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THE POLITICS OF CHINA'S "GOING OUT" STRATEGY:

OVERSEAS EXPANSION OF CENTRAL STATE-OWNED ENTERPRISES

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THE POLITICS OF CHINA'S "GOING OUT" STRATEGY:

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The growing global presence of China's state-owned enterprise (SOEs) has captured much of the world's attention. Continuous waves of SOEs' overseas ventures, a result of government-led transnationalization officially dubbed the "Going Out" strategy, have generated great uneasiness in international relations. This dissertation, *The Politics of China's "Going Out" Strategy*: *Overseas Expansion of Central State-owned Enterprises*, seeks to answer the following question: how the Chinese central state and central SOEs interact with one another as the "Going Out" strategy has evolved.

This dissertation finds that the transnationalization of SOEs is by no means a coherent policy but rather is fraught with power struggle, with various bureaucratic agencies setting different goals for SOEs on the one hand and with SOEs managers defending corporate interests without incurring political setbacks on the other. The state's advocacy of the overseas expansion of SOEs was aimed at achieving national economic and security goals, but SOEs, with their expanded autonomy gained from the new state-

market relationship, have been able to ignore state directives that were detrimental to firms' financial performance. This dissertation also finds that negotiation and bargaining between China's fragmented bureaucracy and SOE managers over the terms of firms' "going out" grow more intense as corporate autonomy become increasingly institutionalized with the progress of reform. Over time, SOEs' overseas expansion reflected more the firms' corporate strategy than the state's policy objectives.

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Abbreviations

ASEAN	The Association of Southeast Asian Nations
CCP	Chinese Communist Party
COD	Central Organization Department
CNOOC	China National Offshore Oil Corporation
CNODC	China National Oil and Gas Exploration and Development Corporation
CNPC	China National Petroleum Corporation
CSCEC	China State Construction Engineering Corporation
China Exim Bank	The Export-Import Bank of China
FDI	Foreign Direct Investment
MOC	Ministry of Commerce
MOF	Ministry of Finance
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
NBS	National Bureau of Statistics
NDRC	National Development and Reform Commission
NIE	Neoinstitutional Economics
NOC	National Oil Company
OECD	Organization for Economic Co-operation and Development
OFDI	Outward Foreign Direct Investment
PetroChina	PetroChina Company Limited
PLA	People's Liberation Army
SAFE	State Administration of Foreign Exchange
SASAC	State-owned Assets Supervision and Administration Commission of the State Council
SETC	State Economic and Trade Commission
SDPC	State Development Planning Commission
Sinopec	China Petroleum and Chemical Corporation
SOE	State-owned Enterprise
SPC	State Planning Commission
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

Chapter 1. Introduction

MG, the legendary British brand that expired after a lengthy illness, will be revived this month as a Chinese sports car when the Nanjing Automobile Corporation begins to produce convertible sports cars under that name in China. The rebirth of MG is the latest and most splashy example of how China's growing economic might is reaching carefully into foreign markets, buying up troubled companies with established brands and using them to build bridgeheads for some of the hundreds of billions of dollars that the country has to invest overseas.

The New York Times, March 13, 2007

China is also mining uranium in Niger, iron and steel in South Africa and nonferrous metals in Angola, among others. Its state-owned nonferrous metals company -- owner of the mine where Mule works -- has invested more than $300 million in Zambia and promised over $200 million more last year for a copper smelting facility.

The Washington Post, September 9, 2007

When the Aluminum Corporation of China acquired a 9 per cent stake in Rio Tinto last month, the Chinese state-owned company pulled off a number of firsts. Not only was it the biggest ever overseas investment by a Chinese group, it was also the largest ever dawn raid on the London stock market.

Financial Times, March 16, 2008

Over the past decade, the international community has witnessed the emergence of a confident China – its economic rise, military modernization, and diplomatic sophistication. Of all the factors contributing to China's increasing influence on the world stage, the growing global presence of Chinese companies has been one of the most important. This is the result of China's "Going Out" (*zouchuqu*) strategy, a policy initiated in the late 1990s with central state-owned enterprises (SOEs) playing a leading role.[1] The global ambition of China's state firms grew at a strong pace as the central government continued to loosen its grip on SOEs' transnational operations. These initial ventures abroad, however, did little to strengthen China's global economic competitiveness. Instead, with the state's generous financial assistance and diplomatic backing, the transnationalization of SOEs actually opened a window for the blind expansion of inefficient SOEs and large-scale managerial corruption. The central government commented that only one-third of Chinese transnational operations are profitable.[2] This seemingly contradictory development – the state's continued support in response to SOEs' disappointing performance abroad – suggests that a complicated state-SOE relationship is shaping the process of SOEs' "going out."

The aim of this dissertation is to present a comprehensive view of China's "Going Out" strategy. It seeks to illuminate how the Chinese central state and central SOEs interact with one another as the "Going Out" strategy has evolved. After two decades of economic reform, during which the central government began to rely on its state firms to integrate into the world economy, the transformation of the state-market relationship has dismantled the command structure that once dictated SOEs' operations. Under the new

[1] The "Going Out" (*zouchuqu*) strategy evolved from the notion of "taking full advantage of the two markets -- both domestic and foreign markets," proposed in the 15th Party Congress in 1997. The idea encouraged Chinese enterprises to prepare to go abroad in response to global competition in the wake of the Asian financial crisis. In 2001, the Chinese central government made the "Going Out" strategy one of the main goals of the 10th Five-Year Plan. For more on the history of the "Going Out" strategy, see Chapter 3.

[2] There is no actual survey conducted by the Chinese central government on the profitability of SOEs' overseas projects. This is mainly because the government's supervision of these overseas assets is still underdeveloped. To compensate for the lack of supervision, in 2007 four ministries – the Ministry of Finance, the Ministry of Commerce, the State Administration of Foreign Exchange, and the State-owned Assets Supervision and Administration Commission of the State Council – launched a joint investigation of the overseas assets of central SOEs. For more on SOEs' initial efforts to venture abroad, see Chapter 3.

institutional arrangements in the economic realm, central SOEs gradually obtained a degree of autonomy vis-à-vis the state. In addition, these state firms have exploited their bureaucratic ties, derived from China's unique Party-state system, to negotiate with China's authoritarian yet fragmented bureaucracy over how their transnational projects are to be pursued. Focusing on the changing government-firm relationship, this dissertation opens the black box of the decision-making process that drives the aggressive global outreach of China's SOEs.

By exploring the dynamics of state involvement in the processes of SOE investments abroad, this research provides insights into the issue of the incompatibility between SOEs' political and economic functions. For political reasons, the Chinese state has continued to utilize SOEs as policy instruments and to put SOE managers under the cadre management of the Chinese Communist Party (CCP). This political control, however, dwarfs SOEs' economic functions by inviting non-economic factors into deciding firms' operations. In other words, effective state control and successful market-oriented reform cannot be achieved at the same time. As a result, the evolution of Chinese political economy during the reform era is imbued with much contradiction. This institutional barrier explains why after three decades of reform China is still far from a full-fledged market economy.

I. THE GLOBAL AMBITION OF CHINA'S STATE-OWNED ENTERPRISES

While the increasing global presence of China's state firms as a product of the "Going

Out" strategy is still in its infancy,[3] "China buys the world" nevertheless has become a buzzword around the globe. The transnationalization of SOEs, initiated in the mid-1990s and accelerated in the early 2000s, represented a turning point in China's economic development which for more than two decades had heavily relied on foreign capital inflows. The Chinese state was actively involved in advocating the transnationalization of SOEs and has created a policy environment that is beneficial for SOEs venturing abroad. Abundant state funding, usually bundled with intense diplomatic maneuvering, is central to this government-initiated overseas expansion. This effort is most notable in high-profile resource-related deals, usually causing a mix of uneasiness and amazement in the international community. As shown below, many scholars have argued that economic considerations and international security are key factors to Chinese SOEs' overseas expansion. They generally start their analyses at the macro level, with economic accounts focusing on the stages of national development and security studies focusing on the degrees of international competition.

The economic propositions suggest that China's official advocacy of overseas investment is a policy response to Chinese enterprises' need to gain broader access to raw materials, market shares, proprietary technology, and overseas networks of Chinese capital.[4] In addition to the macroeconomic explanations, those who focus on firm behavior see the waves of internationalization of SOEs as a product of China's partial

[3] The capital outflows from China still remain small. China published its first official statistical bulletin on outward foreign direct investment (OFDI) in 2004; only capital outflows from non-financial sector were included. The 2006 annual statistical bulletin included, for the first time, OFDI from both financial and non-financial sectors. According to the 2006 bulletin, China's OFDI flows and stocks in the year only accounted for 2.72 percent and 0.85 percent of world OFDI flows and stocks, respectively. For details, see Ministry of Commerce (2007, p. 2).

[4] See, for example, Hong and Sun (2006), Yang (2006), Wu (2005), and Wong and Chan (2003).

economic reform. This perspective appears in various forms, but most versions can be represented by the following two contentions. Business economists find that China's state firms, operating under government intervention, are experienced in dealing with the government's industrial policy and corrupt practices. Thus the firms have advantages in venturing into countries where markets are less developed.[5] The other explanation is that the transnationalization of SOEs serves as a channel for state cadres to use up state assets through the informal privatization associated with offshore businesses. In the name of legitimate overseas investment, corrupt officials hide illicit funds gained during the process of ownership transformation.[6]

All of these economic explanations acknowledge that the majority of Chinese enterprises involved in transnational operations are SOEs; however, none of them explores the dynamics of state involvement in the process of promoting SOEs to invest abroad. Their analyses remain curiously apolitical, in which market concerns determine government initiatives. In the context of the Chinese transition economy, ignoring the impact of the changing national institutions on SOEs' investment decisions is a gross oversimplification of reality.

The security approach to Chinese SOEs' global activities, especially the realist conceptions of the connection between wealth and power, tends to treat the state as the most important variable, if not the only one, in explaining the sustained transnationalization of Chinese state firms.[7] This approach contends that the Chinese

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[5] See, for example, Morck, Yeung, and Zhao (2008)
[6] See, for example, Ding (2000a) and Ding (2000b).
[7] In realism, since economic expansion leads the state to gain more material resources that are important for building military forces, the state's economic and political capacities are complementary in the long run.

government uses SOEs' transnational businesses as a means of engaging other countries, with the ultimate goal of bolstering China's political influence against American domination in periphery regions such as Southeast Asia and Africa.[8] In particular, SOEs' energy-related overseas investment is a key element of China's alleged resource-oriented foreign policy.[9] In a slightly different version, political economists that focus more on the role of national institutions in the internationalization of SOEs posit that the Chinese central state uses SOEs' offshore ventures to respond to the challenges posed by an integrated global economy.[10] While security analysts differ in their perceptions of the threats to American leadership posed by Chinese SOEs' transnational operations, they consistently see these ventures primarily as manifestations of China's increasingly skillful diplomacy.[11]

Given that the state-market relationship has been substantially transformed in the Chinese transition economy after more than two decades of economic liberalization, the security explanations make an argument about China's state capacity that is based on incomplete observation. While the central government's visible hand in striking foreign deals is undeniable, how the policy resources will be employed by the designated SOEs should be subject to careful scrutiny. The insufficiency of the security approach becomes immediately apparent in the lack of a coherent state strategy behind SOE ventures, the

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For the Realist argument of international political economy, see Kirshner (1999). For the realist implication of China's economic growth for international relations, see Mearsheimer (2001, pp.401-402).

[8] See, for example, Economy (2005), Shambaugh (2005), Ohashi (2005), and Womack (2003-4). One exception is the works by Downs (2006, 2007a) that examine China's energy security policymaking and the role of National oil companies (NOCs) in China's global hunt for oil. The author notes that Chinese NOCs are capable of pursuing their own commercial interests and thus further exacerbate the problem of fragmented authority in the making of energy security policy.

[9] See, for example, Taylor (2006), Friedberg (2006), Leverett and Bader (2005-6), and Zweig and Bi (2005).

[10] See, for example, Zhang (Zhang Yongjin 2003).

[11] See, for example, Shambaugh (2004-5).

vicious competition among China's two biggest national oil companies being the most conspicuous case in point.[12] In short, the economic and security explanations oversimplify the power relationship between the state and the market in the reform era, reducing it to an either/or debate. These existing studies are correct that economic and security goals have motivated the Chinese state to pursue the "Going Out" strategy, providing a useful starting point to study SOEs' global outreach. Their arguments, however, remain analytically unsatisfying and tell only part of the political story behind the "going out" strategy.

II. A FRAGMENTED BUREAUCRACY, THE CHANGING STATE-MARKET RELATIONSHIP, AND THE "GOING OUT" STRATEGY

In this dissertation, I propose an argument that highlights constant negotiations and bargaining between a fragmented state and SOEs during the firms' "going out" process. In China's partially reformed economy, state institutions constantly adapt themselves to the changing state-market interactions. Along with institutional adaptation to market forces, the gradual dismantling of the industrial planning system changed the dynamics of bureaucratic control over state firms, leading to a transformation of managerial incentive structures. This change is easily observed in bureaucratic inter-agency relationships and bureaucratic agencies' interactions with SOEs. Focusing on these two threads of power relations, I call this perspective the bureaucratic politics argument.

[12] For details, see Chapter 4.

