder to expropriate minority shareholders. These authors argue that firms obtain funds from IPOs and divert the proceeds to the controlling shareholder through cash dividends. Thus, the root of this problem is the differential pricing of tradable and non-tradable shares. The second explanation is the clientele and monitoring effect of investors. Firth et al. (2016) show that institutional investor ownership increases firms' dividend payout and that this effect holds in SOEs. The idea is that mutual funds prefer to pay dividends to reduce firms' free cash flow, which in turn curbs managers' empire-building incentives and mitigates the agency problem. The third explanation is information asymmetry. Lin et al. (2017) show that SOEs pay less dividends when information asymmetry is high, indicating that dividends are not used to signal or communicate with the market.

Statistics of payout policies for China's SOEs and non-SOEs are presented in Table 2. Both SOEs and non-SOEs pay about 30% of their earnings to their shareholders, presented in consolidated income statements, with no significant difference in statistics. Similarly, both SOEs and non-SOEs pay 0.013 stock dividends per share to shareholders.

Zhuanzeng (the conversion of additional paid-in capital into common shares) is also considered a form of payout in China. The difference between *Zhuanzeng* and stock dividends is that surplus reserve is converted into common shares through stock dividends, whereas additional paid-in capital is converted through *Zhuanzeng*. These two types of conversion do not affect equity value and simply dilute common shares and decrease stock prices. Table 2 shows that compared with non-SOEs, Chinese SOEs tend to make less conversion through *Zhuanzeng*.

The dividend yield (the ratio of a company's annual dividend to last year's share price) reflects the cash dividend return of a stock investment. Table 2 demonstrates that investors can only obtain a dividend yield of 0.91% each year from Chinese SOEs, but the ratio is still higher than that of non-SOEs.

5. Corporate governance in China's SOEs

5.1. The agency problem in China's SOEs

One prominent characteristic of China's SOEs is concentrated ownership, with the central or local governments acting as the controlling shareholder. Table 3 shows the ownership structure of China's SOEs and non-SOEs between 2003 and 2017. On average, China's central government or local governments hold 40.31% of equity directly as the largest shareholder and have secured controlling rights (about 41.86% of voting rights) as the ultimate owner through direct and indirect controlling links. The Chinese government uses a pyramidal structure to control not just a single firm, but a large number of corporations.

Table 3

Concentrated ownership structure of Chinese listed firms. This table presents the percentage of shares of the largest shareholder, the cash flow rights of the ultimate owner, and the control rights of the ultimate owner for China's SOEs and non-SOEs between 2003 and 2017.

Year	SOEs			Non-SOEs		
	Largest shareholder	Cash flow rights	Control rights	Largest shareholder	Cash flow rights	Control rights
2003	46.612	44.442	46.495	32.926	23.785	31.979
2004	45.837	42.296	45.842	33.956	20.447	31.824
2005	44.366	40.305	44.312	32.479	19.803	31.014
2006	39.441	36.127	40.121	31.794	20.230	30.765
2007	39.082	35.630	39.799	32.889	22.570	32.075
2008	38.918	35.502	39.887	33.847	23.664	32.482
2009	39.553	36.623	40.744	35.266	26.748	34.965
2010	39.507	36.551	40.688	36.842	31.228	37.953
2011	39.558	37.032	41.158	36.984	32.487	38.728
2012	39.744	37.581	41.715	37.159	33.108	39.327
2013	39.828	37.816	41.979	37.259	33.328	39.500
2014	39.592	37.959	41.991	38.456	25.620	32.293
2015	38.789	37.280	41.508	37.414	25.124	31.477
2016	38.259	37.181	41.434	37.937	25.588	31.441
2017	38.261	37.273	41.668	36.332	32.606	37.679
Total	40.306	37.829	41.856	36.483	28.225	35.037

Due to their concentrated ownership structure, China's SOEs have severe agency problems,⁴ in which corporate insiders are the controlling shareholder and managers. On the one hand, concentrated ownership creates a conflict of interest between the controlling shareholder and the minority shareholders (Morck et al., 2005; Young et al., 2008). In China, SOEs are likely to incur significant agency costs when state shareholders (i.e., the government or politicians) tend to maximize social or political benefits instead of maximizing corporate profits (e.g., Fan et al., 2007). For example, China's central and local governments often request firms to absorb excess labor, sponsor public projects, and help jump-start local economies (Fan et al., 2017; Lin et al., 1998; Young, 2000). Prior literature provides strong evidence that this type of government intervention is the main obstacle to operational efficiency and investment in China's listed SOEs (Jiang et al., 2010). SOEs are also likely to incur significant agency costs due to managerial entrenchment when state shareholders have less incentive and ineffective mechanisms to motivate and monitor managers (Morck et al., 2005; Xu et al., 2006; Yang, 1997; Young et al., 2008). Previous studies show that SOE managers tend to overinvest for empire-building and consume excess benefits (Chen et al., 2005; Wang et al., 2014). Thus, China's SOEs suffer from this double agency problem. In this context, corporate governance seeks to mitigate the insider agency problem because of the divergence of interests between the controlling shareholder, minority shareholders, and top managers.

