

CRITIQUES ON THE WEBERIAN MODEL OF MODERNIZATION: THE CASE OF CHINA'S STATE INDUSTRY REFORM

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Abstract: Weberian model of modernization presumes that economic progress requires the replacement of traditional institutions and values with a modern bureaucracy and a culture of law. Since the early 1990s, Chinese government not only introduced a variety of Western style "modern enterprise system" but also made efforts to establish a sound economic legal framework to provide the elements necessary for economic actors to carry out activities in a more market-oriented environment. However, this research shows that the introduction of impersonal market mechanism and its practices as well as the introduction of laws to support the market system have not caused the decline of informal-personal practices in China's state industry sector.

INTRODUCTION

Each transition of a country's political and economic environment is affected by inherited political, economic, and legal structures as well as cultural and social factors. The transition in turn determines the conditions, barriers, constraints, and opportunities, under which economic factors must operate. The informal-personal relationships between Chinese individuals have been widely viewed to predominate over formal-impersonal structure before, during, and after the Mao's era. "*Guanxi*" (personal relationship) or "*guanxi wang*" (personal network) has been cited as a significant and enduring factor in explaining the pattern of Chinese societies. The prevalence of *guanxi* practices in Chinese societies has been considered as one of the greatest obstacles to China's transition to "rule of law."

The Weberian model of modernization presumes that economic progress requires the replacement of

traditional institutions and values with a modern bureaucracy and a culture of law.¹⁾ China's continuing economic reforms raise an important question: To what extent has the market system changed the traditional nature, role, and pattern of Chinese informal-personal behaviors? It may seem natural to expect that the role of informal and personal power would be downplayed by the impersonal market mechanisms and the entrance of new players like private enterprises and businesspersons into a game played under new rules. Given the understanding of Chinese traditional culture, however, it is still highly questionable whether the introduction of impersonal market mechanisms and its practices have caused the decline of informal-personal practices in China's economic development. Thus, we need to examine carefully whether there is any necessary correspondence between the emergence of markets and the decline of informal-personal relations.

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1) Max Weber, (Guenther Roth and Claus Wittich, eds.), *Economy and Society: An Outline of Interpretive Sociology* (Berkeley: University of California Press, 1978), p. 11.

WEBERIAN MODERNIZATION THEORY

Every political system and formal organization is the product of the interaction of the two political forces: formal-impersonal structure and informal-personal power. In one form or another, informal-personal politics is manifest in a variety of contemporary and historical settings, both Western and non-Western. Scalapino makes a clear distinction between formal and informal politics. The term "formal politics" is characterized by "an institutional structure that had legal sanctity - 'the state' in official terms," while "informal politics" essentially refers to "patterns of political behavior between and among individuals and groups in any given society."²⁾ In many respects, the notion of informal-personal dimension in politics corresponds with Max Weber's ideas of patrimonialism, whereas formal-impersonal dimension in politics roughly equates with his ideal type of rational-legal rulership.

In Weber's descriptions, rational-legal authority rests in "the legally established impersonal order,"³⁾ while patrimonial authority is based on "a strictly personal loyalty."⁴⁾ In a system of legal-rational authority, rulers are subject to the same laws as everyone else, and obedience is given to norms rather than to persons.⁵⁾ Likewise, the major aspects of formal-impersonal structure are characterized by the formalization, legalization, depersonalization, and institutionalization of politics that are the conditions and necessary ingredients of the rule of law. Power relationships are regularized, standardized, and depersonalized within formal-impersonal arrangements. In contrast, patrimonial

authority depends primarily upon the "personal relations of subordination" and "personal considerations" like favors, promises, and privileges that are dispensed according to "personal discretion."⁶⁾ Patrimonial authority is maintained through extensive networks of personal patronage rather than through ideology or impersonal law. The personal loyalties are closely linked to material incentives and rewards.⁷⁾ The level of personalized politics is therefore high in the patrimonial environment.

Yet, Weber's patrimonial power focuses on the "personalized" administration and recruitment process in traditional political culture before 1789 (e.g., the Middle Ages, French Absolutism, etc.). Many modern regimes do not rely on traditional forms of legitimation or on hereditary succession. These are mostly different from modern patron-client relations. Today's patron-client relations also have been frequently linked with or treated as synonymous with patrimonialism by some scholars.⁸⁾ Given the imbalance of the power between official patrons and entrepreneurial clients, this is one particular form of informal and personal relations. There are many other forms of informal and personal relationships between equals or near-equals.

Most of all, Weberian modernization theory presumes that traditional institutions are not being supplanted by the formal-rational institutions of the modern economy. The role of *guanxi* in China's state industry sector also provides one of the most important examples of an entrenched cultural norm

2) Robert A. Scalapino, "Informal Politics in East Asia: Introduction," *Asian Survey*, Vol. 36, No. 3, March 1996, p. 227.

3) Max Weber, *op.cit.*, p. 125

4) *Ibid.*, p. 1006

5) *Ibid.*, p. 954.

6) *Ibid.*, p. 231.

7) Guenther Roth, "Personal Rulership, Patrimonialism, and Empire-Building in the New States," *World Politics*, Vol. 25, No. 2, January, 1968, pp. 194~206.

8) Barret L. McCormick, {check spelling of this name} *Political Reform in Post-Mao China: Democracy and Bureaucracy in a Leninist State* (Berkeley: University of California Press, 1990), p. 15 and Andrew G. Walder, *Communist Neo-Traditionalism: Work and Authority in Chinese Industry* (Berkeley: University of California Press, 1986).

that is under pressure from international business trends. This paper examines to what extent the adaptation of the state industry sector to the institutions of a market economy has been conditioned by the formal-rational institutions of the modern economy. This article demonstrates that throughout China's reform process, informal-personal relations remain extremely important for Chinese administrators and entrepreneurs, even in an environment of expanding market relations and transformation of enterprise property rights.

REFORM OF ENTERPRISE PROPERTY RIGHTS AND CORPORATE GOVERNANCE STRUCTURE

The state industry sector has been the foundation in China's economy. Reform of state industry sector has been an incremental process. The reforms in the first stage, corresponding to the fifteen years between 1978 and 1993, feature "particularistic contracting," through which the incentives of economic agents were improved and, at the same time, existing interests were also protected. Through experimentation and innovation, a variety of transitional institutions emerged, many of them taking unconventional forms. Until 1993, however, political and ideological factors precluded property rights reform in the state sector. In the second stage (after late-1993), China has shifted its focus to the reform of the ownership structure and the operational mechanisms of state enterprises by setting a goal to establish a rule-based market system. In brief, Chinese state-owned enterprises (SOEs, hereafter) were first allowed to introduce managerial incentive contracts, then to diversify types of ownership and to establish a rule-based corporate governance system.

The new "Company Law" (*gongsifa*) provided a

legal framework for the organization and operation of Chinese enterprises.⁹⁾ This legal framework was designed to facilitate entrepreneurial incentives, increase business efficiency and provide a level playing field that would allow competition to thrive and mitigate the importance of informal networks and political connections. At the 15th Congress of the Chinese Communist Party, held in September 1997, the Central Committee endorsed both the corporatization of large SOEs and the restructuring of small SOEs and decided to step up the pace of reforms. Its central component was "*zhuada fangxiao*" (grasping the big, letting the small go). The notion of "grasping the big" involves two related sets of reforms. First, the government created a number of large enterprise groups with extensive cross-ownership by encouraging mergers in "pillar industries." Second, more efficient, large SOEs were encouraged to list on the stock exchange in order to promote ownership diversification and raise revenue for restructuring. The concept of "letting the small go" provides for further experimentation with ownership reform in small- and medium-sized SOEs including bankruptcies, mergers, and shareholding reform. To support this transformation, the state made a sincere effort to construct the rational-legal economic system that would control the ways in which managers and SOEs would operate.