When I talk about “bureaucratic politics,” I simply mean the bargaining, negotiation, and exchange relationships that arise from policy-making processes among different bureaucratic institutions and politically-ranked SOEs. The definition incorporates important components of bureaucratic structures in China during the reform period. As Lieberthal and Oksenberg (1988) identify in their seminal model of “fragmented authoritarianism,” which is used to describe the bureaucracy of the post-Mao era, the authority of decision-making in a given policy arena is shared among different bureaucratic agencies. Each of them controls considerable administrative resources that are essential to achieving a mutually agreed-upon policy. Because the decentralization of authority in the Chinese political system entitles the affected bureaucratic agencies to “mutual veto power,” Lampton (1992) contends that bargaining is an “authority relationship” of “reciprocal accommodation” which dominates the policy-making processes in China’s complicated territorial and functional hierarchies. In Mertha’s (2008) observation of “the pluralization of the policy process,” he finds that even though more players outside the bureaucracy are included in policy making in response to the socioeconomic change brought by the reform, prolonged bargaining and negotiation is still a defining feature of the Chinese bureaucratic system.

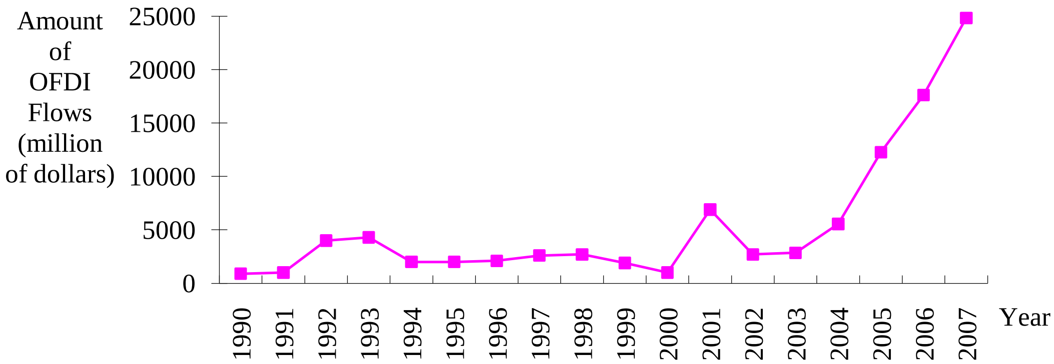
Before presenting my argument, the term “overseas expansion” needs further elaboration. The overseas expansion that this study describes centers on two kinds of firm behavior: outward foreign direct investment (OFDI) and international contracting.[13]

[13] According to the Administrative Regulation on International Engineering and Construction Contracting promulgated by the State Council in 2008, international contracting refers to the activities of contracting foreign construction projects engaged by Chinese enterprises or units. State Council,

Although the policy components of China's "Going Out" strategy also include international labor and service cooperation,[14] the two modes of internationalization I examine represent the firms' pursuit of more hands-on management in offshore activities, by which firms' corporate strategies are easily observed. It is clear that both China's OFDI and international construction contracting witnessed a rapid surge after the "Going Out" strategy was officially listed as a long-term economic development agenda in 2001. How exactly did SOEs interact with central bureaucrats with regard to firms' transnationalization during the economic transition?

Zhonghuarenmingongheguo Guowuyuan Ling Di 527 Hao [*People's Republic of China State Council Order Number 527*], 2008. See http://www.gov.cn/zwgk/2008-07/28/content_1057815.htm, accessed on October 1, 2008.

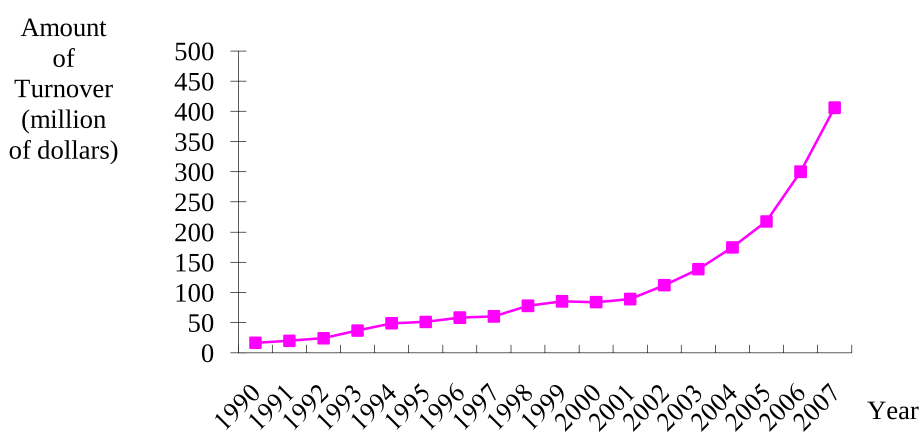
[14] According to the Ministry of Commerce (MOC), international labor and service cooperation mainly refers to: (1) Activities involving labor and service provided for agencies of foreign governments, foreign groups, foreign enterprises, and foreign private employers in exchange for remuneration; (2) Activities of Chinese workers engaging in design, construction, and management with regard to projects of international engineering and construction contracting, projects of foreign economic aids, construction projects of foreign embassies, and missions. Ministry of Commerce, *Duiwai Chengbao Gongcheng, Laowu Hezuo He Sheji Zixun Yewu Tongji Zhidu Jiedu* [The Policy Interpretation on the Statistical Framework of International Engineering and Construction Contracting, Labor and Service Cooperation, and Design and Consultant Businesses], 2007. See http://hzs.mofcom.gov.cn/aarticle/bk/200512/20051201056990.html, accessed on October 1, 2008.



Note: Due to the lack of a centralized tool for collecting OFDI statistics, the Chinese government relies on the OFDI data released by the United Nations Conference on Trade and Development (UNCTAD) for making up the data gap in the pre-2002 period.

Source: Based on various sources of China's OFDI compiled by the Ministry of Commerce (MOC), the National Bureau of Statistics (NBS), and the State Administration of Foreign Exchange (SAFE).

Figure 1.1 China's Government-approved OFDI, non-financial sectors, 1990-2007



Source: China Statistical Yearbook, various years.

Figure 1.2 China's Government-approved Overseas Contractual Projects, 1990-2007

To explain the state-SOE relationship that shapes the process of the “Going Out” strategy, I make two assertions. My first argument is that with the constant negotiations and bargaining between the state bureaucracy and SOEs over the operation of overseas projects, SOEs’ expansion reflected more the firms’ corporate strategy than the state’s policy objectives. The state’s advocacy of the transnational expansion of SOEs was aimed at achieving national economic and security goals, but SOEs, with the expanded autonomy they gained from corporatization reform, have been able to ignore state directives that were detrimental to firms’ financial performance. Two institutional features of the Chinese economy bolster the emergence of SOEs’ corporate autonomy, leading to a behavior change in SOE managers who are facing conflicting political and economic incentives: fragmented and conflicting bureaucratic intervention in SOEs’ operations, and SOEs’ continuous bureaucratic leverage.

Since the pre-reform era, bureaucratic control over SOE operations has never been unified into an overarching national authority. Without being held accountable for any of their decisions ranging from personnel to production, related bureaucratic agencies acted in a predatory way to extract SOEs’ financial surplus (Naughton 1995). The phenomenon of “bureaucratic plundering” worsened as the progress of economic reform decentralized the authority of government intervention by introducing more bureaucratic actors into the game (Steinfeld 1998, p. 61). Moreover, lines of authority among various government bodies are repeatedly redrawn in response to reform-driven changes in the state-enterprise interactions. This administrative restructuring further spurs various bureaucratic parts’ struggle with each other to preserve their parochial interests; in that fight, they attach divergent agenda priorities to the SOE reform and assign different missions for SOEs to carry out. Under this fragmented regulation, SOEs' expected role in the "Going Out" strategy was prescribed to serve different, sometimes incompatible, national goals.

In sharp contrast to the fragmented policy-making process, corporatized SOEs increasingly focus on corporate interests facilitated by their bureaucratic ties, despite their political mandates to serve national security and economic interests. Given that public ownership forms the cornerstone of the CCP regime even throughout the reform era, SOEs are still designated to accomplish certain broader national goals, including carrying out state-led industrialization, generating financial surplus for government expenditures, and maintaining macroeconomic balance.[15] Aiming for goals beyond the economic meaning, all of these SOEs' political functions are imposed in a manner that disregards the potential negative impact on economic efficiency at the firm-level.

Corporatized SOEs, however, are not passive recipients of state-imposed obligations due to changes in managerial behavior. As part of the Party-state cadre system, SOE managers in the post-corporatization period simultaneously face conflicting political and economic incentives when acting as both party officials and business entrepreneurs. As the corporatization reform progressed, providing central reformers the last hope for a market-oriented state sector, SOE managers increasingly prioritized firms' corporate interests over national policy interests to serve their own goals of career

[15] By making this statement, I do not mean that SOEs' political functions under the command economy remained intact during the reform era. In certain areas such as employment creation and compensation, the state has been compromised in terms of SOEs' role in fulfilling state imperatives under socialism. Nevertheless, it is fair to claim that, in the post-corporatization era, the Chinese state still utilizes SOEs to engage in redistribution in the economy. See Naughton (2006).

promotion. SOE managers are thus motivated to take advantage of their bureaucratic ties, opening a channel for SOE managers to lobby for favorable policies in a fragmented decision-making process. It is worth mentioning that the bureaucratic connections that once stifled SOEs' profitability transform into facilitation to protect these firms' lucrative gains from China's partial reform.

Starting with partial liberalization of the price system, China's economic reform is characterized by its incremental and gradual pace of institutional change, with SOEs and their managers being favored by initial price distortion.[16] As the transition literature points out, the gradual and partial reform strategy is more likely to produce a group of winners who benefit from new rent-seeking opportunities created by the lack of complementarity between the reformed and unreformed parts of the economic system.[17] Like Hellman's (1998) observation of the early beneficiaries of economic reform in Eastern Europe, China's SOEs and their managers are politically powerful and have an interest in blocking progress during the transition that can damage their early gains/rents, which leaves China's transition incomplete and stalls the economy in a "partial reform equilibrium."[18]

In sum, it is against this reform background – populated by politically powerful SOEs that are capable of negotiating with a fragmented bureaucracy in favor of corporate

[16] For a comprehensive overview of China's partial reform over the past three decades, see Naughton (2007).

[17] See, for example, Przeworski (1991).

[18] Rent is defined as "part of the payment to an owner of resources over and above that which those resources could command in any alternative use… The term rent seeking is designed to describe behavior in institutional settings where individual efforts to maximize value generate social waste rather than social surplus" (Buchanan 1980, pp. 3-4). Pei (2006) offers an excellent account of how rent is created, protected, and distributed among central SOEs in China's partially reformed economy.

interests – that the "Going Out" strategy was initiated. Unlike the existing economic and security approach to the "Going Out" strategy, which is analytically too static, I argue that the "Going Out" strategy and associated state firms' global outreach are characterized by a dynamic state-SOE relationship, with SOE managers maneuvering conflicting political and economic incentives to venture abroad without incurring career setbacks in the Party-state. I contend that negotiation and bargaining between China's fragmented bureaucracy and SOE managers over the terms of firms' "going out" grow more intense as corporate autonomy become increasingly institutionalized with the progress of reform.[19] I find that increasingly institutionalized corporate autonomy has provided SOE managers with a ready justification to pursue cross-border projects in disregard of state directives. This is not to suggest, however, that SOE managers outright resist state mandates to protect firms' financial interests in their overseas activities. Given that the state controls their career advancement, SOE managers carefully navigate parochial bureaucratic interests, currying favor with certain parts of the bureaucracy to gain support in altering other bureaucrats' decisions that are not in their best interests.

In addition to the dynamic "going out" process, my second argument is that compared to their domestic operations that lack market discipline and economic efficiency,[20] SOEs' overseas activities become increasingly responsive to market signals

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[19] For the institutionalization of SOEs' corporate identity, see Huang (2003).

[20] According to economists, there are two ways to examine SOEs' economic efficiency: total factor productivity and a variety of financial indicators, including profitability, incidence of loss-making, fiscal subsidies, liability-to-asset ratios, and unfunded pension liabilities (Lardy 1998). Analysis based on these measures finds that "by virtue of their size, the industrial assets at their command, the inefficient use of resources, and outright waste on redundant or suboptimal production capacity and on inventories for which there is no market, the dismal economic and financial performance of SOEs is a serious drain on the economy – with ramifications extending well beyond the enterprise sector" (Yusuf, Nabeshima, and

as the “Going Out” strategy proceeds. The imposition of market discipline on SOEs’ overseas conduct, however, occurs as an unintended consequence of the “Going Out” strategy through the combination of changes in the information environment in which SOEs operate and SOEs’ corporate adaption to such changes. Without interference from bureaucratic vested interests, SOE managerial misconduct is more easily detected by non-state stakeholders of SOEs’ overseas projects, including foreign investors and international organizations. Under the pressure of improved information flows in overseas markets, SOE managers learn the standard practices of the world economy and adapt to the global norms of corporate governance. Unfortunately, these improvements are unattainable in the Chinese domestic market due to ineffective monitoring of these firms. While it is still too early to measure how systematic and steady this reforming effect is on the SOEs, in the two sectors – petrochemical and construction – that I examine, there is an increasing tendency of managerial behavior change towards transparency and accountability.