5.2. Is CEO compensation effective?

CEO incentive-based compensation is an important corporate governance mechanism aligning the interests of managers with those of shareholders in the diffused ownership structure. However, CEO compensation is not an effective mechanism for China's SOEs to mitigate the insider agency problem for several reasons. First, in concentrated ownership, the controlling shareholder is in charge of appointing/terminating the CEO and designing the CEO compensation scheme. In China, as the ultimate controlling owner, the government still has a significant and direct effect on the management of SOEs, especially the appointment and termination of top executives (Chen et al., 2013; Ke et al., 2012). Fan et al. (2007) show that the government strengthens its intervention in SOEs by appointing politically connected CEOs and other bureaucrats to the board of

⁴ Under the concentrated ownership structure, corporate insiders tend to appropriate private benefits and thereby expropriate investors because they maximize their welfare as the owner rather than that of outside investors. Stulz (2005) describes this agency problem as "the agency problem of corporate insider discretion."

Table 4

Managerial compensation of Chinese listed firms. This table presents top management compensation for China's SOEs and non-SOEs between 2003 and 2017. Managers' compensation is calculated as the compensation of the top three managers divided by 3. Directors' compensation is calculated as the compensation of the top three directors divided by 3. Stock option dummy is an indicator variable equal to 1 if the firm grants stock options to its top managers during the year.

Year	Managers' compensation		Directors' compensation		Stock option dummy	Stock option percentage
	Mean	Median	Mean	Median		
<i>Panel A: SOE sample</i>						
2003	160,639	118,702	151,746	110,833	–	–
2004	196,940	146,214	171,212	124,896	–	–
2005	212,748	163,866	174,155	119,333	–	–
2006	265,083	200,000	214,577	141,000	0.02	3.89
2007	369,779	257,035	304,230	191,566	0.01	3.04
2008	405,227	288,000	325,305	221,966	0.04	2.84
2009	431,909	320,000	350,609	247,666	0.02	2.77
2010	519,991	383,933	418,771	292,328	0.02	2.69
2011	610,340	443,166	487,363	334,833	0.02	2.64
2012	621,358	476,083	523,277	379,484	0.03	1.92
2013	656,040	500,573	538,918	401,866	0.03	2.28
2014	701,194	514,333	566,614	409,966	0.05	2.26
2015	733,450	553,250	569,302	420,000	0.05	1.83
2016	777,300	574,150	599,206	445,633	0.04	2.48
2017	893,127	637,233	704,067	492,400	0.06	2.99
Total	522,802	366,100	421,018	281,400	0.03	2.54
<i>Panel B: Non-SOE sample</i>						
2003	168,374	118,700	163,079	110,356	–	–
2004	200,459	140,000	194,910	133,000	–	–
2005	213,727	148,366	208,751	133,200	–	–
2006	246,467	160,000	235,042	152,633	0.05	8.28
2007	390,511	196,666	376,177	190,100	0.03	4.72
2008	376,651	234,433	356,621	230,000	0.09	6.39
2009	416,941	262,433	388,546	248,366	0.05	4.47
2010	461,285	321,933	444,347	296,466	0.09	5.31
2011	497,496	368,500	477,864	345,266	0.15	5.19
2012	540,688	393,600	518,856	376,724	0.17	5.53
2013	596,301	417,433	569,448	396,300	0.22	5.20
2014	632,349	452,650	600,900	430,850	0.26	4.22
2015	709,644	491,266	674,199	474,800	0.29	4.36
2016	764,498	544,950	713,943	513,416	0.28	4.27
2017	820,553	594,016	778,953	560,000	0.31	4.73
Total	506,979	340,675	482,357	320,000	0.19	4.73

directors rather than electing directors with relevant professional backgrounds. Second, SOE managers are not only incentivized to increase economic performance but are more likely to fulfill the state's political and social goals in decision-making (Park et al., 2006). More importantly, SOE managers are government officials who will return to a government position when their term as a firm manager ends. Thus, their main incentive to do a good job as a firm manager is to get promoted to a high level government position (Jiang and Kim, 2015). Third, CEO compensation in SOEs has been highly regulated since the government began to seek to maintain social balance between managers and workers in a firm. For instance, "Regulation on Top Managers' Pay in SOEs" published in September 2009 serves to limit the cash compensation of top managers in SOEs. "Trial Measures for Implementing the Equity Incentive System by State-controlled Listed Companies

Table 5

Board directors and independent directors of Chinese listed firms. This table presents the characteristics of the board of directors of China's SOEs and non-SOEs between 2003 and 2017.