The Company Law created two types of organizations: the "limited liability company" (*youxian ziren gongsi*) and the "shareholding limited company" (*gufen youxian gongsi*). Both are independent legal entities or legal persons (*faren*), subject to civil laws, liable for their debts, and responsible for their profits and losses. Enterprises are incorporated by means of share offer. Ownership of a shareholding enterprise is defined under Article 4 of the Company Law by the proportion of

9) The Company Law was approved by the National People's Congress in April 1994, and came into effect in July 1994.

shares each shareholder holds.

Corporate governance is a set of institutional arrangements governing the relationships among the investors (shareholders and creditors), board of directors, and managers. The structure of corporate governance concerns (a) "how control rights are allocated and exercised," (b) "how boards of directors and top managers are selected and monitored," and (c) "how incentives are designed and enforced."¹⁰ Specifically, shareholders have the right to select a board of directors, the right to access information and the right to make strategic decisions. Creditors have priority of payments and have the right to seize collateral and the firm's assets after bankruptcy. Boards of directors have fiduciary duty—the duty of loyalty-toward shareholders, and members of the board can be sued for breach of fiduciary duty. Overall, the rights of shareholders in Chinese shareholding enterprises are, in theory, similar to those of Western companies, including rights to limited liability, election of a board of directors, receipt of dividends, exercise of a residual claim against corporate assets and vote by proxy.

The policy to restructure SOEs into shareholding companies represents a rational and logical step by separating SOEs from the state bureaucracy. To reduce state control, which is believed to encourage inefficiency, the reform attempts to clarify the ownership structure of SOEs by restructuring them into shareholding companies. Although primary ownership would remain with the state, SOEs would be reorganized and run as corporations under the modern entrepreneurial methods. The government would refrain from directly interfering in the production and management of SOEs. Enterprises would organize production according to

the market demand. Rather than act as agents of the state, enterprise directors would be free of party and bureaucratic control and the state would be relieved of its unlimited responsibility for the enterprises. However, this task seems very difficult for China. In the light of the "plan" versus "market" mode of governance, the Chinese political economy, under socialist institutional conditions, is still halfway between a plan and a market economy. Thus, we need to examine carefully how this has been done, and to what extent the formal legal framework has been contradictory to, or compatible with, corporate and social realities.

THE CONTINUING INFLUENCE OF GOVERNMENT AND COMMUNIST PARTY APPARATUS

In the first stage of enterprise reform, China tried to achieve two major goals: *gaohuo qiye* (invigoration of enterprises) and *zhengqi fenkai* (separation of political power from administration of enterprise). In reality, however, the party-state would not allow itself to wither away. The top leadership of SOEs, particularly of the larger ones, is controlled by the Communist Party. SOEs are closely tied in a hierarchical relationship to the government bureaucracy. The various bureaucracies under which SOEs fall could more or less interfere at will in enterprise affairs, or shirk their responsibility for SOE oversight by implicating other bodies.¹¹⁾

This situation led to the absence of a clear

10) Yingyi Qian, "Government Control in Corporate Governance as a Traditional Institution: Lessons from China," Joseph E. Stiglitz and Shahid Yusuf, eds., *Rethinking the East Asian Miracle* (Oxford: Oxford University Press, 2001), pp. 312~313.

11) Barry Naughton, "Hierarchy and the Bargaining Economy: Government and Enterprise in the Reform Process," and Andrew G. Walder, *Local Bargaining Relationships and Urban Industrial Finance*, Kenneth G. Lieberthal and David L. Lampton, eds., *Bureaucracy, Politics, and Decision-making in Post-Mao China* (Berkeley: University of California Press, 1992), pp. 245~279 and pp. 308~333.

division of labor between the state and SOE management. Under the rapidly changing economic conditions of the first stage, the dual nature of reform exposed the underlying problems: namely, the implicitly collusive coordination among local officials, managers and workers. It gave rise to severe mal-practices in the administration of state-assets.

Even under the modern enterprise system reforms, the Party apparatus does not give up its most important power lever: the monopolization of personnel matters. The Party still appears to retain tight control over the individuals leading the shareholding companies. China's official survey conducted by the State System Reform Committee (*guojia tizhi gaige weiyuanhui*) shows that the majority of directors and managers are still appointed by governments or their supervisory bureaucracy.¹²⁾ (SOE directors and managers are still approved in advance by the supervising administrative apparatus even when they are elected.¹³⁾ Before the candidates for managers, board of directors members and supervisory committees are nominated, it is well known that the SOE talks intensively with the local governments and party officials behind closed doors. Moreover, in almost every case, only one candidate is nominated. In fact, the current and future careers of SOE leaders are still in the hands of the supervisory bureaucracy. Agendas of board meeting and shareholder general meetings are distributed and decided in advance, in secret, although all decisions

appear to be made through an open vote. Moreover, most of the listed companies are still majority-owned by the state and other state-owned enterprises. In other words, they are owned by the state through central or local ministries and departments as well as other state-owned enterprises as a form of state legal entities. Thus, the shareholders who elect the directors and supervisors are, in effect, the government ministries. The election of directors and managers may signify nothing more than the ratification of the already appointed person to complete the formal procedure.

Furthermore, a great many directors and managers at the top of state-owned corporate hierarchy are former bureaucrats and members of party cadres who served in the sectorial administrative bureaus.¹⁴⁾ The original managers and party officials hold the key positions of the board and supervisory committee in the new shareholding companies. This whole process has strengthened the long-term informal and personal cooperation between individuals in their circles. The local officials, party cadres, and state entrepreneurs have been closely linked through institutional ties and the overlapping of personnel. It is often hard to define a clear-cut boundary between the various institutions in the Chinese political economic system.¹⁵⁾ The insti-

12) The 1993 survey claims that 92.2% of SOE directors and managers are appointed by supervisory bureaucracy; 48.6%, collective enterprises; the others, 16.8%. Wansheng Liu, Guoyou Konggu Gongsi Yanjiu [Research on State-controlled Shareholding Companies] (Beijing: Jingji Kexue Chubanshe, 1998), p. 135.

13) This was constantly confirmed in a number of interviews I conducted with bureaucrats, managers and directors of SOEs between early-2000 and mid-2001.

14) Most notable are the directors who are directly sent down or appointed by their supervisory bureaucracy. They are expected to serve the interests of the state by accommodating the wishes of their superiors. They cannot afford to ignore the bureaucrat's directives, because their future career is in the hands of the supervisory bureaucracy.

15) This has been true in Yanbian Prefecture. For example, the institutional boundaries and affiliated personnel are overlapped among Yanbian Prefecture Tobacco Monopoly Bureau of Jilin, Yanbian Branch of Jilin Tobacco Corporation, and Yanji Cigarette Factory of Jilin. The factory director (*changzhang*) is concurrently the head of the bureau (*juzhang*), the chief secretary (*mishuzhang*) of the prefecture government and the vice-head (*fujuzhang*) of its higher-level government -- Tobacco Monopoly Bureau of Jilin Province. His assistant director (*changzhang zhuli*) is also concur-

tutional *guanxi* is strengthened by the multiple personal *guanxi* embedded among them. Currently, the frequent formal and informal contacts between firms and governmental officials indicate a continuation of this pattern. Such contacts are easy to organize and likely to be grounded in a personal relationship. Individuals naturally tend to network with people within their social strata where they can make frequent contact. Work colleagues and partners also are included in this *guanxi* category. Normally, network bridging and relational transfers, rather than the transfers of tangible resources, are the main mechanisms through which their *guanxi* capital is accumulated. Implementation of many new laws based on the market demands are subject to personal interpretation of the local officials as will be discussed in the next section. The widely recognized extensive personal network (*guanxi wang*), underlying much of China's economic institutions and transactions, affects the nature of the interaction between SOEs and local government, and provide powerful enforcement mechanisms when the potential for disputes arises. In this manner, the informal and personal behavior of local officials and SOE managers has not been changed even after their firms converted into shareholding corporations. They still function in the same old way.