Meanwhile, the bureaucratic politics explanation accounts for several anomalies not addressed by the existing literature. For example, as mentioned in the beginning of the chapter, SOEs’ initial efforts to venture abroad in the first decade of the “Going Out” strategy have led to considerable loss of state capital and rampant corruption. As will be shown in Chapters 4 and 5, in competing for cross-border projects, both case-study SOEs had been involved in head-to-head rivalry with their domestic counterparts, who also enjoy state preferential policy supports. Such competition, usually accompanied by the

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Perkins 2005, p. 17).

blind expenditure of state funding, hardly advanced national security and economic interests at an aggregate level. The bureaucratic politics associated with the dynamic "going out" process explains why the Chinese state has progressively relaxed its control over SOEs' global expansion despite these early disappointments. Namely, given the negotiated nature of the state-SOE relationship, China's fragmented bureaucracy has initiated the "Going Out" strategy but cannot accurately determine its course. Overall, the bureaucratic politics argument by no means invalidates the existing economic and security explanations. While focusing on bureaucratic politics, I recognize that both economic and security factors are important motivations for the Chinese government's advocacy of the "Going Out" strategy, thus creating a more nuanced and holistic picture than either of the existing theories could provide on their own.

Finally, one caveat should be put forth. It is reasonable to assume that China's authoritarian regime is more capable of insulating its policy initiatives from societal pressures than democratic regimes. However, when I suggest that the Chinese state has its own goals, I do not mean that the Chinese state is a unitary actor with coherent preferences, interests, and agendas. As the preceding introduction of "fragmented authoritarianism" shows, it is not. Instead, I argue that the authoritarian Chinese state can "formulate and pursue goals that are not simply reflective of the demands or interests of social groups, classes, or society" (Skocpol 1985, p. 9). In my analysis, states are institutions composed of various governmental agencies that are guided by a broad "regime orientation," shaping bureaucrats' responses to a given policy environment in a relatively consistent way.[21] In the following chapters, when exploring the role of state interests in driving the "Going Out" strategy, this dissertation tackles the issue not from the perspective of a monolithic entity of the state but rather a coalition of state actors.

III. A NOTE ON METHODOLOGY

In order to explore how the transformation in the incentive structure leads to managerial behavior change, this dissertation departs from the current literature emphasizing macro factors in China's development. Instead, it focuses on individual managers' choices in response to various institutional constraints associated with the new state-market relationships under a condition of hierarchy. As will be discussed in Chapter 2, the theory of agency, derived from Neoinstitutional Economics (NIE), provides an informative analytical tool to study the exertion and limits of hierarchical control and monitoring dictating interactions between China's fragmented party-state and politically powerful central SOEs. By focusing on the behavior of individual SOE managers in authority relations, my "bureaucratic politics" approach to China's "Going Out" strategy allows empirical testing of hypotheses drawn from the logic of principal-agent interactions.

Two hypotheses emerge from my bureaucratic politics perspective and application of NIE. First, because multiple bureaucratic actors in a partially reformed economy delegate different tasks to state firms without simultaneously establishing

[21] Vogel (1996, pp. 20-22) argues that states should be treated as both actors and structures. As actors, states are guided by certain ideas or an orientation conditioning the scope of acceptable policy solutions. State officials share certain "core beliefs" about how to react to external pressures, leading to some degree of consistency in state actions. For more on state capacity to formulate monolithic and long-term policies, also see Skocpol (1985, pp. 14-15).

effective control over the firms, politically powerful SOE managers are not simply instruments of a diverse array of bureaucratic actors but are able to decide how firms' transnational projects develop. Managers' decisions are likely to reflect firms' commercial interests regardless of political mandates, such that even when an SOE's commercial interests in a given transnational project run counter to national security and economic interests, the state has difficulty controlling its behavior. Thus:

> *H1: SOE managers exploit their bureaucratic connections to alter state directives concerning transnational projects that are not in the best interest of corporate financial performance.*

This hypothesis is tested through close scrutiny of managerial behavior related to the case-study SOEs' transnational activities, specifically when SOE managers made business decisions different from what central bureaucratic intended SOEs to pursue. For example, because there was more than one agent SOE engaging in similar transnational activities, central decision-makers frequently called for cooperation among these SOEs, such as forming a consortium, in order to maximize national interests at the aggregate level. Business volume and market share, however, are key indicators in deciding whether SOE managers are promoted to limited positions with higher administrative ranks in the post-corporatization era. Instead of cooperating with each other to share international projects, therefore, SOEs are more likely adopt confrontational strategies against their domestic counterparts. They either engage in price wars with the domestic firms at the expense of state funding or collude with foreign partners with superior market influence in opposition to their domestic counterparts. If this hypothesis holds, managers not only get away with projects counter to the interests of their principals, but they also appear capable of negotiating policy supports for the firms' subsequent overseas activities. Alternatively, if national economic and security interests triumph over SOEs' commercial interests, we should expect that defiance of national mandates to have a negative impact on managers' career development.

There is, however, an important differentiation in SOEs' capability to bargain with bureaucratic actors over the terms of firms' "going out." China's central leaders repeatedly claimed that the government actively and comprehensively supports qualified firms to venture abroad without differentiating firms' ownership structures and bureaucratic ties.[22] Nevertheless, an argument based on the bureaucratic politics framework suggests that SOEs' administrative ranks in China's political hierarchy determine the extent of the political and economic resources at the firms' disposal. Higher administrative ranks mean that SOEs have more wherewithal to bargain with bureaucratic actors to gain more policy supports for their overseas projects as they maneuver among a diverse array of central bureaucratic agencies. Phrased as a general hypothesis:

[22] See, for example, Chinese Premier Wen Jiabao's work report to the National People's Congress in March 2010, http://www.chinareviewnews.com/doc/1012/4/9/6/101249648.html?coluid=7&kindid=0&docid=101249648&mdate=0305122211, accessed March 9, 2010.

H2: The higher a SOE's administrative rank, the more preferential treatments it can acquire from the state.

This hypothesis is tested by comparing state aid packages for the transnational operations of two case-study SOEs with different administrative ranks. Before launching state-initiated transnational projects, the central government often invites the involved SOEs to high-level meetings where central leaders, key central bureaucrats, and representatives of state banking institutions gather to discuss the content of state aid packages, which include diplomatic supports, cut-rate loans, direct capital subsidies, easy licensing procedures, and tax breaks. If the hypothesis is valid, we expect that more state aid goes to SOEs with higher administrative ranks. Alternatively, all SOEs receive similar preferential treatments without differentiating their administrative ranks.

I made use of government reports and archives, corporate documents, and newspaper articles to trace the evolution of the "Going Out" strategy and associated SOE projects. I pay particular attention to two case studies: China National Petroleum Corporation (CNPC) and China State Construction Engineering Corporation (CSCEC). This dissertation will examine change over time within each case as well as across cases. Three factors make these cases promising candidates for testing the theories developed above. First, these cases enable us to explore the two primary forms of overseas expansion prescribed in the official documents of the "Going Out" strategy – OFDI by CNPC and international construction contracting by CSCEC. Although both SOEs undertake three types of firm behavior – OFDI, international contracting, and international labor ad service cooperation – to extend their global reach, I focus on the primary form of internationalization that each firm adopts.[23]

Second, since both firms are policy agents delegated by the central government to fulfill certain security and economic goals, in which the dynamic dimensions in the SOE relationship can be easily observed, they provide rich data on the bureaucratic politics associated with SOEs' overseas expansion. Moreover, both SOEs are the largest domestic firms in their sectors and they have received continuing media coverage and public attention, making it relatively easy to gather relevant information. Most importantly, variations in their administrative ranks allow a more direct test of the second hypothesis developed above. CNPC, which evolved out of the Ministry of Petroleum Industry, is ranked at the ministry level, which enhances its bargaining power vis-à-vis central reformers and protects its market-resistant behavior. CSCEC, which is ranked at the vice-ministry level, is a conglomerate that was formed in the early stages of economic reform through the merger of a diverse array of privileged state-owned construction firms. It is capable of negotiating deals "under the table" during the bidding process for governmental construction and infrastructure projects. By comparing their respective state-aid packages, this dissertation reveals how administrative ranks and associated bureaucratic ties influence the policy-making process of the "Going Out" strategy.

Third, sectoral analysis is an effective way to examine the state-SOE relationship in the Chinese transition economy. While I look at firms as my unit of analysis, Chinese

[23] This research focus is also justified by the fact that international labor and service cooperation reveal little information about corporate strategies.

policy-makers often formulate policy along sectoral lines. Given that CNPC and CSCEC operate in state-monopolized and competitive markets, respectively, they provide a comparable fit. Looking at CNPC and CSCEC enables me to compare how managers responded to changing incentive structures and balanced their dual identities under different sectoral constraints.

IV. OUTLINE OF THE DISSERTATION

I limit my study to transnational projects managed by China's central SOEs. Although transnational projects by local SOEs have impacts on advancing national agendas, central SOEs are the leading agents in fulfilling national policy objectives set by the Chinese central government. Projects undertaken by local SOEs in foreign markets are not necessarily less influential to national development;[24] however, on average local SOEs are less capable of mobilizing the resources required to engage in international competition with strategic importance. This is especially true when talking about China's high-profile resources hunt. Central SOEs also enjoy deeper integration into the world economy than their local counterparts. According to China's official data, central SOEs still contribute the majority of China's OFDI stock.[25] Finally, central SOEs' transnational operations are subject to less, but not necessarily looser, regulatory authority. Overseas expansion by local SOEs incurs complicated bureaucratic interactions between firms,

[24] For example, Shougang Group, a Beijing-based SOE, is one of the flagship companies that pioneered the large-scale transitional operations in the early 1990s. For the case study on Shougang's development into a multinational corporation, see Zhang (Zhang Yongjin 2003, chapter 7).

[25] For details, see Chapter 3.

local governments, and the central government.[26] To clearly specify the state-SOE relationship that emerged from an outward-looking policy in reform China, my research thus focuses on central SOEs as the main policy agents.

Admittedly, China's state sector has undergone a significant degree of privatization, leading to a reduction in the share of industrial value added by the state firms: from 77.6 percent of China's industrial GDP in 1978 to around 29.5 percent in 2007.[27] The study of China's state-owned industries, however, has never lost its contemporary relevance. Numerous SOEs operated at negative margin rates and the average net rate of return on capital invested in the state sector as a whole fell to almost zero in the late 1990s (Holz 2001). While the situation had given rise to considerable pessimism regarding the nation's sustainable growth, a comeback of China's SOEs is now under way. In the past couple of years, China has gone through a sea change in its state sector with state firms, especially centrally government-controlled firms, regaining their importance in China's socialist market economy.[28]

The Chapters of this dissertation are organized according to the following

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[26] To simplify the procedure of investing abroad, the right of approval for an investment valued under $1 million was decentralized to provincial and municipal authorities. In 2003, twelve provinces and cities were chosen for a pilot study in which they were given more authority in the process of approving projects of overseas investment worth no more than $3 million.

[27] For statistical details, see National Bureau of Statistics (2008). "State firms" here refers to state-owned and state-holding industrial enterprises. Since the mid-1990s, China's state sector has undergone a series of ownership restructuring. One of the most well-known programs was "grasping the large and letting go of the small" (*zhuada fangxiao*) by which profitable large SOEs were retained under the public ownership while loss-making small SOEs were transferred to private hands. A less well-known but influential reform agenda was the ownership restructuring program within each individual SOE, known as "corporatization." Central SOEs directly supervised by the State Council were especially targeted. To diversify corporate ownership, many of these corporatized SOEs either issued shares on stock exchanges or set up subsidiaries or affiliates through legal-person shareholding. While these SOEs lack the traditional outlook of state firms which are characterized by 100 percent state ownership, they are still considered to be state firms due to the government's right to retain formal control.

[28] For a brief overview, see Naughton (2009).

arrangement: Chapter 2 lays out my analytical framework and theoretical perspective that build upon the insights of the NIE, emphasizing that individual actors involved in the "Going Out" strategy intend to maximize their objective functions under institutional constraints. Chapter 3 traces the broad history of Chinese SOE reform to explore the origin of the incompatibility between SOEs' political and economic roles. I then proceed to detail the political and economic situations faced by the state sector and against which the "Going Out" strategy has evolved.

Chapters 4 and 5 apply the theoretical model to two case studies - the China National Petroleum Corporation (CNPC) and the China State Construction Engineering Corporation (CSCEC). In the concluding chapter, I discuss some broader implications of the neoinstitutional analysis of SOE reform in China that were developed in the previous chapters. I pay particular attention to two aspects of China's partial reform: the negotiable nature of the state's control over SOEs and the socialist nature of SOE reform. Contrary to the hopeful view that successful SOE reform will build positive momentum for political reform, this dissertation puts forth a gloomy scenario in which market-oriented SOEs become another tool for the state to put off political liberalization.

Chapter 2. An Analytical Framework: The Neoinstitutional Approach

As discussed in the previous chapter, the traditional analyses of economic factors and security strategies provide an insufficient foundation for understanding the recent surge in overseas expansion of China's SOEs. Without taking into account China's transition from plan to market, the traditional explanations oversimplify the power relationships between the state and its SOEs. This chapter presents a "bureaucratic politics" framework to study SOEs' overseas expansion by building upon theoretical insights of Neoinstitutional Economics (NIEs). The focus is on hierarchical authority structures in state institutions and how individual actors perform assigned tasks under such arrangements. In China's Party-state, the CCP controls the bureaucratic system to advance its agenda, by which "the hierarchy of government organs is overlaid by a parallel hierarchy of Party committees that enables Party leaders to supervise Party members in the government and lead the work of the government" (Shirk 1992, p. 63). How has the bureaucratic politics associated with this Party-state arrangement shaped the evolution of China's "Going Out" strategy? The purpose of this chapter is to introduce NIE as a conceptual guide to understand bureaucratic delegation and control in China's state sector, to illuminate the organizational dynamics of the Chinese bureaucracy, and to explain the government-initiated overseas expansion of central SOEs.