	SOE sample				Non-SOE sample			
	Directors		% Independent Directors		Directors		% Independent Directors	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
2003	9.98	9	32	33	9.73	9	33	33
2004	9.93	9	34	33	9.30	9	35	33
2005	9.83	9	34	33	9.11	9	35	33
2006	9.75	9	35	33	8.97	9	36	33
2007	9.74	9	36	33	8.95	9	36	33
2008	9.62	9	36	33	8.82	9	37	33
2009	9.54	9	36	33	8.74	9	37	33
2010	9.55	9	37	33	8.70	9	37	33
2011	9.52	9	37	33	8.63	9	37	33
2012	9.54	9	37	33	8.62	9	37	33
2013	9.49	9	37	33	8.48	9	38	33
2014	9.32	9	37	33	8.35	9	38	33
2015	9.19	9	37	36	8.27	9	38	36
2016	9.20	9	37	33	8.28	9	38	36
2017	9.16	9	37	36	8.24	9	38	36
Total	9.54	9	36	33	8.76	9	32	33

(Domestic),” published in 2006, regulates the incentive-based compensation of top managers in SOEs.⁵ As a consequence, there is little managerial pay for performance sensitivity in China's SOEs (Kato and Long, 2006), even in SOEs cross-listed on the Hong Kong market (Ke et al., 2012). Chen et al. (2013) provide further evidence of weak compensation incentives for the management of China's SOEs. Their findings suggest that state-controlled Red Chip firms' stock option compensation plans were merely window dressing to satisfy foreign investors and were never fully implemented due to the unique managerial labor market of China's SOEs. Therefore, the managerial compensation scheme of SOEs cannot serve as a monitoring mechanism to moderate the insider agency problem. Information on the managerial compensation scheme of China's SOEs and non-SOEs between 2003 and 2017 is presented in Table 4.

5.3. Are independent directors effective?

The board of directors and its independence are often considered the most important internal corporate governance mechanism. In China, “The Code of Corporate Governance for Listed Companies in China” was published jointly on January 7, 2002 by the CSRC and the State Economic and Trade Commission. The Code of Corporate Governance requires Chinese listed firms to have a two-tier board structure (i.e., a board of directors and a board of supervisors). “The Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies” published in 2001 by the CSRC mandated the board of directors of all listed firms to be composed of at least one third of independent directors by June 30, 2003. Regulators in China have made it the primary and legally explicit responsibility of independent directors to monitor insiders (e.g., large controlling shareholders and managers) on behalf of minority shareholders. In Table 5, we provide information on the number of board directors and independent directors in SOEs and non-SOEs between 2003 and 2017.

⁵ Since 2006, a series of regulations on the incentive-based compensation of top managers for SOEs has been implemented. For example, “Trial Measures for Implementing the Equity Incentive System by State-controlled Listed Companies (Domestic)” was jointly published by SASAC and the Ministry of Finance in September 2006; “Notice on the Issues related to the Launch of a Special Campaign to Strengthen Corporate Governance in Listed Companies” was published by the CSRC in March 2007; “Memorandum No. 1 & No. 2 on Issues related to Equity Incentives” was published in March 2008 and “Memorandum No. 3” in September 2008 by the Department of Listed Company Supervision of the CSRC; and “Notice on Issues related to the Regulation of the Implementation of the Equity Incentive System by the State-controlled Listed Companies” was jointly published by SASAC and the Ministry of Finance in October 2008.

Table 6
Blockholders' Ownership (%) of Chinese Listed Firms.