As Table 2 demonstrates, the board and management are often comprised of the same members. While companies under the modern enterprise system reform have nominally set up a

rently the general manager (*zongjingli*) of the factory and the assistant head of the bureau (*juzhang zhuli*). It is extremely common in China that many officials simultaneously wear several hats at different institutions and levels of governments. The long lists of current and former position titles on their name cards not only denote the richness of *guanxi* nurtured through their work careers, but also show the complexity of their institutional affiliations. This information was gained from interviews with the vice-general manager of the factory, in Jilin, January 2001.

governance system with the so-called *xinsanhui* - a board of directors, a supervisory board and shareholders general meetings - they are often ineffectual and have no clear division of responsibilities. To a considerable degree, the committee of the Chinese Communist Party still influences the appointment and removal of the principal managers and chairperson of the board of the supervisory agencies of local governments. Yet, the committee itself became relatively less influential as the modern enterprise system reform (*xiandai qiye zhidu gaige*) proceeded.¹⁶⁾ Instead, the Party secretaries themselves started to shift the focus to the management of the company from political and ideological affairs. For example, since early 2000, all the political affairs of the road construction company in Table 1 have been handled by not the party secretary, but by the vice-party secretary.¹⁷⁾ As seen in Table 2, in some shareholding companies that were transformed after 1994, there was a fusion of the board of directors and the party committees.¹⁸⁾ The rationale was that a fair amount of overlap would minimize internal bickering between the two major power organizations.¹⁹⁾

16) In case that the Party secretary is not in accord with the managers and local government officials, the authority of the party in appointment and especially in the dismissal of managers, serves as an important counterbalance against managerial discretion. In reality, however, that seems rare.

17) It should be noted that in Table 4.2 all ranking officials, including supervisors (*buzhang*), are Communist Party members. In fact, non-party members cannot hold directorships or management positions in SOEs.

18) According to the party secretary of Guangzhou, Gao Qiren, in a shareholding company, his company can experiment with the system of the party secretary doubling as board chair and general manager. He suggested that China must further rationalize the system of the party and political leadership of enterprises. He added that it is all right for the factory director and the party secretary to be the same person. Sujiao Guo, *Post-Mao China: From Totalitarianism to Authoritarianism* (Westport: Praeger, 2000), pp. 188~189.

19) Willy Wo-Lap Lam, *China After Deng Xiaoping*

Table 1. Corporate Positions Held by the Head of Party Organization

Positions held concurrently by the head of party organization	%
Chairman of the board of directors	24
Vice-chairman of the board of directors	39
General Manager (<i>zongjingli</i>) or Vice-general manager	32
No other positions	5

Source: Modified from the 1995 survey result in On Kit Tam, *The Development of Corporate Governance in China* (Cheltenham: Edward Elgar, 1999), p. 80.

Table 2. Composition of Laosanhuai and Sinsanhui

Three Old Committees (<i>Laoshanhui</i>)	Three New Committees (<i>Xinsanhui</i>)
Committee of the Communist Party (<i>dangwei</i>)	Board of Directors (<i>dongshihui</i>)
Workers Representative Council (<i>zhigong dahui</i>)	Board of Supervisors (<i>jianshihui</i>)
Workers Union (<i>gonghui</i>)	Shareholders General Meeting (<i>gudong dahui</i>)

After the Party secretaries started to join corporate management, the three major powers - the board chair, the general manager, and the Party secretary - usually colluded. The so-called *sanweiyiti moxing* (the Trinity model) problem arose.²⁰ The Workers Representative Councils and Workers Unions of the old committees (*laoshanhui*) do not appear to have played a very active role in the public listing of SOEs, although they have not been phased out. The Workers Representative Council has lost much of its relevance and essentially ceased to function since the introduction of the Company Law, the Bankruptcy Law, and the new Social Insurance Law. Neither does The Workers Union does not seem to have actively participated after the

shareholding reform (*gufenzhi gaige*).²¹ A 1997 study shows that only 6.2% of all appointment arrangements of SOE managers were influenced by workers, whereas 67.4% of them were appointed directly by their supervisory bureaucracy.²²

CORRUPTION IN THE TRANSFORMATION AND REORGANIZATION OF SOES PROPERTY RIGHTS

It is now regularly reported in the Chinese media that state property, particularly the assets of SOEs, is being illegally siphoned off and depleted (*guoyou zichan liushi*). The local officials and enterprise insiders, with a political mandate for development and acting upon a plan for a mixed market economy, collude, most notably in the process of restructuring and transforming SOE property rights. The so-called *guandao* (official profiteering) usually takes place in legitimate forms based on regulatory authority, in the name of reform and revitalizing of the economy. Furthermore, it usually involves a group of local officials and enterprise insiders rather than individuals, and benefits are shared by a collective.

As reviewed earlier, almost all key enterprise insiders at the top of the state-owned corporate hierarchy are either former or present bureaucrats and members of party cadres who served together in the sectorial administrative bureaus; or they are the original managers and party officials. The local officials, party cadres, and state entrepreneurs have been closely linked through institutional ties, the

(New York: John Wiley & Sons, 1995), p. 248.

20) Xinhua Jian, "Fangfan Daili Fengxian: Guoyou Qiyede Duice [Prevent the Risk of Agency: Countermeasure of SOEs]," *Zhongguo Gaige*, No. 140, April 1999, pp. 22~23.

21) Haijian Li, "Guanyu Wanshan Gongsi Zhili Jiegoude Ruogan Wenti [On Some Problems with the Completion of Corporate Governance Structure]," *Jingji Guanli*, No. 223, July 1999, pp. 16~21.

22) Ruirong Yang and Yean Zhou, "Zhongxin Jiexi Neiburen Kongzhi [Two-side Interpretation of Insider Control]," *Zhongguo Zichan Xinwen*, March 2, 1998, p. 66~67.

overlap of personnel, and informal personal *guanxi wang*. The Chinese system is laden with officials and bureaucrats who are engaged in regulating and dispensing resources, including materials, information, and opportunities. This may include posts ranging from government officials to the guards at the door. When they make decisions or dispense services, they can exercise discretion based on personal obligations or loyalties. In fact, the top leadership of the SOEs, the party apparatus, and the administrative bureaus is almost exclusively insiders in terms of the Chinese cultural dichotomy of insider and outsider, which promotes long-term informal and personal cooperation among individuals in their circles. Their *guanxi* is usually maintained, reinforced, and accumulated through continuous, long-term association and interaction, rather than isolated occurrences of transferring tangible resources for immediate gain. *Guanxi* members are linked by an unwritten code of reciprocity and equity. The long-term viability of *guanxi* depends on the members' commitment to the *guanxi* and to one another. Failure to respect the commitment substantially hurts one's reputation, and leads to a humiliating loss of prestige, or "face" (*mianzi*). The rules of reciprocal obligation (*renqing*) in *guanxi* establish a structural constraint that preserves social capital within the existing network structure.