I. A PRINCIPAL-AGENT ANALYSIS OF CORPORATIZED CENTRAL STATE-OWNED ENTERPRISES

With the assistance of NIE's analytical insight into hierarchical interactions,[1] the core of this dissertation concerns the aggregation of organizational dynamics affecting central SOEs' transnationalization, including those 1) among different parts of the central state bureaucracy, and 2) between various bureaucratic actors and central SOE managers. In the following sections, I briefly introduce each of the NIE theoretical components and apply them to the study of China's state sector.

1. Neoinstitutional Economics and the Study of Public Bureaucracy

By introducing constraints on information and transaction costs into the analysis of economic organizations, NIE articulates how various contract arrangements induce different economic behaviors. In the real world, a principal would find an agent to fulfill some specific task that he/she cannot to perform due to a lack of relevant knowledge or limited time. Eggertsson states that "an agency relationship is established when a principal delegates some rights – for example, user rights over a resource – to an agent who is bound by a (formal or informal) contract to represent the principal's interests in return for payment of some kind" (Eggertsson 1990, pp.40-41).

The principal hires the agent in exchange for the agent's skills to act in her/his

[1] The term of "Neoinstitutional Economics" (NIE) was first coined by Oliver Williamson in 1975. The NIE research program represents a theoretical departure from the Neoclassical Economics that emphasizes empirical testing. Broadly speaking, the NIE studies are concerned with economic arrangements and institutional changes. See Williamson (1975) and Menard and Shirley (2008).

interests. Yet the principal cannot always induce the optimal effort and performance of the agent simply because the agent may not share the same goals as the principal. At the same time, the agent has information advantages in his/her own work such as professional knowledge that the principal does not have or the level of effort that the principal cannot observe. Since the cost of monitoring every piece of information pertaining to the agent's performance is too high for the principal to afford, there is always room for agents' opportunism. As North explains, "we can think loosely of opportunism, at this point, as the ability of one party to an exchange to benefit at the expense of the other party by violating the agreement in his or her post-contractual behavior" (North 1981, p. 36).

Notably, the agent is still constrained by the contractual relationship with the principal in a hierarchical setting. He/She will strategically respond to constraints imposed by the contractual relationship and seek to maximize his/her own returns. The concerns of the agent's opportunism and his/her compliance therefore are the focus of the NIE literature (Jensen and Meckling, 1976). The NIE studies concentrate their efforts on searching for incentive structures, usually institutional arrangements, to control the agent's opportunist behavior and lower agency costs stemming from setting up a monitoring mechanism (Coase 1998).

NIE's economic contractual framework also informs analyses of political institutions.[2] Moe (1984) draws special attention to the application of NIE to the study of

[2] For a critical investigation in the application of NIE to the study of political economy, see Caporaso and Levine (1992, chapter 6).

public bureaucracy with some necessary revisions.[3] Agency studies on public bureaucracy are primarily concerned with how political authorities, as a principal, maintain control over self-interested bureaucratic agents, while bureaucrats hold private information not available to political authorities (Moe 2005b, p. 29).[4] Although agency theories of public organization have been applied mostly in democratic contexts, their basic insights also provide a solid foundation for understanding hierarchical control in Soviet-type systems. In a Soviet-type system, central planning substitutes for capitalist market mechanisms, and central planners rely on information collected by subordinate bureaucrats to elaborate the plan.[5] For the plan to be feasible, central planners must have access to accurate information. It is thus imperative for lower-level bureaucrats both to implement the plan and to transmit accurate information to the center. Yet the information problem is pervasive in such a system, not only because of the complexity of information processing but also because subordinate actors have incentives to distort their real productivity in order to lower production tasks. Monitoring therefore quickly became the backbone of centrally planned economies (Solnick 1999, pp. 27-28).

These ideas and the logic of the agency theory led to the growth of unusually productive works on Chinese political economy in the reform era.[6] At the heart of their analyses, institutional changes in the reform era such as the regime of property rights are

[3] For example, the NIE relies on the assumption of "voluntary exchange among rational individuals" in private organizations; however, Moe argues that public institutions emerging from political processes oftentimes are "structures of power," not "structures of voluntary cooperation," and thus are not mutually beneficial to all participants involved as the NIE assumes. See Moe (2005a).

[4] See also McCubbins, Noll, and Weingast (1987).

[5] The discussion is drawn mainly from Kornai's works. See Kornai (1992, chapter 7) and Kornai (1990).

[6] For example: Lin's (Lin Yimin, 2001) research on the transformation of China's state-owned enterprises in both political and economic markets; Whiting's (2001) investigation on incentive structures and local officials' behavior; Oi's (1999) study on the institutional foundations of economic growth in rural China; and Huang's (1996) work on inflation and investment controls in different localities.

the result of strategic interactions among relevant actors under institutional constraints imposed both by the historical legacies of the command economy and reform resources available to them. Their emphasis on contextual factors in creating institutional evolution reflects the attempt to include contextual settings in the conceptual framework addressed by the NIE literature.[7] My analytical framework builds upon these theoretical observations. In the following section, I discuss factional dynamics within the Chinese central bureaucracy in charge of SOE reform, which I describe as fragmented bureaucratic principals with conflicting parochial interests in SOE reform.

2. Fragmented Bureaucratic Principals

The public bureaucracy in the Chinese Party-state includes three hierarchical organizations – the CCP, the government, and the People's Liberation Army (PLA). The Party exerts ultimate political authority over the other two entities (Lieberthal 2004, pp. 77-83). As in the Soviet system, the CCP Party apparatus parallels government agencies at all levels, with the Party committee (*dangwei*) in each agency managing government administration to ensure the Party's control over the system. In addition to the Party committee, which is theoretically elected by Party members in each government organ, the CCP Central Organization Department (COD) appoints the Party group (*dangzu*) in key government organs such as central ministries.[8] In principle, the Party committee is established for governing Party members and corresponding government work inside the

[7] Avner (1998) notes that there are recent efforts "to explore the role of history in institutional emergence, perpetuation, and change" within the NIE tradition.
[8] See "The Constitution of the Chinese Communist Party, Article 46."

agency at all levels, and the Party group is set up for assisting the CCP's supervision of government operations including both Party and non-Party bureaucrats' decision-making.

At the central level, we can observe many confusing authority relationships, with both the Party committee and the Party group holding overlapping leadership positions. In theory, the Party committee plays a governing role in a given agency which is termed a "leadership relationship" (*lingdao guanxi*), while the Party group represents the supervision from those above in the Party hierarchy which is termed an "advisory relationship" (*zhidao guanxi*). The Party group is thus not a formal institution with administrative authority. However, in most cases, when the Party committee and Party group co-exist in a government body, the latter is more powerful than the former. This is because the Party group is appointed by the superior Party units, exercising authority from above.

Aside from Party control of the state apparatus, another source of confusion comes from the co-existence of both vertical authority relationships called lines (*tiao*) – from central ministries in charge of various sectors down to agencies with the same functional authority at various levels – and horizontal relationships based on territorial administration within a given geographic jurisdiction called pieces (*kuai*). Provincial governments are bestowed a bureaucratic rank equal to central ministries' in the administrative hierarchy. Much of time, functional government organs at the provisional level listen to their territorial bosses, the provincial governments, rather than their functional superiors within the State Council ministries. Such a power alignment can render futile the central government's effort to maintain the integrity of the regulatory framework, especially in the realm of regional economic development, when excessively strong *kuai* relationships can lead to local protectionism and rigid lines of *tiao* can cause bureaucratic fragmentation (Mertha 2005). In particular, local authorities obsessed with attaining high growth rates, a leading criterion in assessing cadre performance, often protect local enterprises by setting up discriminative policy barriers against economic actors from other jurisdictions. Trade wars among different localities have created a collection of competing local markets instead of a unified national market.[9]

The confusion of bureaucratic authority extends even to state firms and their managers.[10] Each state firm and its managers are given bureaucratic ranks depending on their significance in the Chinese political system. For example, CNPC and its general manager are given administrative ranks equivalent to those of a central ministry and minister, resulting in regular tension with central regulators of equal or lesser bureaucratic rank. Chronic oil shortages bring about uneasy interactions between two oligopolistic oil giants, CNPC and China Petroleum and Chemical Corporation (Sinopec), and the planning apparatus – specifically the Department of Price of the National Development and Reform Commission (NDRC). Under current price regulations, the firms lose money on refining imported crude oil when domestic government-controlled prices lag behind global market prices, creating a powerful disincentive to production. In spite of public unrest caused by the artificial shortage of refined petroleum products, CNPC and Sinopec regularly reduced their product supply to domestic gas stations and

[9] For the impact of regional competition and local protectionism on China's economic reform, see Wedeman (2003) and Yang (1997).

[10] The most important document establishing a systemic framework for bureaucratic rank was "The Decision of the Salary Reform" (*Guanyu gongzi gaige de jueding*) promulgated in 1956, in which the Chinese government categorized state employees into 30 grades.

instead exported their oil products for better returns when their production costs were not covered by regulated oil product prices set by the NDRC's Price Department. CNPC and Sinopec resisted political pressure from central regulators, who were lower-ranked in the bureaucratic hierarchy, and successfully forced a government compromise on the issue – either increasing the regulated oil price or compensating firms' losses resulting from the price control.[11]

Despite the complexity of the Chinese bureaucratic web, the role of the CCP in bureaucratic decision-making is prominent, mostly through the *nomenklatura* system in which the Party monopolizes appointments to public organizations such as government agencies, the judicial system, and state firms.[12] In light of the nature of China's bureaucracy, when I use "bureaucratic politics approach" to explore central SOEs' transnationalization, I incorporate bargaining, negotiation, and exchange relationships that arise from bureaucratic interactions in both the government and the Party without further determining which influence is more important in a given area. In theory, the Party and the government are two separate public organizations, but in reality, the organizational boundary between the Party and the government is blurred. The reasons for this are twofold.

First, because major decisions are made by the Party, the government is actually

[11] The problem of fuel scarcity was covered extensively in the Chinese press. See, for example, http://www.nfcmag.com/articles/857, accessed January12, 2010.

[12] Lieberthal (2005, p. 234) defines the *nomenklatura* as "consist[ing] of lists of leading positions over which party units exercise the power of appointment and dismissal, lists of reserve candidates for those positions, and rules governing the actual processes of appointments and dismissals." He also notes that "through its *nomenklatura* system, the CCP exercises control over who attains leading positions not only in the party, but also in the government, judicial system, schools and universities, enterprises, research establishments, religious organizations, museums, libraries, hospitals, and so forth." For a study on the reformulation of the Chinese *nomenklatura* system in response to changes brought by the economic reform in 1998, see Chan (2004).

an organization that implements the Party's policies. To ensure Party leadership, the leading positions in a given government body are held by Party officials, meaning that one individual acts as both the Party official and the head of the government body.[13] Second, in certain cases, the staffing in the government agency and its Party counterpart overlaps, rendering the former a hollow shell. The two bodies are one identical institution under two names (*yitao renma, liangkui zhaopai*). For example, the State-owned Assets Supervision and Administration Commission of the State Council and the State-owned Assets Supervision and Administration Commission of the CCP Central Committee have identical membership. As such, it is logically justified to ignore organizational boundaries of the Party and the government in terms of bureaucratic decision-making. My analysis primarily explores two sets of authority relationships at the center – interactions among various central bureaucratic actors and interactions between central SOEs and their central superiors.

On the top of China's official organizational chart are the Politburo, representing the Party, and the State Council, representing the government: the former has paramount authority of decision-making while the latter carries out decisions. Below the State Council are ministries and provinces. As I noted in the previous chapter, the defining organizational feature of the Chinese political system is "fragmented authoritarianism" – the segmented dynamics found across an array of bureaucratic organs. In studying the policy process of China's energy sector, Lieberthal and Oksenberg suggest that it is "a fragmented bureaucratic structure of authority, decision making in which consensus

[13] The recent exceptions at the ministerial level are Wan Gang, the Minister of Science and Technology, and Chen Zhu, the Minister of Health, who were appointed in 2007.

building is central, and a policy process that is protracted, disjointed, and incremental" (Lieberthal and Oksenberg 1988, p. 22). In other words, no single bureaucratic actor has the ultimate authority to dominate the policy process. Instead, the political process is fraught with negotiation and compromise, accommodating parochial departmental points of view to hammer out the details of the policy. As a consequence, China's bureaucrats have a greater propensity for issuing a "joint document" (*lianhe fawen*) to accommodate related agencies' political interests without specifying the distribution of bureaucratic responsibilities. In the language of agency theory, I call central bureaucratic actors involved in governing state firms "fragmented bureaucratic principals," implying that multiple bureaucratic agencies assign divergent tasks for a given SOE to fulfill in order to pursue their organizational missions.