	SOEs sample			Non-SOEs sample		
	TOP1	TOP2-10	TOP2/TOP1	TOP1	TOP2-10	TOP2/TOP1
2003	46.750	15.495	53.673	32.819	25.460	9.929
2004	46.003	16.839	52.428	33.448	26.468	10.925
2005	44.427	17.418	40.688	32.158	25.713	11.477
2006	39.424	17.433	23.895	30.848	25.112	9.490
2007	38.993	17.276	21.822	31.753	24.057	9.616
2008	38.997	16.800	21.833	32.766	23.183	10.236
2009	39.568	16.844	20.541	32.888	23.220	10.306
2010	39.577	17.117	20.930	33.980	26.027	8.651
2011	39.596	17.123	20.783	34.165	26.905	8.012
2012	39.905	17.028	21.351	34.366	26.099	8.526
2013	40.007	17.184	21.867	34.250	24.851	8.315
2014	39.735	17.292	20.440	33.360	24.579	7.932
2015	38.981	18.765	15.034	32.396	26.118	6.877
2016	38.492	20.130	13.287	31.945	27.507	5.926
2017	38.550	20.820	13.273	32.220	28.969	5.513
Total	40.419	17.664	24.539	32.982	26.130	7.862

Do independent directors play a monitoring role in the insider agency problem in SOEs? Many will find this question difficult to answer. First, independent directors have less ability and incentives to restrict the controlling shareholder, as the power of governance is in the hands of the largest controlling shareholder in SOEs. Independent directors are not truly independent. For example, [Zhu et al. \(2015\)](#) find that independent directors are less likely to vote against the proposal of the board, especially in SOEs. Second, empirical evidence of the relationship between independent directors and firm performance is mixed.⁶ A recent study by [Liu et al. \(2015\)](#) provides the first comprehensive and robust evidence of the relationship between board independence and firm performance in China after explicitly accounting for potential endogeneity problems. This study finds that board independence reduces tunneling through intercompany loans and improves investment efficiency, leading to better performance in SOEs. Therefore, independent directors may play a role in limiting managerial misbehavior in SOEs but have a less effective role in limiting the looting of controlling shareholders.

5.4. Are outside blockholders effective?

Non-controlling large shareholders play an important role in corporate governance in emerging markets, in which controlling shareholders' expropriation is a major concern ([Sun et al., 2016](#)). Non-controlling large shareholders have incentives to monitor insiders because of their high ownership stakes in SOEs. According to China's Code of Corporate Governance, listed firms must actively implement the cumulative voting system for the election of directors, especially when the controlling shareholder owns more than 30% of the shares. In this context, non-controlling large shareholders are likely to play an effective monitoring role through board representation in China ([Zhu et al., 2015](#)).

Several studies document the effectiveness of the monitoring role of non-controlling large shareholders. For example, [Zhu et al. \(2015\)](#) show that directors representing non-controlling shareholders are more likely to vote against the proposal of the board in low performing firms and in SOEs. Using data on the split share structure reform in China, [Hope et al. \(2017\)](#) find that both state outside blockholders and non-state outside blockholders have governance effects on SOEs by improving their performance. They also find that this performance improvement is stronger when firms have multiple outside blockholders. [Table 6](#) presents basic information on outside blockholders for Chinese SOEs between 2003 and 2017. As shown in [Table 6](#), the average shareholding of the 2 to 10 largest shareholders is about 18% for listed SOEs and about 26% for listed

⁶ One possible reason is that most controlling shareholders simply hire the minimum number of independent directors ([Jiang and Kim, 2015](#)).

non-SOEs, which indicates that there are significant blockholders. The Herfindahl index of the top 10 largest shareholders (HHI_10) for SOEs is higher than for non-SOEs due to greater ownership of major shareholders. Since the split share structure reform in 2006, the ownership of blockholders in Chinese listed firms has remained stable.

5.5. Takeover market and China's split share structure reform

An effective takeover market is an important external corporate governance mechanism that can discipline managers and mitigate the agency problem (Lel and Miller, 2015; Cain et al., 2017). Indeed, the threat of a takeover gives additional incentives for the board to discipline managers and for the shareholders to discipline themselves to avoid losing control rights. However, there is no active market for corporate control in China. First, the concentrated ownership structure with up to 40% of the shares held by the largest shareholder in SOEs is a barrier to an active takeover market. Second, before 2005, the volume of non-tradable shares was also an obstacle to a market for corporate control because the presence of non-tradeable shares only allowed negotiated (friendly) takeovers. As argued by Hartzell et al. (2004), a negotiated takeover is difficult to interpret as a corporate governance mechanism, as insiders receive fortunes through these mergers. Third, government regulations constrain the takeover market. For example, the only payment method allowed for mergers prior to 2006 was cash.