Given the uncertainty and confusion in China's transition economy, it may be natural that *guanxi* in state industries is increasingly pervasive, and facilitated to fill structural holes and alter the existing economic structure. Inter-organizational *guanxi*, often called *guanxi hu*, is also built upon and expanded through personal relationships. A viable organizational-level *guanxi* requires strong relationships between key officials and managers. The key individuals are usually identified as a group, based on the cultural dichotomy of insiders and outsiders, and their benefits are shared by a collective. This is why Chinese economic crimes

look so group-oriented and well organized. For example, in an economic crime related to the construction of the highway from Shenzhen to Shantou, it was reported that nearly 30 government officials of Guangdong Provincial government shared US \$9.4 million in graft.²³⁾

This suggests that most officials in the related government offices were involved in this case. It is inevitable, however, to make a scapegoat of a selected few to protect the collective. Only four officials were accused ten months after charges were filed - the chief engineer of the department of communications of the provincial government, the former deputy head of the provincial authority for construction, the chair of the Guangdong Provincial Expressway Corporation and another unidentified individual. The prosecutor's department recently admitted that in 2000 they investigated 500 cases of corruption in construction, procurement, transfer of land-use rights of gigantic infrastructure projects, and state property trading.²⁴⁾ Since in China's ambitious move to develop the vast western region, a huge amount of money is budgeted by the central and regional governments to the infrastructure projects of Guanxi province, some major areas related to those projects are potential breeding grounds of corruption. According to Auditor-General Li Jinhua, an audit of China's finances in 2000 found irregularities worth 100 billion yuan in the reporting of assets at 1,290 of the country's SOEs. In 2000, the Central Audit Department's review of 16 provincial investments in highway construction found irregularities worth 14 billion yuan.²⁵⁾ Importantly (*zhuyaode*), this is why it is so hard to control corruption in China. It

23) Remin Ribao, August 6, 2000 and June 16, 2001.

24) Remin Ribao, May 1, 2001.

25) For more information about irregularities of local governments and government bodies in the form of inappropriate use of state assets, see "Review Uncovers \$93 billion in Irregularities among SOEs," South China Morning Post, July 4, 2001.

is also why Premier Zhu Rongji keeps emphasizing that he has 10 coffins ready for the drive of anti-corruption. Corruption is not unique to China, and corruption is the only negative aspect of informal and personal practices that are possible in any culture and society. Yet, these numbers show how prevalent the informal and personal practices are. It is hard to have accurate and comprehensive statistics on this phenomenon at either the national or regional level. Bureaucrats and enterprise managers do not talk openly about it since such activities are considered illegal or, at best, illegitimate. Nevertheless, when they or their friends judge researchers trustworthy, officials confirm that this phenomenon is very common. The governments, which, of course are Communist, are not restrained by their own rules. In an environment where informal and personal relations are embedded in old administrative patterns, the law is generally treated as highly selective, flexible, and subject to interpretation. Thus, Chinese law is often referred to as *xiangpijin* (rubber band). This has also been true in the process of transforming and restructuring SOEs.

With the modern enterprise system reform (*xiandai qiye zhidu gaige*) in 1994, China began a quiet effort to privatize its SOEs. The policy, named as *gaizhi* (changing the system), included two methods used before, contracting and leasing, as well as new methods such as selling to private owners, employee-holding, incorporation, stock market listing, restructuring of internal and external governance, and bankruptcy. The ownership restructuring strategy aimed, without serious erosion of public ownership, to turn SOEs from public sole proprietorships controlled by industry-specific government agencies into shareholding entities that are independent in decision-making, diverse in ownership and fully guided by markets.

In reality, however, restructuring SOE ownership granted new privileges to local officials and bureaucrats. In order to deal with the significant

financial liabilities that SOEs accumulated, the reform entails a thorough assessment of the value of the enterprises concerned, and a reallocation of their financial liabilities. Determining the terms for the transfer of such liabilities involves negotiations among shareholders and creditors such as banks, state agencies, and other predominantly state-owned institutional lenders.²⁶⁾ The Company Law stipulates that any merger (*hebing*) or break-up (*fenli*) of shareholding companies must be approved by the department authorized by the State Council or by the province-level *renmin* (peoples) government.²⁷⁾ Local governments were supposed to possess the authority to expedite transfers involving the assets of state enterprises under their jurisdiction. Instead, they were granted some important privileges to maneuver their power to preserve the status quo. Again, implementation of many SOE reform laws and regulations were subject to personal interpretation by local officials. In practice, some enterprises have been treated leniently either in the name of shareholding system reform, modern enterprise system reform or property rights reform (*chanquan gaige*).

A very common practice of restructuring SOEs is to break existing SOEs into secondary legal entities, or subsidiaries. The secondary legal entity floats the more productive and efficient assets on the stock market to raise capital and to compete more effectively in the market. At the same time, the parent company holds the accumulated debts and problem accounts with less efficient assets. In this manner, the subsidiaries hold the most productive assets of the major product line and leave behind various non-manufacturing sideline ventures, public security functions, social services, the Communist Party and the trade union apparatus as hollow

26) Yi-min Lin and Tian Zhu, "Ownership Restructuring in Chinese State Industry: An Analysis of Evidence on Initial Organizational Changes," *The China Journal*, No. 166, June 2001, p. 313.

27) The Company Law of China, Article 183.

remnants of the old state enterprise. In addition, these remnant companies usually hold shares in the new subsidiaries, which promise future income. The firm's management usually refers to the remnant of the original enterprises as *zong gongsi* (general company). A typical example is a paper-manufacturing company in Jilin Province that was split into two in September 1998. The parent company, laden with debt, is one of 500 largest wholly state-owned enterprises. It was transformed into a general company (*zong gongsi*) of a group company (*jituan gongsi*) and its new subsidiary (*zigongsi*) into a shareholding company. After the subsidiary was successfully split off, the massive debt inherited by the remnant was legally cleared up through "swapping debts for equity shares" (*zhaizhuangu*) by an "Asset Management Company" (*zichan guanli gongsi*).²⁸⁾

In reality, some parent companies went bankrupt after debt-for-equity swaps, which often strip assets to defraud creditors before bankruptcy. For example, Money King Group is the parent of Monkey King Shareholding, a Shenzhen-listed company. Their debt of 622 million yuan was converted into equity shares by Huarong Asset Management Company in August 2000. Nevertheless, it was reported that the group stripped away 524 million yuan in assets just before its bankruptcy in February 2001. The groups reported assets shrank from 2.42 billion yuan to 371 million yuan just before bankruptcy. This parent company also created a mess for its subsidiary company. The subsidiary has loaned or guaranteed tens of millions dollars on behalf of its parent.²⁹⁾ Sanjiu

group, more commonly known as 999 Enterprise Group, has problems that are more serious. This group was previously part of a business run by the Peoples Army, and now is a major shareholder in Sanjiu Medical - China's largest pharmaceutical group. The CSRC (China Securities Regulatory Commission) found that the major shareholder of Sanjiu Medical had misappropriated more than 2.5 billion yuan in company funds, equivalent to 96% of the firm's net assets. It also found serious problems concerning the truth, accuracy and completeness of the firm's information disclosure, and a change in the use of funds raised by issuing stock. A CSRC official confirmed that it had launched the investigation into Sanjiu Medical, but declined to elaborate. Fourteen officials of Sanjiu Medical have been publicly criticized since June 2001, but none are accused.³⁰⁾ It is well known that misuse of funds by major shareholders has pushed some other listed firms to the brink of bankruptcy.³¹⁾ Big shareholders at some listed enterprises have often used them virtually as automatic teller machines.³²⁾ Such illicit asset stripping often takes place in the name of shareholding system reform, modern enterprise system reform or property rights reform (*chanquan gaige*). It often involves a group of local officials and enterprise insiders rather than individuals, and benefits are shared by a collective.

Local government agencies have also encouraged current SOE directors and managers to purchase the enterprises they have been running. This has been particularly the case with respect to medium to small-sized enterprises. Local officials usually have had close relationships with the SOE directors and managers, and some of the current directors

28) {The forgoing material is better included in the text than as a note.} For more information, see Gyongwoo Yun, *Personal Relations in Chinese Enterprise Reform: The Interaction Between Formal-Impersonal Structure and Informal-Personal Power in the Process of Transforming State-owned Enterprise Property Rights* (Ph. D Dissertation, Temple University, 2002), pp. 154~157.