Such a multiple-principal policy environment is not unique to China's state sector. Waterbury finds that SOEs in other political contexts also face "a coalition of principals…Each component of the coalition wants the SOE sector to serve different, and not always compatible, ends. The agents in this drama have to answer to many different masters who do not speak with one voice" (Waterbury 1993, p. 109). However, the Chinese case suggests an even more intricate principal-agent relationship associated with SOE governance during the economic transition, with the transformation of SOEs into commercial entities on the one hand, and with the regular government restructuring program in response to the changing state-market relationship on the other. Namely, both principals and agents constantly adapt to changing institutional constraints and opportunities at different stages of the transition.

The monitoring issue arising from such a dynamic principal-agent relationship can be seen as a twofold issue. From the perspective of bureaucratic regulators, there must be an effective division of labor in controlling SOEs. From the perspective of SOEs, there is always incentive to protect their interests that are not compatible with those of bureaucratic regulators. These two competing logics and the corresponding behavior are deeply and dynamically intertwined with each other. In this chapter, I present the bureaucratic side of the monitoring issue – the organizational evolution of central macroeconomic agencies as they attempt to control state firms in the ongoing transition. The SOE side of the issue is addressed in the next chapter with a detailed examination of China's reform process. In the late 1990s during the post-corporatization period, the restructuring of bureaucratic control over state firms coincided with the initial stage of SOEs' transnationalization. This bureaucratic control is mainly exerted by industrial ministries, including the National Development and Reform Commission, the Ministry of Commerce, the Ministry of Finance, and the State-owned Assets Supervision and Administration Commission of the State Council. In addition, other central government organs in different bureaucratic domains also exert multi-faceted hierarchical control over state firms' operations, depending on the SOEs' industry- or firm-specific attributes. For example, the electricity industry is also regulated by the State Electricity Regulatory Commission. Before delving into the above central macroeconomic agencies' organizational evolution and departmental interests, a brief account of the reform process is useful to contextualize administrative restructuring.

As will be detailed in Chapter 3, the early 1990s was a watershed in the history of

China’s economic reform. After a slowdown in reform caused by the 1989 Tiananmen incident, Deng’s southern tour in 1992 provided a necessary impetus for central reformers to resume their efforts to establish a market economic system. As market mechanisms played an increasing role in economic activities, the government’s involvement in the economy faced growing demands for rationalization, which resulted in the 1998 and the 2003 government restructuring programs (Yang 2004).[14] As Yang notes, “with the government restructuring of 1998, China reached the final stage for transforming a government designed for central planning and bureaucratic command to a regulatory state catering to the market ” (Yang 2001, p. 37). The following 2003 administrative reorganization further realigned industrial ministries to build up a foundation for a coherent regulatory apparatus which was a prerequisite for China’s membership in the World Trade Organization (WTO). Poor bureaucratic coordination after these two reform attempts, however, remains an obstacle for effective monitoring of SOEs.

The National Development and Reform Commission (NDRC) was established in 2003 through a merger of the State Development Planning Commission (SDPC) and part of the State Economic and Trade Commission (SETC). The NDRC is the most powerful institution governing the Chinese economic system; it is usually referred to as the “lead

[14] There have been six government restructuring programs during the reform era: 1982, 1988, 1993, 1998, 2003, and 2008. The first three rounds of administrative reform took place at a time when SOEs’ commercial autonomy had not yet been fully established. With the justification of improving economic governance over the growing economic complexities brought about by reform, self-preserving bureaucrats intensified their intervention in SOEs’ operations by expanding relevant agencies and personnel despite the reformers’ pursuit of government rationalization. Before the 1998 restructuring program, therefore, China’s economic bureaucracy “went through cycles of ‘streamlining- bloating- more streamlining- and more bloating’” (Yang 2001, p. 23).

comprehensive department" (*diyi dabu*) or a "mini-State Council."[15] Its precursors, the SDPC (1998-2003) and the State Planning Commission (1952-1998), functioned as a comprehensive planning apparatus to formulate industrial policies essential to the operations of the centrally planned system. The State Planning Commission promulgated plans, including the short-term annual economic plans and the long-term Five Year Plan, to allocate resources and command investment projects.[16] With reform came the need to change the command system in response to the growing force of the market. A comprehensive state plan seemed inadequate. The State Planning Commission was restructured into the SDPC, with the SETC taking over a part of the regulatory authority over industrial SOEs, in the 1998 round of administrative reforms.[17] This reorganization limited the extent to which the state planner could intervene in enterprises' activities. Nonetheless, the authority of SDPC as a planner of the whole economy was retained and state firms were still under its heavy regulation. In the 2003 round of administrative reforms, the SDPC was reorganized into the NDRC, with the latter taking over a part of the regulatory authority of the SETC and absorbing the function of the State Council Office for Restructuring Economic System.

As a supra-ministerial agency, the establishment of the NDRC reflects the central reformers' intention to use market factors rather than state planning to manage the

[15] In order to tackle the problem of bureaucratic fragmentation and overlapping responsibilities, a new round of administrative reform was initiated in 2008, which aims to further streamline the central government and reshuffle the existing bodies into a few super-ministries. One of the primary agendas is to adjust the mammoth NDRC's jurisdiction to focus on only macro regulation without involving economic micromanagement.

[16] Naughton (1995, p. 26-27) notes that "resource allocation decisions" and "redistribute[ion of] resources into the investment program" are two defining feature of a command economy.

[17] In this round of restructuring, the SETC also absorbed about 10 state industrial administrations, making the Commission a "MITI-style super-ministerial government agency for overseeing and regulating industrial enterprises" (Yang 2001, p. 37).

Chinese economy (Yang 2004). Like its predecessors, the NDRC continues its dominant role in supervising macroeconomic management. Although it is granted an equivalent rank to other ministries, the NDRC actually commands a broader mandate over industrial policy with the assistance of its subordinate units that almost correspond to the constitution of the central functional ministers. For example, the Department of Foreign Capital and Overseas Investment at the NDRC is charged with supervising both inward and outward FDI, overlapping with the regulatory authority of the Ministry of Commerce. The broader spectrum of regulatory power makes the NDRC identify itself as a neutral central organ that transcends departmental interests. However, in practice, the situation is quite the reverse. Given that the other central ministries are at the same bureaucratic level as or even lower than the NDRC, the overlap of the NDRC's comprehensive organizational missions with that of other central bureaucrats has led to parochial bureaucratic battles, both between the NDRC and ministries and within the NDRC itself.

Ironically, while the NDRC is expected to manage the economy by introducing market mechanisms,[18] bureaucrats inside the organization are still significantly committed to outmoded bureaucratic customs, inclined to using administrative measures to manage the Chinese economy. Most notably, price control and the "review and licensing" authority (*shenpi quan*) are the two non-market mechanisms that attract much public criticism. The NDRC adopts a long-term view toward the economy as a whole, creating an incentive to engage in "macro [economic] adjustment and control" (*hongguan*

[18] Yang (2004) notes that the renaming of SDPC as NDRC, removal of the word "planning," and addition of the word "reform," reflect the official mindset of employing market-based means to managing the economy.

[jingji] taiokong) to tackle economic overheating. The instrument to steer the economy is administrative in nature, and it is not always compatible with the departmental interests of other sector-specific ministries. As will be discussed in Chapter 4, the NDRC retains control over energy prices, imposing enormous difficulties on the three national oil companies (NOCs) in their quest to become real market players.

The Ministry of Commerce (MOC), also established in 2003, can be seen as the pioneer in the government restructuring program that aims to streamline central bureaucratic institutions into a few "superministries." By merging certain functions of the SDPC, SETC with the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), the MOC is designated as a central organ with unified regulatory authority over trade-related issues in response to China's entry into the World Trade Organization (WTO).[19] Most of the work of the MOC involves microeconomic details of the domestic market and enterprises. As the premier institution of China's WTO affairs, the MOC has an interest in promoting enterprises' adherence to international market standards. Its inclination to advocate market-oriented behavior for the state sector puts SOEs with a national mandate from the NDRC in a hard position. While the NDRC controls the long-range development program, the MOC provides a detailed vision of promoting domestic enterprises' competitiveness in the globalized market.

The divergence in assigned organizational missions, combined with the NDRC's overlapping "review and licensing" authority, results in regulatory delays. For example, in certain specific areas such as overseas investment, the NDRC and the MOC have

[19] For more information on the MOC's missions concerned with WTO affairs, see http://sms.mofcom.gov.cn/aarticle/gywm/200606/20060602467456.html, accessed January 19, 2010.

different views of investment priorities and conflicting regulations governing the approval process, creating additional non-market factors influencing long-term corporate strategy. To be sure, when conflicts arise between the NDRC and the MOC, the former with its superior authority as a "mini-State Council" has an upper hand over the latter. Yet, before obtaining final approval, firms have lost the advantages of timing they might have had as they responded to changes in the market if the confusion of regulatory authority were not present.

The Ministry of Finance (MOF) collects taxes and plays a powerful role in the process of distributing national wealth. Given the amount of resources under its supervision, most governmental decision-making requires the participation and cooperation of the MOF. Yet since the MOF promulgates its policies on a yearly basis, its decisions sometimes clash with other bureaucratic agendas that have more long-term perspectives. For example, the MOF and the NDRC quarreled over how to impose a windfall profit tax on the three domestic oil majors, with the NDRC declining to introduce the corresponding market-oriented price setting mechanisms suggested by the MOF to control inflation. The NDRC's insistence on oil price control makes the collection of any oil windfall profit tax more complicated and opaque.[20] The MOF is also responsible for subsidizing and extracting dividends from state industries, exposing itself in the turf war regarding SOE governance. For example, SOEs began to pay dividends to the central government in 2007; however, the MOF and the State-owned Assets Supervision and Administration Commission of the State Council had difficulty in

[20] For more information, see http://big5.china.com.cn/chinese/news/1175267.htm, accessed January 19, 2010.

reaching an agreement on the division of the dividends.[21]

The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) is a new superministry that emerged from the 2003 government restructuring.[22] It brings together the regulatory apparatuses with oversight over state firms, which were previously dispersed among a number of agencies. Among these agencies, the defunct SETC (1998-2003) transferred most of its functions to the SASAC. The SETC was the successor of the Sate Economic Commission (1982-1998), one of the powerful commissions that had existed in various guises since 1949. Continuing the role of the State Economic Commission in coordinating day-to-day operations of state firms, the SETC was charged with sector-specific policies. In comparison with the preference of the SDPC for state interventionism, the SETC advocated greater corporate autonomy in China's transition economy (Shirk 1993, p. 98; Naughton 2003, p. 4). The divergent approach toward state firms invoked much bureaucratic wrangling over industrial policies.

In theory, the rationale for China's industrial policy is to retain the state's control over state firms that operate in sectors with strategic importance, such as the petroleum and telecommunications industries. The SASAC, with its distinctive administrative position under the direct leadership of the State Council and ability to act as owner or controlling shareholder of central SOEs on behalf of the central government, represents

[21] For more information, see http://mgb.chinareviewnews.com/doc/1001/5/5/3/100155319.html?coluid=58&kindid=1210&docid=100155319&mdate=0911123624, accessed January 19, 2010.

[22] The State Council established the Administrative Bureau of State Assets in 1988, which shared regulatory authority over state assets with a number of agencies, including the Central Enterprise Work Committee, the Central Organization Department, the MOF, the State Economic Commission, and the State Planning Commission. The Administrative Bureau of State Assets was absorbed into the MOF during the 1998 administrative reorganization, which was merged into the SASAC in 2003.

such an effort (Pearson 2005).[23] In reality, however, the SASAC is still adapting to the workings of the elephantine Chinese bureaucracy, and the legal basis for its mandate has been subject to intense debate. Particularly controversial is whether the SASAC should be given regulatory authority over SOEs, beyond its management function on behalf of the central government.[24]

The SASAC therefore has differing degrees of influence over different issue areas. For example, given manpower and information constraints, the SASAC has difficulty monitoring capital outflows from central SOEs, especially from those with administrative duties during the period of the planned economy.[25] Moreover, in 2007, the SASAC had difficulty reaching agreements with the MOF on sharing state firms' profits. As the controlling shareholder of central SOEs, the SASAC claimed that it had final authority over firms' dividends. However, such a claim undermined the MOF's authority over public budgets. The SASAC was thus forced to compromise over SOEs' dividends and ultimately relinquished the money to the MOF.[26] It did, however, control the process of restructuring central SOES, picking three "national champions" in each sector. The SASAC also established a monitoring system that ensures an effective assessment of

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[23] The SASAC is in a special bureaucratic position in which it is under the direct lead of the State Council without the ministerial status. It is categorized as a "special public non-profit organization" (*tebie shiye danwei*) of the State Council. Upon its establishment in 2003, all 196 central SOEs were put under the SASAC's supervision. As the program of restructuring central SOEs proceeds, now there are 129 central SOEs subordinate to the SASAC.

[24] For example, see http://news.xinhuanet.com/newscenter/2007-12/26/content_7317347.htm, accessed November 3, 2009.

[25] One notable example is the financial scandal of Singapore-listed China Aviation Oil, which hit the headlines in the end of 2004 when it appealed to Singapore's High Court for protection from creditors after losing 550 million dollars in speculative oil derivatives trading. For the special reports of this incident, see "Jukui 5.5 Yi Meiyuan, Zhonghangyou Zhejichensha Shimo" [The Loss of 550 Million, the Story of Zhonghangyou], *Renmin Ribao* [People's Daily], http://finance.people.com.cn/GB/8215/41815/index.html, accessed March 7, 2008.

[26] Naughton (2006) provides a detailed account about the fight between the SASAC and the MOF.

SOE management.