In 2006, the split share structure reform was accompanied by the adoption of two regulations, “Measures for the Administration of the Share-trading Reform of Listed Companies” and “Measures for the Administration of the Takeover of Listed Companies” published by the CSRC in 2005 and 2008, respectively, which activated the creation of the market for corporate control. The reform effectively removed the legal and technical barriers to the transfer of state-owned shares to public investors. An increasing number of studies document the effects of China's split share reform on firm performance and other economic consequences. Liao et al. (2014) show that the split share reform has boosted SOEs' outputs, profits, and employment, but has not changed their operational efficiency and corporate governance. In addition, the split share structure reform has enhanced the governance role of outsider blockholders by directing their current threats to insiders, thereby improving firm performance (Hope et al., 2017).

5.6. Information transparency

Information transparency enables outside investors to protect themselves from insider expropriation. However, most studies (Fang et al., 2017; Chen et al., 2011) do not find that the quality of auditors improves the quality of information in China's SOEs. For example, Wang et al. (2008) show that Chinese SOEs tend to hire small auditors in the same regions compared with non-SOEs. Similarly, Chen et al. (2011) show that non-SOEs audited by Top 8 auditors have a lower level of earnings management, but not SOEs in China. In addition, controlling shareholders (the government and affiliated SOEs) have incentives to keep the information environment opaque. For example, Piotroski et al. (2015) find that SOEs have political incentives to suppress negative information in response to incentives created by political events that temporarily increase the cost of releasing bad news.

6. Chinese SOEs' participation in corporate social responsibility

Traditionally, SOEs are perceived as initiating and engaging in corporate social responsibility (CSR) activities (e.g., See, 2009) for two reasons. First, SOEs are special entities. They are not necessarily designed to maximize profits, but to fulfil social responsibilities, such as maintaining social stability, reducing unemployment, or promoting the government's prosocial goals (Luo and Zhang, 2009; Qian et al., 2015). In other words, SOEs can be considered “social organizations” with social roles and obligations. Although during economic transitions SOEs evolve from “social organizations” to “economic organizations,” they cannot completely abandon their social obligations (Enderle, 2001). Second, the responsiveness of SOEs to government mandates is the primary driver of managerial decision-making (McWilliams and Siegel, 2001). Therefore, it

will supplement the government in assuming social responsibilities at all levels and responding to its social and political policies.

Carroll (1979) identifies four motivations for CSR activities: economic, legal, ethical, and discretionary (or philanthropic). While economic responsibility (for example, employment creation and fair remuneration for workers) is the foundation of the Chinese economy, the treatment of society/the environment with delicacy and friendliness are two other aspects of CSR that are favored and important for SOEs (Wang and Qian, 2011). In this section, we discuss CSR issues in China's SOEs in terms of employment creation, environmental protection, and corporate giving.

6.1. Employment creation as an example of social stability

Employment creation is the foundation of social responsibility (Carroll, 1979). Given the role of China's SOEs in maintaining social stability, sustaining employment or providing welfare to workers may well be the government's concern (Bai et al., 2006).

China's SOEs were wholly owned by the state until the early 1990s. During the Mao period (i.e., before 1977), the heavy-industry-oriented development strategy did not create enough job opportunities for urban residents. Due to the government's concern for social stability, political interference tended to dominate labor decisions (hiring, firing, and promotion). The absence of a well-functioning and independent social security system in the country required an employment creation strategy that met the cradle-to-grave needs of a large urban population. Although employee salaries only covered their daily consumption, SOEs provided them with lifelong employment and many other benefits and services for free, such as retirement pensions, housing, healthcare, and education expenses for their children. All of these expenses were covered by the state's fiscal appropriation.

When China's reform started in 1978, SOEs dominated China's industrial sectors in all areas. Labor mobility was non-existent. Following China's transition to a market economy, improved labor market mobility led to the rural-to-urban migration of more than 150 million workers. As entry restrictions imposed on non-SOEs were also gradually relaxed, China's SOEs started facing more competitive challenges due to the coexistence of different ownership types. While less regulated and less protected non-SOEs attracted young workers, China's SOEs were forced to create job opportunities by producing surplus products that society did not want. Lin et al. (1998) show that SOEs were not only prohibited from dismissing excess workers but were also forced to employ more workers.⁷ As a result, 20% to 30% of the total labor supply in China's SOEs was redundant (Bai et al., 2006). While private firms could hire temporary workers, SOEs did not enjoy the same flexibility, as they relied mainly on permanent workers assigned as part of the central planning system of the government. This led to alternating cycles of labor shortages and surpluses in firms (Nee, 1992). In addition, China's SOEs suffered from aging facilities, aging workers, and the heavy burden of social services (Lee, 2001). Most aging workers in SOEs were uneducated, indicating an inferior workforce.