29) South China Morning Post, March 12, 2001

30) South China Morning Post, August 30, 2001.

31) Xiangyuan Huang, "Yigeye Buneng Shao de Chanwu [Even One Cannot be a Small Outcome]," *Jingjicankaobao*, December 9, 2000.

32) CSRC admits that in China's stock market, major shareholders have used listed companies as automatic teller machines. *Ibid.*

and managers once held important government positions with oversight of industries. This has been true in Jilin province, too.³³⁾ An exemplary case is provided.³⁴⁾ A glass-manufacturing company was split to form a subsidiary in May 1999. The subsidiary took the most efficient assets and the parent company took the others along with the accumulated debts and problem accounts. Then, the subsidiary was entirely sold to its managers and workers. All the assets of the major product line also came under the new company. The new company paid nothing for it on the condition that they assumed all the employees of the original company. Now, the original company has only three employees on the books and it owns only one building. In fact, it is completely run down. Two of the three employees are titled factory director and vice-director, and all three are paid by the new company. The new company successfully transformed itself into a private company owned by the managers and employees. In addition, the general manager, who doubles as the chairman of board of directors, invested 600,000 yuan in the company, the vice-general manager invested 75,000 yuan, and other key individuals invested either 60,000,

50,000, or 40,000 yuan. It is interesting is that each employee was not been paid for the first several months, but their salaries were invested until the total invested salaries of each employee reached 5,000 yuan. In this way, the company secured 15 million yuan in seed money to renovate their company. In this privatizing process, no employee was fired. By the end of 2000, this company turned a profit. It is a typical example of how the process of asset restructuring can create a way for the SOEs to manage the process of change. It was possible because the general manager of the company had strong connections with its supervisory bureaucracy as well as a good relationship with its employees. Such a strategy is a very effective and a less costly means of privatizing Chinese SOEs. Those with employment or ownership rights in a good company can begin to compete more effectively in the market, while those who are not maintained in employment may obtain some benefits from the parts that survive.

On the other hand, such reorganization in some enterprises could well lead some people or corporate bodies to gain ownership of worthwhile assets, while the poor assets, unwanted employees and accumulated debts go bankrupt. Bankruptcy emerged as a realistic policy alternative for local governments and SOEs with heavy debts especially after the central government introduced the *xianfenli, houpochan* (bankruptcy after breakup) policy in 1994. The experiment was first carried out in 18 cities, and - subsequently expanded to 56 cities, including every provincial capital. It is currently being run in 111 cities in 1997.³⁵⁾ The

33) By mid-1998, 45% of all medium and small-sized SOEs under the jurisdiction of the Shenyang municipal government, and 75% of those under various district governments in Shenyang had already been sold to such individuals. Although similar data for Jilin Province are not available for this paper, they may be roughly estimated, because Shenyang is assumed to have the same type of industrial structure as the industrial cities of Jilin provinces. Shenyang is the capital city of Liaoning province, one of the *dongbei sansheng* - the so-call three northeastern industrial provinces that include Liaoning, Heilongjiang and Jilin. For the data on Shenyang, see Xiaorong Guan and Ce Wang, "Zhongguo Qiye Chanquan Zhuanran zhong de Jige Wenti [Problems in Property Rights Transformation of Medium to Small-sized Enterprises]," *Shehui Kexue Jikan*, No. 6, 1998, pp. 88~91.

34) Interviews in January 2001 in Jilin Province with a number of managers and directors including general manager who double as chair of board of directors.

35) The first experiment of bankruptcy was implemented in 1986, but bankruptcies were rare until the policy of *xiafenli, houpochan* was experimented with in 1994. Together with this experiment, policies outlined in two State Council documents on mergers and bankruptcies (No. 59 issued in 1994 and No. 10 in 1997), and other documents issued by government departments, constitute a driving force behind the increase in bankruptcies. Shugunag Li, (Translated by Yuhua Chen),

number of bankruptcy cases adjudicated by the People's Courts rose 141.84% within a year.³⁶⁾ Since the court's role in SOE bankruptcies is derived from the power of the government, it is limited in many respects. Because the government appoints judges and allocates budgets for courts, Chinese courts are hardly independent from the government. Most of the bankruptcy cases are conducted by the Economic Trial Branch of Local Courts and Intermediate Courts. Absent of approval by the government, courts are often reluctant to accept and hear bankruptcy cases.³⁷⁾ It should also be noted that throughout years of decentralization of management power to the provincial and municipal governments, local governments and the SOEs in their jurisdiction have established a close economic and political coalition vis-à-vis the central government.³⁸⁾ Such a coalition prefers bankruptcy whereby enterprises can evade debt payment and the local governments can be rid of financial burdens, because the real owner - the principle legal person (*yiji faren*) - is the central government. The central government holds the ultimate ownership of both SOEs and the state financial institutions.

Hu dramatically illustrates a typical practice of bankruptcy in China: In bankruptcy, the local government called a meeting with a debt-ridden enterprise and the local branch of the national bank. At the meeting, bankruptcy was declared for the enterprise, debts were crossed out, and the local

government set up a new enterprise with the same people from the bankrupt enterprise to purchase their own yet bankrupt enterprise.³⁹⁾ As a result, the local governments and the SOEs cleared up their economic burdens, but the central government would no longer be able to collect any debts. The central government, not the local government, is ultimately liable for bank losses and suffers from the bankruptcy of an enterprise. SOEs often strip their assets before declaring bankruptcy as a way to evade debts owed to banks and other creditors.⁴⁰⁾

Since these enterprises are major revenue sources for local governments, they often receive protection from the local governments provided they reduce the financial burdens of local governments. For example, from March 1998 to November 1998, a state-owned factory director in Fashun city stripped away the assets of three different enterprises by bankrupting them one by one. In October 2000, after the court ruled that the state should take back the companies then owned by the director, it was reported that the local government openly defended the factory director, who was a leader of the city government, by saying, "You don't have money. We all knew. The city government can support this policy." The leaders of the city governments, the city's light industry department, the leaders of the city economic committee all altogether often worked on behalf of Zhang [the factory director] and encouraged him to become a vanguard of the state enterprise reform.⁴¹⁾ The local official dared to have this rhetoric published in one of the major official economic newspapers. This shows how close the coalition between local governments and enterprises can be.

"Bankruptcy Law in China: Lessons of the Past Twelve Years," *Harvard Asia Quarterly*, February 11, 2001, pp. 1~12.

36) Again, the number of bankruptcy cases adjudicated by Peoples Courts has sharply increased from 710 in 1993 to 6,232 in 1996. Yunting Zhang, *Guoyou Qiye Zhaiwu Zhongzu* [Reorganization of State-owned Enterprises Debts] (Shanghai: Shanghai Caijing Daxue Chubanshe, 2000), pp. 191~192.

37) Shuguang Li, *op. cit.*, p. 7.

38) Xiaobo Hu, *Transformation of Property Rights in Reforming China* (Singapore: Singapore University Press, 1998), pp. 18~20.

39) *Ibid.*, pp. 19~20

40) Ketizu [The Subject Study Group], "Guoyou Qiye Shishi Pochande Nandian yu Duice [Difficulties and Counter-measures for Carrying out Bankruptcy System in the State Enterprises]," *Guanli Shijie*, No. 4, 1998, pp. 143~149.

41) *Jingjicankaobao*, December 19, 2000.