In sum, continuing bureaucratic realignment and reform has inevitably led to turf wars. While old agencies were dismantled, surviving bureaucratic actors sought to preserve their influence on the policy process under different guises. The bureaucratic battle over SOE governance was not limited to four general ministries. A diverse array of state regulators with divergent interests in SOEs' operations also entered the conflict. For example, about a dozen state actors were involved in the regulation of CNPC and CSCEC. It is worth mentioning that with few exceptions, there is no overarching organ that can broker agreements between these conflicting agencies. Nevertheless, even policy areas in which a higher coordination organ is established are not immune to departmental struggles. As will be discussed in Chapter 4, the National Energy Leading Group, created in 2005, was headed by Premier Wen Jiabao to coordinate disagreement over energy governance among line ministries.[27] It advisory authority, however, faced constant challenges from powerful bureaucratic agencies, leading to its dissolution during the 2008 administrative reform.[28] Within the institutional structure of the Party-state, the dynamics of bureaucratic fragmentation opened a channel for SOE managers with strong bureaucratic ties to stall the progress of a full-fledged market-oriented reform.

3. Managerial Dual Identities and Bureaucratic Control in China's State Sector

Faced with multiple bureaucratic principals with divergent policy agendas, how did self-

[27] The 2008 administrative reform demolished the National Energy Leading Group and transformed it into the National Energy Commission, which will be established in 2010.

[28] For example, see http://www.nfcmag.com/articles/1895/page/1, accessed January 19, 2010.

interested SOE managers satisfy their political bosses' demands? My focus throughout is on individual mangers of central-level SOEs, but their individual interests are consistently mediated by the sectors in which they work.[29] Though SOEs currently provide far fewer social benefits than they did in the past, their continuing social welfare role is of great importance to the Chinese government. SOEs are also still expected to generate revenues sufficient to support public social spending. There have even been calls for SOE dividends to be used to revamp the social welfare system which was destroyed with the breakdown of the command economy.[30] SOEs in key sectors, such as energy, are also seen as valuable to national security and social stability. On many occasions, Chinese leaders have publicly announced that the state sector continues to be the "pillar" of the national economy.[31] To ensure the fulfillment of SOEs' political functions, Chinese decision-makers exert their control via managerial appointment and incorporate SOE managers into the state cadre system.[32] In the era of post-corporatization with SOEs gradually acquiring more autonomy in economic decisions vis-à-vis the state, this personnel arrangement has given rise to managers' differing political and economic motivations, which are at times in conflict with each other. In the rest of this section, I

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[29] The use of the individual as the analysis unit is thought of "methodological individualism" in the rational choice framework. According to Green and Shapiro (1994, p. 15-16), theorists who use this analytical approach aim to "explain collective outcomes by reference to the maximizing actions of individuals."

[30] "*Guowuyuan guanyu shixing guoyou ziben jingying yusuan de yijian* (Opinion of the State Council Concerning the Pilot Implementation of the State Capital Operating Budget)" (The State Council [2007] No. 26).

[31] See, for example, Hu Jintao's report on the 17th National Party Congress, http://news.xinhuanet.com/english/2007-10/24/content_6938749.htm, accessed November 4, 2009.

[32] Although newly-recruited managers have not been given bureaucratic ranks since 2007, almost all the top management positions in central SOEs are still dominated by those who have already obtained their bureaucratic ranks. "Guoqi Laozong Chuantong Shenfen Jinnian jiang Zhongjie" [The Old Role of Managers in State-owned Enterprises will be Ended This Year], *Shichangbao* [Market News], March 3, 2006, http://www.people.com.cn/BIG5/paper53/16995/1492644.html, accessed June 1, 2008.

focus on the conflicting roles of central SOE managers during this period as the state seeks to achieve political control and economic efficiency at the same time.

SOE managers are economic actors, but they are even more so political officials (Waterbury 1993, p. 127). Similar patterns can also be found in other post-socialist countries (Kornai 1992, p. 505). Central SOEs' top executives are listed on the CCP's *nomenklatura*,[33] though this power was weakened after the SASAC introduced a new executive selection system.[34] More specifically, according to the latest 1998 *nomenklatura*, senior managerial positions in key central SOEs are either on the "job title list of centrally managed cadres" (*Zhonggong zhongyang guanli ganbu zhiwu mingcheng biao*) or on the "list of cadre positions to be reported to the center" (*Xiang zhongyang bei'an de ganbu zhiwu mingdan*) (Chan 2004). This arrangement represents the CCP's desire to continue its control over personnel appointments in corporatized central SOEs, which is the source of central SOE managers' dual identities – as party officials and corporate executives. Different from the SOE managers in many other countries, the political role of SOE managers in China is institutionalized with formal bureaucratic titles. Because of their political position within the CCP, Chinese SOE managers often have even stronger interests in obtaining higher Party positions than in obtaining economic

[33] The term "*nomenklatura*" originally refers to the ruling class in the Soviet Union. According to Lieberthal, "the *nomenklatura* system consists of lists of leading positions over which Party units exercise that power of appointment and dismissal, list of reserve candidates for those positions, and rules governing the actual process of appointments and dismissals…All positions of real importance in China fall under the CCP's *nomenklatura*" (Lieberthal 2004, pp. 234-35).

[34] Since 2003, the SASAC has organized the public recruitment of senior managers in key central SOEs, by which seven senior managerial posts in a total of six central SOEs were selected. The numbers of the posts for public recruitment increases each year, with 16 posts in 2008. For two reasons, however, publicly-recruited managers are not covered by this dissertation. First, this new executive selection system has yet to be institutionalized and is subject to policy changes on a yearly basis. Second, in addition to the SASAC, the CCP Central Organization Department is the other host department involved in public recruitment and usually has the final authority over the SASAC's selections.

results or material gains.

In principle, before corporatization, the managers' behavior was mostly shaped by political considerations. Without open and objective economic indicators, such as return on capital, the central government could only judge managerial performance based on whether managers carried out their political responsibility, such as employment creation. Moreover, central SOEs in state-monopolized industries, such as the petroleum and electricity industries, were actually administrative organizations during most of the reform era. A logical development is that the managers shared the policy positions in concert with the interests of the central state.

Over time, however, central SOE managers increasingly prioritize their economic identities over their political ones, meaning that they become more inclined to act in their firms' interests rather than the state's when making business-related decisions. This trend has especially accelerated since the corporatization of SOEs and the establishment of monitoring by the SASAC in the early 2000s. Compared to political functions, the SOEs' economic performance is more easily observed and subject to routine evaluation. Moreover, unless gross defiance of SOEs' political functions is involved, managers are encouraged to pursue corporate commercial gains. As I show in the next chapter, this has long been the official position toward the state sector since the early stages of economic reform – seek to establish SOEs' profit motive without sacrificing political control. Nevertheless, only after corporatization, by which the linkage between corporate financial performance and managerial promotion was created, are SOE managers motivated by profit maximization.

This shift in managers' perceptions of their dual identities – from a rule-taker who implements state policies to a rule-maker who negotiates a commercially acceptable mode of enterprise operation – has been incremental. But the autonomy gained from corporatization was an essential source of SOE managers' capacity to choose business interests over national political mandates. This propensity is more evident when the clash between corporate interests and the national welfare mandate is present. In the example of the artificial oil shortage mentioned earlier, senior management of CNPC and Sinopec regularly defended their corporate interests by lowering domestic supply and even exporting oil products for a better return despite causing domestic fuel rationing. In other words, most corporatized SOEs are reluctant to bear policy-induced losses without any compensation.

Still, the tendency for SOE managers to increasingly tilt toward their economic roles does not necessarily mean that they put more emphasis on pecuniary gain than political advancement. In China's transitional economy, the CCP still uses *nomenklatura* as an instrument to control leadership selection and day-to-day management of state firms. The career prospects of SOE managers for promotion, either within or outside of the firm, are subject to the CCP's discretion. In such a system, where the Party maintains its intrusive role in the economic sphere, the decisions of corporatized SOE managers like those of their predecessors are dominated by political calculations.

A related point is that unlike their Western counterparts, most senior management executives of China's SOEs will continue to ascend the bureaucratic hierarchy, being promoted to higher-ranking political positions after leaving their current posts. This bureaucratic tradition is found not only under the planned economy but also in the present economic transition, where it shapes the career paths of numerous general managers of state firms. As will be detailed in Chapter 4, the most striking example of bureaucratic CCP politics in SOE staffing and management was the "petroleum system" which was composed of high-profile technocrats with a petroleum profession background. Among the Chinese elite, the faction had been at the apex of the political system during the third generation of leadership headed by Jiang Zemin and now extends its influence to the fourth generation of leadership under Hu Jintao. Recently, a number of SOE general managers were appointed as provincial governors or Party chiefs, granted ranks equivalent to that of the central ministries.[35]

The tendency suggests that SOE managers deliberately seek to move up the political ladder no matter which economic systems they are under. The only difference is the criteria by which this new batch of managers have been selected for promotion – those who gained executive posts under the old structure of ownership depended singularly on their ability to extract resources for political goals, whereas those promoted since corporatization have been judged largely on firm productivity and performance in the market place. In short, corporatized SOEs' declaration of profits implies an increase in not only managerial salaries but also managers' political assets, which explains SOE managers' pursuit of corporate interests at the expense of national political mandates.

Nonetheless, the managerial choice between conflicting economic and political

[35] For example, Guo Shengkun, the former Chinalco's general manager with a joint appointment as the Party secretary, was appointed as the vice chairman of Guangxi Zhuang Autonomous Region People's Government with a joint appointment as the deputy secretary in 2004. Another example is Li Jiaxiang, the former president of Air China, is now the director of Civil Aviation Administration of China.

incentives is not always easy, especially when the missions assigned have enormous implications for long-term industrial development. Given that their appointments are still political in nature, SOE managers cannot always ignore unprofitable yet politically significant tasks. Nevertheless, they cannot afford to disregard firms' financial performance either, as another group of bureaucratic principals in charge of monitoring SOE financial performance can also decide their promotion. Under this condition, politically motivated SOE managers would undertake these difficult missions while simultaneously lobbying relevant bureaucratic actors to engage in rent-seeking to compensate for firms' financial losses.[36] In so doing, corporatized SOE managers maximize their competence to satisfy diverse bureaucratic interests without incurring setbacks in their career prospects.

Again, the case of energy price control is helpful. To facilitate the NDRC in preventing inflation, NOCs were subject to price regulation and their downstream refining operations have suffered from substantial financial losses. The oil monopolies were not content with the rent created by their privileged market access which had been designed to compensate their refining losses. Their politically powerful managers constantly maneuver to influence bureaucratic actors, the rent creators and allocators, to maintain the remarkable records of the firms' fiscal surplus.[37] The manipulated oil shortage mentioned above is a good example. Once rent-seeking opportunities were created, such as government subsidies and price elevation, NOCs resume their task of

[36] For the definition of rent, see ft. 18 in Chapter 1.
[37] For a brief overview of rent production and allocation in China's partially reformed economy, see Ngo (2009).

stabilizing energy supply at a below-market level.[38]

In sum, the state-SOE relationship in the post-corporatization era is far more dynamic and messier than any other stage of the reform process. Interactions between bureaucratic principals and agent SOEs are constantly renegotiated and recalibrated. A comprehensive understanding of China's "Going Out" strategy is possible only when a full grasp of bureaucratic politics associated with SOE governance is present.

II. EXPLAINING GOVERNMENT-INITIATED OVERSEAS EXPANSION: THE "GOING OUT" STRATEGY

How does the preceding discussion on principal-agent interactions in China's state sector enable us to understand the government-initiated overseas expansion of central SOEs? By focusing on individual managers in central SOEs, my bureaucratic politics framework fleshes out the negotiated nature of the state-SOE relationship in the process of implementing the "Going Out" strategy. In other words, while bureaucratic decision-makers initiated the transnationalization of central SOEs, the process of "going out" is characterized by continuing tensions and struggles between the state and the firms. Before presenting the bureaucratic politics explanation, one clarification is helpful.

It is worth noting that using individual managers in central SOEs as units of analysis does not directly lead to the contention that all central SOE managers as a group have the same degree of compliance with the hierarchical settings within which they seek

[38] See, for example, http://big5.china.com.cn/city/txt/2007-10/30/content_9146508.htm, accessed January 21, 2010.

to maximize their own interests.[39] This is because these managers' preferences and corresponding strategies are also shaped by the sectors in which they work. These sectoral differences in turn produce divergent institutional constraints under which SOE managers develop their interactions with government agencies. In this sense, the study explains the policy shift from a micro individual perspective while incorporating factors at the macro level such as the structure of the national economy. Such a research approach creates a dynamic investigation into institutional evolution. In so doing, the study presents a connection between two distinct levels of analysis – individual and structural – without falling into the trap of deterministic arguments as suggested by the existing economic or security explanations.