This heavy burden on China's SOEs with redundant and aging workers and many retired employees led to competition for the distribution of SOEs' retained earnings between the state and the labor force (Boisot and Child, 1988), which limited the operations of SOEs and resulted in low economic efficiency. In 1996, after 18 years of gradual transition, the share of SOEs in China's total industrial output dropped from 77.6% in 1978 to 28.8%. However, SOEs still employed 57.4% of urban workers and held 52.2% of total investment in industrial fixed assets (Lin et al., 1998). In a country where the main goal of SOEs is to maintain social stability, it is not surprising that SOEs lost to non-SOEs on all possible performance measures because of their heavy burden.

Since 1992, the layoff of many redundant workers has invariably started to promote SOEs' efficiency. Across the public sector, new employees are no longer hired for life. With the adoption of the modern enterprise system in the early 1990s, the internal work environment of SOEs has become increasingly dynamic and

⁷ In mature markets, firms are free to make employment decisions and let the separate social security system take care of redundant workers. Therefore, labor surplus is normally non-existent.

Table 7
Employment and wages in China's public sector between 2000 and 2017.

Year	Total employment (million)	Total urban employment (million)	Total employment in urban units (million)	Total employment in urban state units (million)	Average annual employee salary in urban units (RMB)	Average annual employee salary in state units (RMB)
2017	776.40	424.62	176.438	60.64	74,318	81,114
2016	776.03	414.28	178.881	61.70	67,569	72,538
2015	774.51	404.10	180.625	62.08	62,029	65,296
2014	772.53	393.10	182.778	63.12	56,360	57,296
2013	769.77	382.40	181.084	63.65	51,483	52,657
2012	767.04	371.02	152.364	68.39	46,769	48,357
2011	764.20	359.14	144.133	67.04	41,799	43,483
2010	761.05	346.87	130.515	65.16	36,539	38,359
2009	758.28	333.22	125.73	64.20	32,244	34,130
2008	755.64	321.03	121.925	64.47	28,898	30,287
2007	75.321	309.53	120.244	64.24	24,721	26,100
2006	749.78	296.30	117.132	64.30	20,856	21,706
2005	746.47	283.89	114.04	64.88	18,200	18,978
2004	742.64	272.93	110.989	67.10	15,920	16,445
2003	737.36	262.30	109.697	68.76	13,969	14,358
2002	732.80	251.59	109.852	71.63	12,373	12,701
2001	727.97	241.23	111.658	76.40	10,834	11,045
2000	720.85	231.51	116.125	81.02	9333	9441

challenging, with extensive training and retraining programs organized to help employees adapt to the challenges of new work demands.

Despite efforts to reduce redundancy, statistics show that in 2017, the employment rate of SOEs⁸ accounted for about 34.37% of total employment in urban units, even with China's total industrial output in the public sector reduced to 19.75%.⁹ According to statistical data, the average annual salary of SOEs and non-SOEs has increased substantially since 2000, but the dynamics of salary growth of SOEs are more vigorous. The average annual salary of employees of SOEs is 8.38% higher than that of non-SOEs.¹⁰ Of the 980,300 above-scale corporate entities in 16 industries surveyed by the State Statistics Bureau in 2017, the average annual salary of employees was RMB61,578. In contrast, the average annual salary of employees of SOEs was RMB78,549, the highest of all above-scale enterprises surveyed.¹¹ Table 7 provides detailed information on the evolution of China's employment and wages since 2000.¹²

6.2. SOEs' actions to protect the environment

While the market expects firms to fulfill its economic mission within the framework of legal requirements, firms are expected to do what is right, just, and fair to fulfill their ethical responsibility (Carroll, 2004). In addition to the important role played by Chinese SOEs in employment, as discussed above, the country has witnessed substantial growth in CSR-related activities (Zhang et al., 2010), as the Chinese government has strongly promoted the concept of CSR and encouraged corporations to actively engage in socially responsible activities, including environmental protection and corporate philanthropic giving.

Previous studies analyze how the spread of CSR norms and practices in China has driven and been fueled by regulators' attention to CSR (See, 2009; Moon and Shen, 2010; Wang and Qian, 2011). In a broader context, the Chinese government and the CPC have issued numerous pronouncements about the importance of all citizens and organizations increasing their social responsibility (e.g., the sixth plenary session of the 16th Party Central Committee, 2006) and about the national commitment to enhancing China's capacity for sustainable development (e.g., President Hu Jintao's report to the 17th National Congress of the CPC, 2007; President Xi Jinping's reports to the 18th and 19th National Congress of the CPC, 2012 and 2017). A number of CSR guidelines and initiatives have been published as a strategy for large companies to balance the social and environmental effects of rapid economic growth.¹³ These administrative, regulatory, and legal documents emphasize the determination of government policies to promote the adoption of CSR by SOEs.