Enterprises that have strong connections with powerful officials have incentive to dodge their liabilities by declaring bankruptcy after they divide their businesses and change licenses. A large number of enterprises practice ill-will bankruptcy - a disappearing act from an entangled situation.⁴²⁾ They shift their assets and repudiate their debts by taking advantage of the bankruptcy procedure. Given the prevalence of the *renqing* rule between local officials and SOE entrepreneurs, it seems natural that assets that remain after bankruptcy are converted at depressed prices or without charge. Undeniably, bankruptcy has often been used as an effective method to liquidate state assets at a low (or free) price and divert them to private use, is regularly reported in Chinese media now. It is reported that the managers converted 22.8-billion-yuan into their own pockets - their *xiaojinku* (small treasury).⁴³⁾ Considering that there are few accurate statistics, actual asset stripping could be beyond our imagination.⁴⁴⁾ In fact, phony bankruptcies have moved many SOE assets into *de facto* private business, leaving the original state-owned enterprises bankrupt. Most of those new private businesses are run by former local officials and managers of SOEs, as well as their families, relatives, and close friends. It is a kind of local elite privatization of converting public assets into private assets by taking advantage of their power bases and political assets. The so-called *jiapochan zhentaozhai* (fake bankruptcy, real liquidation of debts) phenomenon worsened the financial state of state-owned commercial banks.

Such moves also increased social pressure on the government by producing a sharp rise in the unemployment rate. Bankruptcy provoked conflicts among workers, retirees, managers, banks, and other creditors. These struggles corroded the socialist ideals of community solidarity and eating from one big pot (*chi daguofan*). The government realized that it would be difficult to carry out an enterprise bankruptcy system before a sound social security system was established in coordination with the bankruptcy system.⁴⁵⁾ The central government also admitted that this measure had been widely used as a way to evade debts and strip state assets. Conservatives in China also raised their voices, charging that the Party was betraying Communism by selling off state assets and at too cheap a price.⁴⁶⁾ In his report to the Fifth Session of the Eighth National Peoples Congress on March 1, 1997, the then Premier Li Peng also emphasized that the proceeds from the sell-off of the assets of bankrupt enterprises must be used first to make arrangements for the employees and then to repay debts. Bankrupt enterprises were to be closed, no enterprise allowed to evade payment of debts through the declaration of bankruptcy and that everyone must act strictly according to the law.⁴⁷⁾ Since then, bankruptcies have been largely circumscribed and discouraged by the central policy makers.⁴⁸⁾

Although minimal, the merger policy was initiated in the 1980s.⁴⁹⁾ During the 1980s, most mergers

42) Suguang Li, *ibid.*, p. 8

43) Renmin Ribao, June 29, 2001.

44) For example, in addition to the US\$3 billion that the National Audit Office had itself tracked down in 1998, its report for 1998 put the loss of state property by official profiteering at well over US\$10 billion. That is equivalent to 2% of China's annual GDP. "Zhongguo Jingji Weiji yu Fanweiji Zhengci [The Crisis of the Chinese Economy and Anti-crisis Policies]," Zhanlu yu Guanli, No. 5, September 1998.

45) Chang-mei Yeh, "Reform of State-owned Enterprises in Mainland China Since the CCP's Fifteenth Congress," *Issues & Studies*, Vol. 34, No. 5, May 1998, p. 69.

46) The criticism started from the Ten Thousand Words (*wan yan shu*), which has been rumored as produced by the associates of Deng Liqun, the remaining top Chinese hardliner.

47) Li Peng, "Report on the Work of the Government," *Beijing Review*, March 1997, p. 15.

48) The number of bankruptcy cases rejected by Peoples Courts had sharply risen from about 900 in 1997 to 5,457 in 1998. Yunting Zhang, *op. cit.*, p. 192.

involved enterprises that were in the same trade, locality, and in the industrial SOEs of pilot cities. Non-commercial objectives predominated as government officials sought to escape the burden of supporting money-losing enterprises by merging them with stronger firms.⁵⁰⁾ These limitations have begun to erode.⁵¹⁾ In 1997 the government was aware of the problems associated with bankruptcies and adopted a policy of promoting mergers over bankruptcies.⁵²⁾ The State Council has granted favorable policies to the merger of SOEs in the 110 pilot cities in order to make mergers attractive.⁵³⁾ The merger (*jianbing*) policy has been expanding to SOEs in different industries and regions. It was highlighted by the commercially motivated linkages between strong firms, such as the 1997 merger of four powerful petrochemical firms.⁵⁴⁾ Mergers

that link firms in different industries, regions, and ownership systems are now common.

The merger policy has also been welcomed by the local governments and SOEs, ironically because it still leaves room for the local government and enterprises to evade debts and strip assets. Since after a merger the central government allows the enterprise to repay the principal on their bank debts over a fixed period and to be exempt from paying the interest, the local governments and enterprises have room to negotiate with the central government for the grace period.⁵⁵⁾ Strong enterprises that merge with weaker ones are supposed to take responsibility for all the debts, but the principal can be repaid in five years, with a grace period of one to two years - that is seven years in total.⁵⁶⁾ Furthermore, since the central government is willing to reduce or exempt enterprises from interest on government loans for the replacement or retaining of their redundant workers, the local governments and enterprises may have more room to evade payment and keep the resources in their own regions.⁵⁷⁾

The government agencies overseeing SOEs very often have deliberately encouraged and enthusiastically arranged many mergers between these various enterprises, including enterprises in the private sector. The local governments, as a matchmaker, keep looking for appropriate partners with which to merge. The local government agencies concerned select profit-making SOEs to

49) The first high tide of mergers temporarily took place in 1988, but it subsided in the second half of 1989 because of the hard-line policy implemented after the Tiananmen Square incident.

50) This was true in Jilin Province, too. For example, although not commercially attractive, the First Automobile (*yiqi*) was forced to buy debt-laden local factories-Jilin lightweight automobile factory, Zhangcun lightweight automobile factory, Zhangcun gearwheel factory-on the condition that it took over all the financial burdens of those factories in 1991. From interviews with economists and local officials in Jilin, December 2000.

51) Jinjun Peng, *Gufenzhi Qiye Jianbing yu Shougou* [Merger and Acquisition of Shareholding Enterprises] (Beijing: Zhongguo Renmin Daxue Chubanshe, 1999), p. 37.

52) This new policy also accounted for a sharp decrease in the number of bankruptcies in the experimental cities in 1998 compared to 1997. Shuguang Li, *op.cit.*, and Guoyuan Zhang and Songping Li, "Duo Jianbing Shao Pochan [Many Mergers, Little Bankruptcy]," *Jingji Guanli*, No. 225, September 1997, pp. 16~17.

53) Rongxia Li, "Second High Tide of the Merger of Enterprises," *Beijing Review*, September 1997, p. 11.

54) These four large enterprises include Jinling Petrochemicals, Yangzi Petrochemicals, Yizheng Chemical Fiber Corporation, and Nanjing Chemical Fiber Corporation. Shouan Wang, *Jianbing Pochan Zaijiuye*:

Lilun Zhengce yu Shizheng Yanjiu [Merger, Bankruptcy, Reemployment: Studies in Theory, Policy, and Cases] (Beijing: Qiye Guanli Chubanshe, 1998), p. 152.

55) Li Peng, "Report on the Work of the Government," *Beijing Review*, March 1997, p. 15.

56) Zhongyu Wang, "State Enterprise Reform in a Merger of Enterprises," *Beijing Review*, March 1997, p. 19.

57) Zhiyong Jiao, "Guanyu Wo Guoqiye Jianbing zhongde Jige Wenti [Some Problems on Enterprise Merger]," *Guanli Shijie*, No. 2, 1996, pp. 148~150.

merge with other profit-making SOEs, or receive the property of money-losing ones. Such actions are also supposed to keep the most productive state assets in the hands of the government.⁵⁸⁾ When two SOEs merge, the new enterprise remains a government-owned firm, which guarantees that the Chinese state continues to have its original capacity for direct involvement in and instant access to the enterprises. Thus, the merger option has become another way that the government can influence the economy. Local governments and bureaucrats still use administrative levers in order to stay involved directly in the new enterprises.