The remainder of this section will be devoted to explicating the neoinstitutional assumption of central SOE managers in carrying out the "Going Out" strategy and to presenting the "bureaucratic politics" explanation. Three assumptions of NIE must be closely scrutinized when studying SOEs' overseas expansion – managerial opportunism, information flows, and bounded rationality. First, I assume that the actors involved in SOEs' transnational projects are self-interested and strategically interact with one another under various institutional constraints. Various government bodies in the Chinese bureaucracy, as the principals, and central SOE managers, as the agents, have divergent interests concerning firm overseas operations. Ideally, SOE managers are expected to follow the state's prescribed goals, which aim to utilize SOEs as instruments to serve

[39] The use of the individual as the analysis unit is thought of "methodological individualism" in the rational choice framework. According to Green and Shapiro (1994, p. 15-16), theorists who use this analytical approach aim to "explain collective outcomes by reference to the maximizing actions of individuals."

national economic and security interests. Managers, however, have a different calculation regarding their compliance with the demands of their bureaucratic superiors. Beyond economic motives, SOE managers retain a stake in their firms' financial performance for their political advancement. Thus, managerial opportunism in the "Going Out" strategy is best understood as the managers' pursuit of private agendas: managers devote minimum energy to carrying out the missions assigned in exchange for maximum return on political prospects.

Second, in the NIE literature, the preceding managerial opportunism is a product of an imperfect information environment. I assume that, in transnational projects, central SOE managers have more information regarding firm-level operations than the state has, and that the cost of collecting every piece of information is too high for the state to implement. Admittedly, SOE reform in China has improved the problem of information flows by setting up the supervisory mechanism of corporate accountability. Nonetheless, as noted above, bureaucratic monitoring is fragmented and far from satisfactory. This is more so in terms of SOEs' cross-border activities. Asymmetrical distribution of information, therefore, favors managers' opportunism at the expense of the national goals of the "Going Out" strategy.

Third, given the limits of their cognitive ability, I assume that SOE managers engage in rational "satisfycing" when balancing their private agendas and the tasks delegated to them by the state (Simon 1957). The assumption of bounded rationality is essential to understanding the conduct of China's central SOE managers in response to the government-initiated transnationalization in the post-corporatization era. Changes in the institutional arrangements that governed firms' behavior have produced changing constraints on the set of choices available to managers in central SOEs. Confronted with the uncertainty introduced by new reform measures, the managers act in an adaptive and evolutionary way to advance their interests in this fluid policy environment. The bounded rationality and satisfycing behavior of managers must therefore be interpreted in the context of specific institutional environments in which they find themselves at particular moments in time and in specific areas of the policy space. This can help us move beyond the arguments common in the existing literature, which tend to assume static and simple institutional contexts.

How do the negotiated state-SOE relationship and neoinstitutional assumptions of managerial behavior translate into the process of SOEs' "going out"? In essence, the transnationalization of SOEs is by no means a coherent policy fraught with power struggle, with various bureaucratic agencies setting different goals for SOEs on the one hand and with SOEs managers defending corporate interests without incurring political setbacks on the other (see Figure 2.1). The "Going Out" process was initiated when the CCP leaders were motivated by security and economic objectives.[40] The first explicit government endorsement supporting SOEs' global expansion as an attempt to increase the competitiveness of state firms is Jiang Zemin's report on the Second Plenum of the Fifteenth Communist Party Central Committee in February 1998. Three years later, the

[40] The agency theory is usually applied to the study of public bureaucracy with a neat chain of linked principal-agent interactions. In state enterprises, however, Waterbury (1993, p. 110) notes that, "there are many layers of principals and agents in the typical SOE sector…there is nothing neatly hierarchical about where one is located in this system." For SOEs, therefore, the CCP leaders also play the role of the principal. Nonetheless, my study focuses on the principal-agent interaction between central bureaucratic agencies and SOE managers.

"Going Out" strategy, the utilization of FDI, and foreign trade were listed as the three primary drivers of development in an open economy in the Tenth Five-year Plan in 2001.

After the CCP leaders' instructions on the "Going Out" strategy were translated into national agendas, such as five-year plans/guidelines, a diverse array of government agencies made corresponding policy goals for SOEs to carry out according to their organization missions. Fractional bureaucratic interactions, however, make SOEs' "going out" frequently more of a compromise among incompatible parochial interests than a rational blueprint for achieving any overarching national agendas. To make the situation more complicated, new bureaucratic players emerging from ongoing administrative reform continue to join the game. The presence of the new players increases the difficulty in building a consensus on the transnationalization of SOEs reform.

The immediate impact of factional bureaucratic interactions without any institutional coordination is segmented and incoherent government supervision over firms' overseas activities. The corollary is that there is plenty of room for politically powerful managers to manipulate the protracted process of decision making. By currying favor with certain bureaucratic agencies, they gain supports to resist the directives of the other agencies that do not best serve their corporate interests. As managers acquire more autonomy vis-à-vis the state during the progress of corporatization, managerial bureaucratic leverage enables the firms to grasp more of the economic rent generated along with overseas projects, such as generous state subsidies and preferential tax treatment. The higher a SOE's administrative rank, the more rents it can extract. In short, SOE managers are able to negotiate a "satisfycing" way to venture abroad without risking their political advancement in the Chinese Party-state.

Such a negotiated policy process does not end with SOE managers exploiting state resources to support firms' overseas expansion. When these SOEs operate abroad, they face a well-established market system in which their inefficient ventures abroad will not be bailed out like their domestic operations. More importantly, a number of non-state stakeholders who are created in the course of SOEs overseas activities, such as foreign investors and international organizations, have enormous interests in SOEs' market-oriented behavior. Compared to parochial bureaucratic actors, this group of actors functions as a neutral party that can monitor every detail of SOEs' operations. In light of this, the continuation of SOEs' international expansion provides a fragmented bureaucratic system with a relatively coherent information environment, which in turn facilitates the domestic decision-making process. Under this improved information environment in which their opportunism is more easily exposed, SOEs' overseas operations are inclined to adapt to the global norms of corporate governance. The disciplining effect, however, has yet to be systematic and sound due to the weak position of the non-state stakeholders in corporate decision-making. Nonetheless, this reforming effect has increasingly occurred, as Chapters 4 and 5 will reveal.

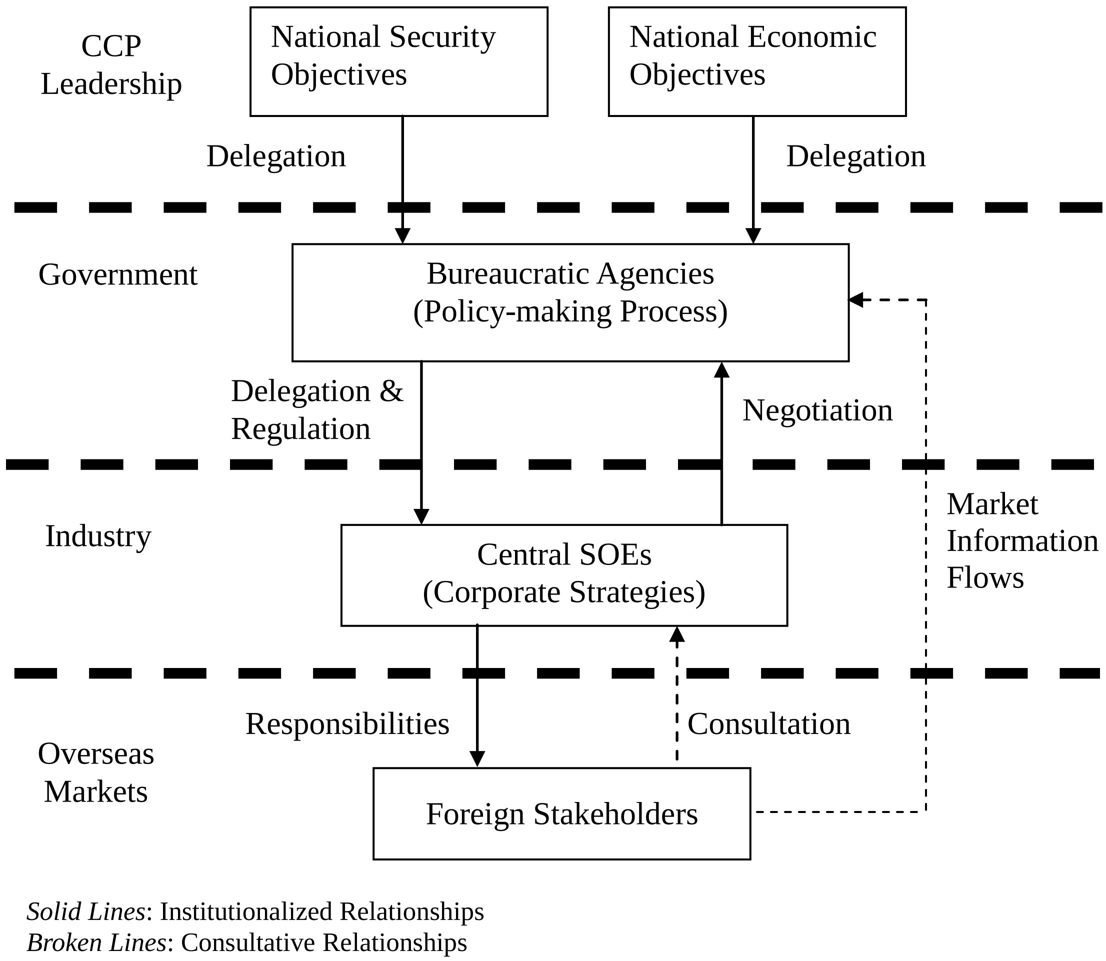

Figure 2.1 The Decision-making Process of the "Going Out" Strategy

III. CONCLUSION

The bureaucratic politics framework proposed in this chapter opens the black box of bureaucratic decision-making in the transnationalization of central SOEs, which is not acknowledged in conventional wisdom. The existing literature on central SOEs' overseas expansion only represents two extremes in the interactions between principals and agents, neither of which reflects the political reality of the state-enterprise relationship in a reform economy. From the security perspective, full information is assumed and state capacity to punish SOE managers' inaction has never been questioned. From the economic perspective, agent SOE managers have full authority to manage state assets without incurring any responsibilities. Yet when agents' opportunism, a product of principals' concerns for monitoring costs, is introduced into the analysis of bureaucratic decision-making, the oversimplified nature of the existing accounts becomes all too apparent.

Chapter 3. State-owned Enterprise Reform and State-owned Enterprises' "Going Out"

Stick to and improve the basic economic system and deepen the reform of the state property management system. In line with the requirements of releasing and developing the productive forces, we must uphold and improve the basic economic system, with public ownership playing a dominant role and diverse forms of ownership developing side by side.

Jiang Zemin, 16th Party Congress, November 2002

Improve the basic economic system and the modern market system. We need to uphold and improve the basic economic system in which public ownership is dominant and different economic sectors develop side by side, unwaveringly consolidate and develop the public sector of the economy, unswervingly encourage, support and guide the development of the non-public sector, ensure equal protection of property rights, and create a new situation in which all economic sectors compete on an equal footing and reinforce each other. We will deepen the reform to introduce the corporate and shareholding systems in state-owned enterprises, improve the modern corporate structure and optimize the distribution and structure of the state sector of the economy to enhance its dynamism, dominance and influence. We will deepen the reform of monopoly industries by introducing competition, and strengthen government regulation and public oversight of them.

Hu Jintao, 17th Party Congress, October 2007

The state sector has constantly frustrated Chinese reformers' quest for a successful transition to a full-fledged market economy.[1] Because public ownership has underpinned the legitimacy of the CCPs' power, SOEs have played a political role in addition to their

[1] The state sector includes three interdependent parts – the government, industrial SOEs, and state banks. The alarming issue of non-performing loans in China's banking system is the outcome of the state's injection of capital into underperforming SOEs, which further resulted in the deterioration of the government's fiscal system. On the financial performance of the state sector as a whole, see Holz (2001). For the interconnection between the health of China's financial system and the performance of SOEs, see Lardy (1998).

economic function of generating state revenue. They carry out vitally important tasks that have implications for the CCP's governance, such as social welfare provision, state-led industrialization, and maintaining macroeconomic balance. Chinese reformers, therefore, have deliberately preserved the dominant position of state firms as the backbone of China's industrial sector. To a certain extent, China's partial reform programs, which have gradually introduced market mechanisms without rapid privatization, represent the reformers' simultaneous pursuit of two goals - retaining SOEs as policy instruments and improving SOEs' economic efficiency. As will be discussed in the following sections, even though SOEs have been a major drain on state coffers throughout the reform era, the system of public ownership remains an ideological doctrine that has never encountered serious challenge. The difference between Chinese reformers and conservatives is their opinion on the extent of the role the market should play in compensation for the inefficiency of central planning.[2]

Given the political implications of the state sector, the state has exercised political control over SOEs throughout the economic transition. Before corporatization, bureaucratic intervention in SOEs' daily operations had been extensive, with each supervisory organ exploiting the firms for its own administrative duties. Even after corporatization, as SOEs have acquired more economic autonomy vis-à-vis the state, hierarchical control over SOE managers remains largely intact. This hierarchical control follows the state cadre management system. As the history of China's economic transition shows, however, political control is hardly compatible with economic efficiency. As

[2] For an insider's account, see Zhao (2009), especially Parts 3 and 5.

mentioned in Chapter 2, while political interference in SOEs' operations was a key factor leading to firms' declining efficiency during the pre-corporatization period, the close ties SOE managers have with bureaucratic agencies have empowered corporatized SOEs to engage in rent-seeking activities. In this sense, the reform goal of Chinese reformers, improving economic efficiency without sacrificing political control, are fundamentally incompatible.

In this chapter, I present the broad background against which the problem of incompatibility between SOEs' political and economic functions arises. I discuss how partial reform programs created leeway for managerial opportunistic behavior in response to new institutional constraints. I also offer a detailed account of how the "Going Out" strategy emerges and is carried out in the post-corporatization era while Chinese policymakers still cling to old ideas about SOEs' political functions from the pre-corporatization era. This chapter aims to contextualize the government-initiated transnationalization of state firms, with the contention that the above dilemma over SOE governance would inevitably frustrate the official goals of the "Going Out" strategy – making use of SOEs' cross-border transactions to serve national security and economic agendas.