In China, disclosing environmental protection information is a mandatory requirement of regulators rather than a voluntary action of firms. Although mandatory CSR disclosure modifies firm behavior and generates positive externalities, with evidence proving that firms reporting mandatory CSR experience a decline in profitability, Chen et al. (2018) find that firms spending more on environmental protection are those of the most polluting industries, not SOEs in particular. Given that political connections motivate political rent-seeking in SOEs, corporations obtaining a "green image" and becoming a "green company" by providing environmental reports become the capital of executives' promotion. Firms run by former government officials are more likely to spend on CSR to seek private political benefits (Hung et al., 2012). For instance, Cheng et al. (2017) find that political connections can significantly increase the level of corporate environmental information disclosure (CEID), especially in highly polluting industries.

⁸ Due to data availability, we use statistics for employment and employee salaries of state units to replace those of SOEs. However, state units may include not-for-profit organizations. We also assume that all state units are located in urban areas.

⁹ Source: <http://www.stats.gov.cn>.

¹⁰ In addition, SOEs still enjoy the benefits of resource allocation. SOEs' total investment in industrial fixed assets accounted for 38.5% if all domestic companies in the same year, while the number of SOEs only accounted for 5.02% of all above-scale industrial enterprises (Source: <http://www.stats.gov.cn>).

¹¹ Details are provided at http://www.stats.gov.cn/tjsj/zxfb/201805/t20180516_1599565.html.

¹² Source: <http://www.stats.gov.cn>.

¹³ "Guidelines on Social Responsibility of Companies Listed on the Shenzhen Stock Exchange" issued by the Shenzhen Stock Exchange in 2006 and "Guidelines for Listed Companies to Reveal Environmental Information" issued by the Shanghai Stock Exchange in 2008 require listed companies to disclose CSR information using the stand-alone CSR report or their annual reports.

6.3. Corporate philanthropic activities of SOEs¹⁴

Corporate giving is considered as a strategic decision of firms. Engaging in corporate philanthropic activities can be opportunistic and potentially linked with a manager's pursuit of self-interest (McWilliams et al., 2006). From the government's perspective, SOEs' philanthropic contributions can promote the socially responsible public image of the government and reduce its financial burden. When the government fails to fund adequate public services, it encourages firms using financial resources to make philanthropic donations. Therefore, SOEs' contribution decisions are at least partially driven by the desire to fulfill their corporate and social obligations to the Chinese government (Luo and Zhang, 2009), especially because SOEs have strong political attachments and connections.

Corporate philanthropic giving in China has grown rapidly.¹⁵ According to statistics, philanthropic donations from China's listed companies in 2017 totaled about RMB7.2 billion (about US\$1 billion), up 14.71% from the previous year, of which RMB3,776 billion came from SOEs. The total contributions of SOEs in 2017 represented 2.49% of their total assets (RMB151,711 billion in 2017).

Deciding whether to give, how much to give, and what to give is a discretionary judgment and choice of firms (Carroll, 1979). Many factors driving China's growth in philanthropic giving have been studied. As CSR information disclosure is mandated in China, the controlling shareholders of SOEs are reluctant to donate their assets or resources to charitable organizations (Tan and Tang, 2016). Given that Chinese firms engaging in corporate giving activities do not receive equal benefits from these activities (Wang and Qian, 2011), corporate giving from SOEs may not reflect their general concerns about different stakeholders or their responses to them (Qian et al., 2015). Previous research shows that SOEs in China can effectively balance multiple stakeholders in terms of legitimacy building with the government while still seeking to maximize shareholder profits (Bruton et al., 2015).

See (2009) argues that SOEs only engage in CSR based on the benefits they can extract. Similarly, Du et al. (2014) state that "SOEs have passive, involuntary attitudes toward philanthropic giving." (pp.238) Evidence from other studies shows that SOEs engaging in corporate giving are less associated with corporate financial transparency, corporate misconduct, or tunneling than their non-SOE counterparts (Du et al., 2014; Qian et al., 2015). In addition, using data from the CSRC web pages, Li and Zhang (2010) show that SOEs donate less than private firms.

7. Conclusions and future studies

China's SOE reform has been central to China's economic reform over the last 40 years. Therefore, many studies examine and explain SOEs' performance, financial behavior, corporate governance, and social responsibility. The literature on the theories of SOEs is well developed, and the reform of Chinese SOEs is based on these theories and an empirical approach in practice. However, current research reaches no consensus on what the best practices are for Chinese SOEs. For example, given their externalities, why do SOEs perform well and support China's rapid economic development? How can the SOE system be linked with the Chinese political system to become efficient? Future research should build on current evidence of the inefficiency of state ownership and focus on constructive suggestions on how to improve SOE efficiency based on the political ecosystem of China.