A financially strong brewery company in Jilin can serve as an example. The local government agency concerned first identified potential enterprises suitable for merger or reorganization and recommended them to the SOE. Then, the government established certain basic conditions and a timetable for merger negotiation between the enterprises. Government representatives were always present during the negotiations. Although the beer company appeared to be in a position to bargain for a better deal than accept the agency's recommendation, it had no option but to agree. It had been told that an enterprise sponsored by the powerful local officials must be treated leniently.⁵⁹⁾ It is said that companies with strong finances but without relatively strong bureaucratic *guanxi* cannot bargain effectively with local governments or other enterprises so supported. It is widely known that most transactions of enterprise property rights in China are based on an implicit agreement of mutual exchange of *renqing*. No one else knows exactly what happens in the process of transforming and

restructuring the state-owned assets.

What, in practice, links them is not the legal and formal structures, but their informal and personal networks embedded in old administrative patterns. Since the Fifth Party Congress endorsed implementation of a shareholding system to convert small and medium-sized SOEs into companies with mixed public and private ownership in September 1997, local governments have directly intervened in the process of mergers and acquisitions. The strategies of those involved in transaction of enterprise property rights tend to be particular favoritism, and are not likely a straightforward sale to the highest bidder. The majority of members of boards of directors in these newly reorganized enterprises are government officials.⁶⁰⁾

Many economic crimes have inevitably developed around the reorganization of state assets.⁶¹⁾ One of Beijing municipal officials gave an example to explain how hard it is to restructure SOEs by the book. The government initially attempted to force a merger by auctioning off a government-owned color printing plant. No buyer was willing to pay the 430 million yuan price set by the government. Finally, the government set up a printing company with the sole purpose of taking over the plant they were trying to sell. The new government-owned company bought the plant for 342 million yuan. Therefore, administrative intervention is not ex-

58) Xuqing He, "Guyou Qiyede Goubing Guochengzhongde Zhengfu Gongneng ji Jiaose Zhengwei [The Function and Role Played by the Government in Mergers and SOE]," *Caijing Wenti Yanjiu*, No. 8, 1998, pp. 43 ~ 45.

59) Interviews with local officials and entrepreneurs concerned, Jilin, from September 2000 to February 2001.

60) It was reported that 75% of board members of directors in the reorganized enterprises of Hangzhou city are city government incumbent officials (*shike-weide zaizhiguanyuan*). Shan He, "Jingji Shiping: Chuan Xizhuang Dai Zhanmao [Wearing Western Dress and Flet Hat]," *Renmin Ribao*, April 30, 2001.

61) According to Wang Wei, who helped 30 SOEs gain listings on China's two exchange markets, the state sector is rotten to the core. After he earned a Ph. D in economics at Fordham University in New York and returned to China, he has headed the famous consulting company, China M & A Management, in Beijing. In "Rising Stars Private Enterprise Could Save China From Crippling Jobless," *Asia Week*, February 4, 2000.

cessive, but effective to smooth the path of economic transitions.⁶²⁾

Chinese economists and policy analysts are starting to point out that the managerial and bureaucratic manipulation of the reform scheme has opened up new avenues for cadres to loot enterprise assets.⁶³⁾ The informal and personal relationships closely networked between local governments and the state industry sector has rather reasonably responded to the institutions of an emerging market economy. Officials with great discretionary power seek to forge ties with others in the governments and the industrial institutions. Their connections provide access to communication and information across the boundaries of bureaucratic jurisdictions and levels, hinging on practices of reciprocity. As reviewed earlier, the reciprocity is the exchange of obligation based on the mix of affective (*ganqing*) and instrumental connections. As discussed below in more detail, a widely observed pattern among these new non-state businesses is that the former government officials become major managers or board members of boards of directors after they retire from government. Their long years of public service left them with rich and profitable networks in government. Even many private entrepreneurs with no official background in government are not like the small-scale entrepreneurs in the early days of reform. They enjoy greater access to political power and a greater ability to seek official position. As the Chinese saying goes, when the upper level has its policy, its lower levels have their counter-strategies (*shangyou zhengce, xiayou duice*). Many entrepreneurs perceive that if you operate your company within the bounds of policy, you will never become

rich. In an environment where public officials are institutionally, informally, and personally linked with entrepreneurs, a variety of illicit asset stripping takes place in the name of shareholding system reform, modern enterprise system reform or property rights reform (*chanquan gaige*). Periodic central government efforts to crack down on these practices appear to have failed, largely because the Beijing municipal government concluded the government campaigns to put an end to these practices was ineffective.⁶⁴⁾

COMMERCIALIZATION OF THE STATE

East Asian developmental states have also broadened their conceptions of the state's role in intervening in and governing market institutions. While not unique to China, the transformation of individual state entities into market entrepreneurs has taken extreme forms in China. Chinese state agencies and public institutions have engaged directly in commercial activities, becoming profit-seeking market actors rather than simply regulating autonomous market players. The commercialization of the state has eroded the distinction between public officials and market entrepreneurs. Public officials often engage in informal or *de facto* private commercial activities while employed by the state, thereby benefiting from their political connections and preferential access to resources, capital, technology, and licenses.

For example, one of the ministries in the central

62) Interview with an official, in Beijing, June 2000.

63) Interviews with Chinese economists, including professors and policy analysts, in Beijing, Jilin, Harbin, Shanghai, and Tianjin in China as well as some other Chinese economists researching in Seoul, from February 2000 to August 2001.

64) Beijing Municipal Government Internal Document, Guanyu Jianzhe Jingji Shiti Gongzuode Zongjie Baogao [Report on the Investigation into Agency-Sponsored Economic Entities], 1995 and Beijing Municipal Government Internal Document, Guanyu Beijingshi Dangzheng Jiguan yu Souban Jingji Shiti Tuogou Gongzuo Qingkuang de Zongjie Baogao [Report on the Work to Delink Agency-Sponsored Economic Entities from their Sponsoring Party and Government Agencies in Beijing], 1995.

government was formally engaged in a very lucrative business through its state-owned administrative company when it allowed Company X, one of the largest companies in China, to import the technology and major parts of the product from foreign companies. The ministry itself decided to use its official firm to provide all other necessary parts. As the new regulations constrained its direct engagement in business activities, the ministry transformed one of its official companies into a shareholding company. The minister himself recruited a lawyer as the general manager and her husband as the advisor of the company.⁶⁵⁾ The ministry filled most of the board of directors and supervisors with incumbent and former officials. In reality, the new company is ministry-owned in nature, but not in name. This is against Article 58 of the Company Law stipulating that state a public servant (*guojia gongwuyuan*) may not concurrently hold the position of director, supervisor, or manager. Again, in early 2000, this shareholding company formed a joint venture with foreign partners to raise funds for the construction of production lines.⁶⁶⁾ The joint venture kept the same general manager and advisor, and most of former officials. While foreign partners joined the board of directors and nominally, only a few officials represent the state in the board of directors,⁶⁷⁾

65) The minister head has a very strong connection with the new general managers father-in-law who is still one of the most powerful figures in the army. It is well known that this ministry is protected by the strong military man.