A remarkable feature of SOEs is their corporate governance, which is a nexus of formal and informal institutions, contracts, and corporate policies to address conflicting objectives between insiders and outsiders. Concentrated ownership increases the complexity of agency problems in Chinese SOEs. Unlike those in the western companies, insiders in Chinese SOEs are the controlling shareholders and managers. Evidence is

¹⁴ As early as 1999, the "Public Welfare Donation Law" was published during the tenth plenary session of the 9th Standing Committee of the National People's Congress to encourage and normalize philanthropic giving and receiving of Chinese companies. In 2009, SASAC published "Notice on Reinforcing Corporate Giving in Central SOEs," setting specific rules for the scope, scale, approval, and procedure of corporate giving for central SOEs.

¹⁵ China's total philanthropic giving was RMB139,294 billion in 2016, accounting for 0.19% of GDP, compared to 2.1% in the US and 0.52% in the UK (<http://www.gongyishibao.com/html/gongyizixun/12735.html>).

mixed regarding whether and how different types of corporate governance mechanisms (e.g., laws, regulations, contracts, corporate policies) contribute to corporate value maximization. We deemed the following questions interesting. First, it would add insights to the existing literature to investigate the roles of SOEs' managers and board members in the labor market, since individuals, including managers and board members, make decisions based on their knowledge and incentives (Brickley and Zimmerman, 2010), which depends on the efficiency of the labor market. Second, existing evidence regarding how corporate governance mechanisms interact is scarce, which can be supplemented by future research. Third, the functioning of corporate governance mechanisms still depends on the quantity and quality of information. Using new data technologies, such as big data, future research should analyze the effect of new data and information dissemination technologies on the functioning of corporate governance mechanisms.

The analysis of CSR activities in China's SOEs allows us to understand the current state of research and practice and to further explore research questions in this area. First, in recent decades, the CSR practices of Chinese SOEs have been considered as a burden and as discretionary activities required by the government, leading to inefficient practices. The Chinese government is the primary resource allocator of the economy, and is expected to build a harmonious society through initiatives in promoting employment and employee benefits, training and education, environmental protection, and poverty alleviation. The Chinese SOEs respond to the orders and recommendations of the government. Although Friedman (1970) argues that the social responsibility of a business is to increase profit, other researchers view that integrating social responsibility and profit maximization facilitates social changes (Mulligan, 1986). Over the last two decades, studies have addressed important questions about the creation of goodwill, reputation, image, or status, collectively and loosely termed "social evaluations." Therefore, future research can contribute to the literature by examining how organizations seek and benefit from social evaluations (George et al., 2016; Wang et al., 2016). While the Chinese government strongly encourages CSR practices, CSR is likely to go beyond companies doing the right thing. To some extent, the CSR practices of Chinese SOEs shift their production and profitability responsibilities to help maintain social stability. With the spread of CSR norms and practices in the country, the number of NGOs in China is increasing, creating a demand for improving business reputation (Moon and Shen, 2010). As a result, Chinese SOEs must work effectively with many stakeholders (Bruton et al., 2015) to meet the CSR requirements set by the government to avoid reputational damage and conflicts of interest. Therefore, future research should focus on the pressures, incentives, strategies, and economic consequences of CSR decisions made by SOEs in China.

Finally, the theories and practice regarding the Chinese SOEs and the "China puzzle" seem to suggest a new explanation of the Chinese SOEs – the social enterprise theory. Social enterprises refer to a prime example of hybrid organizations in Western countries; they were created to achieve social goals, yet through business methods (Brakman Reise, 2013). Therefore, they are different from for-profit and not-for-profit organizations, and can be defined as organizations that integrate both social logic and financial logic (Battilana and Dorado, 2010).

Chinese SOEs are companies fitting the social enterprise concept in that they are set to balance the demand of multiple stakeholders effectively (Bruton et al., 2015). More important, China's institution provides a better supporting ecosystem for SOEs to reinforce the creation of social value when pursuing value maximization. SOEs could sacrifice profits and efficiency to fulfill social roles when necessary. Such a characteristic enables the Chinese government to focus on developing social welfare with supporting economic infrastructure, and thus makes the "China puzzle" feasible. We believe using the perspective of social enterprise to explain the Chinese SOEs will enrich future studies regarding SOEs.

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