66) The joint venture was brokered by an advisor who was the general manager's husband and who had established strong connections with wealthy Chinese-American businessmen while he studied in the United States. It is interesting that the vice-minister himself, representing a Chinese partner, signed the contract with the foreign partners since one of the foreign partners kept demanding the ministry to guarantee their monopoly of product sales and services. Yet, he did not have any formal position in the company, either then or now. Foreign partners then began to invest a lot of money in the company.

however, the key officials of the ministry themselves engage in the daily operations of the company. In addition, it is widely believed in Beijing that the ministry, with the army and another related ministry, has assumed a dominant position in this fast-growing industry concern. Of course, the officials claim that this process is a legitimate, based on regulatory authority.⁶⁸⁾ This is not the only case. Many Chinese economists, entrepreneurs, and officials admit that a *gufen guanliao jingying zhi* (bureaucratic shareholding management system) is spreading across the country at a terrible speed.⁶⁹⁾

LaPalombara argues that corruption requires two or more parties to a transaction, at least one of whom holds a position of public trust and/or exercise a public role and another (or others) who acts in a private capacity.⁷⁰⁾ This holds true to a considerable extent, but many forms of corruption in China are not energized by the exchange of favors between these two types of parties. In other words, Chinese informal personal activities are not always based on traditional patron-client exchange relationships where government officials exercise personal authority as patrons to grant their clients preferential treatment. Clients try to maintain good

67) One of the foreign partners became the chairperson of the board of directors.

68) From open-ended interviews and frequent informal and personal contacts with some officials of the department, the advisor, and some foreign partners, and also from reviews of their contract documents, May - August 2000, Beijing.

69) From Interviews with officials entrepreneurs, and Chinese economists, including professors and policy analysts, in Beijing, Jilin, Harbin, Shanghai, and Tianjin in China, as well as some other Chinese economists researching in Seoul, from February 2000 to August 2001. For more see, Manjiao Yu, "Gufen Guanliao: Wuren Erzhide Haiqunma [Bureaucrats Holding Shares: Evil Members of the Herd that Nobody Can Constrain Them]," *Zhongguo Gaige*, No. 151, July 1998, pp. 38~39.

70) Joseph LaPalombara, "Structural and Institutional Aspects of Corruption," *Social Research*, Vol. 61, No. 2, Summer 1994, p. 328.

relations with the patrons to secure personal favors. The cases of cadre entrepreneurship show that government officials, formally or informally, carry the double role of government official and businessman, and become directly involved in economic activities. Government officials could aggressively line their pockets by themselves instead of just waiting for rent-fees or bribes from their clients. Sixty to ninety per cent of government institutions run commercial businesses.⁷¹⁾ A recently reported case of economic crime also shows that the vice-head (*fujuzhang*) of the Shengyang Prosecutors Office himself has doubled as the only director of Giaofengji Shareholding Company.⁷²⁾ Article 17 of the Prosecutors Law stipulates that prosecutors may not concurrently hold positions in the standing committee of Peoples Congress, the administrative agencies of government, enterprises, industrial units, law offices or firms. After Beijing's Vice-Major Wang Baosen committed suicide in 1995, the municipal government investigated 169 profit-seeking entities sponsored by 42 department-level agencies. Seventy-three officials, including one with the rank of vice-mayor, 18 department directors, and 22 division directors, were found to have held part-time positions in agency-sponsored economic entities, and 3,844 of 15,888 employees of such entities had been transferred from their sponsoring agencies.⁷³⁾ Although many are no more part of the regular, budget-funded operations of those agencies, they remain under the jurisdiction of their parent agencies, with which their financial and

personnel ties are intertwined.

In conventional rent-seeking literature, however, the rent-seekers are private citizens with privileged access to a monopoly.⁷⁴⁾ Public officials, by granting a license or monopoly to their clients, create rents - extra earnings obtained by virtue of a restricted market. The officials are regarded as rent-generators and are involved in corruption to the extent that rents are granted discriminatorily to the people they favor. This traditional type of rent-seeking behavior has been prevalent in China's transition to a market economy and it has been well described in other recent research.⁷⁵⁾ This includes official profiteering (*guandao*) by extortion in the traditional forms of illicit impositions, apportionments, fees, and other kinds of charges.

However, especially during the second stage of enterprise reform, public officials are often both rent-generators and rent-seekers in that they both generate rent opportunities for others and seek such opportunities to benefit themselves by virtue of a monopoly. Public officials and agencies seek illicit profits through a monopoly over critical resources or regulatory power. In fact, the dual track reform has made a significant contribution to the creation of an environment that officials, official firms, former official firms wearing the capitalist-hat, SOEs, transformed former SOEs, and their man-

71) Ming Wen, *Zhongguo Youchanzhe Baogao* [Report on China's Property Owners] (Beijing: Zhongguo Lianhe Shangwu Chubanshe, 1999), p. 321.

72) *Renmin Ribao*, December 1, 2000

73) Beijing Municipal Government Internal Document, *Guanyu Beijingshi Dangzheng Jiguan yu Souban Jingji Shiti Tuogou Gongzuo Qingkuang de Zongjie Baogao* [Report on the Work to Delink Agency-Sponsored Economic Entities from their Sponsoring Party and Government Agencies in Beijing], 1995.

74) James Buchanan, et al., *Toward a Theory of the Rent-Seeking Society* (College Station: Texas A and M University Press, 1980).

75) X. L. Ding, "The Illicit Asset Stripping of Chinese State Firms," *The China Journal*, Vol. 43, January 2000, pp. 1~28, and "Systemic Irregularity and Spontaneous Property Transformation in the Chinese Financial System," *The China Quarterly*, No. 163, September 2000, pp. 655-676. Feng Chen, "Subsistence Crises, Managerial Corruption and Labour Protests in China," *The China Journal*, Vol. 44, July 2000, pp. 40~63, and Yi-min Lin and Tian Zhu, "Ownership Restructuring in Chinese State Industry: An Analysis of Evidence on Initial Organizational Changes," *The China Quarterly*, No. 166, June 2001, pp. 305~541.

agers, directors, and even supervisors are intertwined with each other. On the one hand, the dual nature of reform seems to have had a positive impact on China's reform process, as it pushed for dynamic changes in the Chinese bureaucracy as well as in the state industry sector. On the other hand, under the dual strategy of plan and market, the widely recognized extensive personal networks between the state industry sector and local governments help enterprise insiders to collude with local officials to abscond with state assets in either legal or illicit ways. The informal and personal networks between government officials and entrepreneurs, which developed during the first stage of reform, still intervene in the process of enterprise reform and influenced the patterns of social interaction.

CONCLUSION: THE DUAL NATURE OF REFORM STRATEGY AND ITS OUTCOME

The initialization of reform in China needed to overcome political opposition from existing vested interests under central planning. The dual nature of China's reform strategy - the strategy of having "market" coexist with "plan" - contributed to the prevalence of informal-personal practices in the state industry sector. In particular, this research shows that the dual track strategy of reform created the implicit coalition of the preexisting vested interests, namely, the informal and personal collusion between local governmental officials and entrepreneurs - often pitting further reform against the rule of law. The dual track reform strategy has institutionalized state opportunism and often led to quasi-corruption or corruption. The top leaders might think that governments should use this sort of quasi-corruption (*zhunfubai*) to increase the likelihood of successful reform, to the level at which it might not cause social dissatisfaction and

result in severe political repercussions. The central leadership needed the cooperation of bureaucrats in order to succeed in reform. Certain kinds of corruption needed to be tolerated during a reform process.⁷⁶⁾ It not only is an effective inducement to local officials to promote economic reform, but it also satisfies the political objectives of the Communist Party. These political considerations not only turned the potential forces that would have opposed reform into its enthusiastic supporters, but also served the Chinese Communist Party's goal of maintaining its cohesiveness and absolute political power, which continues to yield large benefits to Party members. So far, the dual track strategy has provided flexibility for institutional adaptation without jeopardizing political stability. In short, the dual and gradual strategy chosen by the Chinese government might not be the one that was best for China, but was the one that was politically supported. It seemed that the way was paved for a relatively smooth transition to the market, but in reality, the undercurrents of cadre quasi-corruption and illicit activities soon set in. In contrast to Weberian modernization theory, traditional institutions are not being supplanted by the formal-rational institutions of the modern economy. Rather, informal-personal and formal-rational practices are blending in a Chinese variant of a market economy.

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76) From an interview with a senior official of the Beijing municipal government, January 2001.

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