I. CHINA'S PARTIALLY REFORMED ECONOMY AND MANAGERIAL OPPORTUNISM

From its very beginning, every step of the Chinese economic reform has been accompanied by a major ideological breakthrough by which the CCP retains its leading role in the economy. To a large degree, ideological debates within the CCP concerning economic reform have centered on the relationship between the state and SOEs. Under the unchallenged tenet of public ownership, each breakthrough represents a progressive revision of Chinese socialism, with more economic space opening to market forces and non-state actors. Based on these ideological trends and associated policy initiations, the history of SOE reform can be roughly divided into four phases: (1) expand enterprise autonomy, 1978-1984; (2) the separation of ownership from management, 1984-1993; (3) the socialist market economy and the ownership restructuring program, 1993-2003; and (4) deepening corporate governance and building up a new state-owned asset management system, 2003-present. China's state sector has long been under attack for their inefficient uses of resources, which has its root in the central planning system that was developed in the pre-reform era. Even after initiation of the reform, it is not rare to find that SOEs' business conducts lack market discipline and corporate accountability.[3] Each of the reform's stages, therefore, involves the realignment of managerial incentive structures to induce SOEs' market-oriented behavior.

In China, authority over the state sector is divided between the central government and local governments according to the level of government which manages the firms.[4] While I limit my analysis to central SOEs, the SOE reform agenda applies to

[3] See, for example, Steinfeld (1998).

[4] In addition to the official classification according to authority over state firms, the term "state-holding enterprises," whose majority shares are owned by the state, has been used in official statistics since the mid-1990s. Nevertheless, separating this new category based on the shareholding structure from the existing classification of "state-owned enterprises" does not add much weight to our analysis of the state-SOE relationship, since control rights covering the rights to appoint managers and manage assets still

both types of state firms. Before the creation of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) in 2003, state assets in both central and local SOEs were regarded as being owned by the state, although in most cases local governments behaved as *de facto* owners of local SOEs. Only after a new state asset management system was introduced through the establishment of the SASAC did the legal limit of the central government's jurisdiction cover only central SOEs.[5]

It should also be noted that in the Chinese industrial sector, state firms are not the only public enterprises classified by the state. Collective enterprises in both urban and rural areas which also operate under public ownership have been another important force in industrializing the Chinese economy. These firms are collectively owned and operated by local government at various levels – county or village governments in rural areas and municipal governments in urban areas. Except for belonging to the same ownership classification, there are a number of differences between the two types of firms. Unlike the state firms, the assets of collective enterprises are owned by members of the firms and usually mediated through the management of a specific local government. Compared with SOEs, the industrial outputs of collective enterprises play a secondary role in national industrial development, and they have less importance in the provision of employment. When SOEs are protected by distorted market mechanisms created by partial reform programs, the state rarely provides collective enterprises with similar

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belong to the government. See Huang (2008, pp. 13-19).

[5] In addition to the SASAC under the direct leadership the State Council, numerous local SASACs have been set up at the provincial and municipal (regional) levels. However, the authority of the SASAC and the relationship between the SASAC and local SASACs still need to be further legalized. Currently, there is no unified framework for the operation of various local SASACs, which depend on the structures of local economies. For academic debates about the authority of the SASAC, see 21st Century Business Herald (2004).

preferential treatments. As a result, while collective enterprises also experience a variety of ownership restructuring programs, they are not the subject of the SOE reform agenda.

Table 3.1 China's Industrial Structure by Ownership, 1985 and 1995

	Total Asset (%)		Employment (%)		Industrial Output (%)	
	1985	1995	1985	1995	1985	1995
State	74.6	53.7	41.1	31.6	64.9	34.0
Collective	24.0	23.8	49.5	39.8	32.1	36.6
Private	0.0	1.0	0.0	3.3	0.0	2.6
Individual	0.5	1.9	8.9	17.5	1.8	10.5
Share-holding	0.0	5.0	0.0	1.7	0.0	3.5
Other	0.9	14.6	0.5	6.1	1.2	12.8

Source: the National Bureau of Statistics (2001).

1. Expanded Enterprise Autonomy, 1978-1984

Facing an economic breakdown caused by the Cultural Revolution, Chinese leaders started to relax their ideological insistence on state monopoly in the economic arena. The immediate effect of ideological relaxation was that more economic decisions were left to resource allocation mechanisms other than the central planning system. It is also in this very beginning stage that the Chinese leaders began to understand the positive role of managerial incentive structures in improving an enterprise's financial performance. General speaking, this period aimed at expanding enterprise autonomy under the guideline of "streamlining administration and decentralization; reducing taxes and surrendering part of profits" (*jianzheng*, *fangquan*, *jianshui*, *rangli*). This reform measure was to redress imbalances in the development of the national economy, a result of over-emphasized heavy industrialization led by the state. In recognition of this, central reformers increasingly relied on economic levers in decision-making and allowed SOEs to retain a certain amount of profits. The period of expanded enterprise autonomy actually went through three stages, with each stage incrementally reducing the state's control over SOEs' production activities: an experimental program on expanded enterprise autonomy in 1978-1980; the implementation of industrial economic responsibility system in 1981-1982; and a system of tax-for-profit in 1983-1984 (Zhou and Ding 2005).

In October 1978, six factories in Sichuan were selected for the pilot of an experimental program of expanded corporate autonomy, whereby firms were allowed to retain a share of profits and workers were given a bonus in addition to their meager wages. In 1979, the profit retention system was further applied to 100 SOEs in Sichuan, leading to an increase in industrial outputs by about 15 percent and in profit by 33 percent (Zhang Dicheng 2006, p. 32). In view of the effect of giving workers better incentives, the profit retention system was soon adopted nationwide. Staring from September 1981, the central government introduced various contractual responsibility systems that specified minimum profitability and product standards that the firms had to meet. Under this scheme, each SOE was held responsible for the profits and losses it made, meaning that inefficient operations would not receive state capital injections. However, it has been amply demonstrated that China's state sector up to this point has yet to entirely meet this policy goal. Because of their political function and ideological importance, state firms are considered too substantial to fail, so the state continues to offer cheap capital to sustain loss-making SOEs. In the search for a better managerial incentive structure as a solution to underperforming SOEs' low productivity, central reformers again adjusted their reform strategies in 1983. The central government replaced SOEs' profit remittance with a corporate tax of a maximum rate of 55 percent, which was negotiated individually between firms and their superior bureaucratic agencies. Firms could use the after-tax profit either to finance their investment or to pay bonuses to their employees.

In implementing the preceding reform programs, central reformers began to utilize the market as a subsidiary means to facilitate the operations of central planning. Nonetheless, it is misleading to argue that the market and the entailed exchange relationships dominated the formation of state planning. After all, the function of the market had its limitations, being subject to ongoing ideological debates over whether the market system belongs only to capitalism.[6] As a result, enterprise autonomy was enlarged, but state firms during this period were still directed by the state as a part of the bureaucracy. To be precise, state firms' operations were under the reins of the CCP. Party committees supervised the day-to-day operation of state firms and Party secretaries exerted the ultimate authority over the process of decision-making. This was the so-called "factory director responsibility under the supervision of the Party committee" (*dangwei lingdao xia de changzhang fuzezhi*), in effect between 1956 and 1984. Under such personnel control, managerial decision-making was largely subordinate to political discretion.

Since state firms at this point were subdivisions of China's hierarchical

[6] For details, see Zhao (2009, p. 138).

bureaucracy, Chinese policymakers continued to create new SOEs to spearhead certain industries. China State Construction Engineering Corporation (CSCEC), one of the case-study firms in this dissertation, is a good example. CSCEC was established in 1982 after the merger of a diverse array of privileged state-owned construction firms. In addition to domestic construction activities, CSCEC was selected as one of the main agents in carrying out the state's foreign aid programs, mostly concentrated in African countries. Specializing in infrastructure and construction projects, CSCEC followed the state's foreign policy in formulating its overseas strategy. In short, at this beginning stage of the reform, the introduction of market mechanisms was seen as an expedient to solve the financial difficulty brought about by the rigid central planning system. SOEs' role as independent economic entities had yet to be institutionalized.

2. The Separation of Ownership from Management, 1984-1993

Judging from statistical indicators related to SOEs' industrial performance, reform programs initiated at the first stage failed to achieve SOEs' economic goals. A large number of state firms still operated at a loss.[7] From reformists' perspective, the lack of firm-level autonomy in making production decisions was still the key. Economically autonomous SOEs could emerge only when the state retreated its intrusive hand. Merely enlarging enterprise autonomy without simultaneously terminating political control of the bureaucracy inevitably led to SOEs' failing economic performance. The second period, therefore, emphasized the separation of ownership from management under the

[7] Lardy notes that the financial performance of SOEs had deteriorated dramatically over the course of reform, See Lardy (1998, pp. 21-58).

guidelines of "the planned commodity economy" (*you jihua de shangping jingji*).

Building upon the previous stage, central reformers adopted the initial step of meaningful marketization. As usual, they first sought to step over the ideological obstacle by declaring that the concepts of planning and market are not incompatible. The system of the planned commodity economy was operated between two extremes - the central planning economy dictated by administrative commands and the market economy dominated by voluntary exchanges. In fact, the system was a compromise between reformist leaders and conservative leaders at the center, recognizing that "the state adjusts the market, the market guides enterprises"[8]. In this sense, the expanding role of market mechanisms was used to reinvigorate commercial demands that was once banned in the old system but was desired for developing the urban economy. At the same time, central reformers defended the system as socialism with Chinese characteristics, in which the predominance of public ownership was the defining features.

Among various measures to separate ownership from control, two reform agendas were essential to our study of managerial behavior – long-term contracting (*chengbao*) and the adoption of the dual-track price system.[9] The former refers to "[the replacement of] annual negotiated targets with a multiyear contract, signed between the enterprise and his superiors, that would specify profit deliveries and other targets" (Naughton 1995, p. 213). The implementation of long-term contracting was coupled with the establishment of a managerial responsibility system. In the past, Party secretaries led and managers

[8] For insider's comment on this, see Zhao (2009).

[9] During this period, long-term contracting was designed for large and medium SOEs, while small SOEs were leased out.

followed. Beginning in 1986, under the supervision of Party committees, managers became the sole representatives of state firms and had authority over firms' operations including personnel decisions.

Meanwhile, instead of the rapid liberalization of industrial product prices, reformers adopted a dual-track system (*shuangguizhi*) for price reform at a gradual pace. Administrative control over prices and sales of consumer goods was relaxed as state firms were allowed to sell their above-plan outputs at market prices. Namely, planned outputs were sold at state-fixed prices that were usually below-market level, and above-plan outputs were determined by supply and demand in the market. As a result, the same product had two prices – one decided by the state and the other decided by the market. By allowing price flexibility, the co-existence of the plan and market sectors gave SOE managers commercial incentives without sacrificing price stability (Lau, Qian, and Ronald 2000).

Nevertheless, the above improvements in managerial autonomy and incentive structures did not yield positive effects on managerial behavior. Instead, SOE managers enjoyed more and more leeway to take advantage of the economic rent brought about by the partial reform programs. The primary problem came from the unequal distribution of information between SOE managers and bureaucratic principals. Given that managers were well-informed about every detail of their firms' operations, they had incentives to manipulate the specific inside knowledge to negotiate favorable targets. For example, because bargaining over targets existed between managers and their bureaucratic principals on a one-by-one basis, contracts were not made by relevant economic factors but by managerial manipulation of production information (Naughton 1995). Long-term contracting also led to the "ratchet effect," a phenomenon that central reformers intended to avoid. In the attempt to negotiate an easy target, managers were motivated to lower firms' current performance. Thus, when the first round of three-year contracts ended while the Chinese economy suffered severely from the setback of the Tiananmen Incident in 1989, central reformers acknowledged that the managerial contractual responsibility system did not yield the reform effect that they initially expected.

An even more serious problem was the proliferation of managerial corruption as a product of the dual-track system. Above-plan outputs that were determined by market prices usually gave state firms a better return relative to the compulsory output quota decided by state-set prices. However, due to the incomplete nature of market mechanisms, market prices were usually negotiated among related parties rather than decided by actual demand and supply. This practice directly led to price disorder, ranging from the plan price to the market price. It also gave rise to large-scale corruption among officials who exerted discretion over resource allocation and among SOE managers who benefited from price distortion. Although the dual-track system brought more troubles than benefits, it was the first time that Chinese SOEs experienced the impact of the market forces.

During this period, while several attempts were made to incorporate market mechanisms into China's economic system, the role of the market has yet to be institutionalized due to the constant ideological struggle. That is, although there was a consensus on the compatibility between the central planning and market systems, market mechanisms still played a secondary role in resource allocation under the guidance of administrative commands. In the meantime, while SOEs were never again seen as a part of the bureaucracy, they were by no means independent economic entities.

3. The Socialist Market Economy and the Ownership Restructuring Program, 1993-2003

The third period, from 1993 to 2003, represented a watershed in the history of Chinese SOE reform. During this period, the role of the market was not an ideological issue. Rather, it was more of a technical issue. State ownership as an unchallenged tenet was compromised, so Chinese reformers started to introduce diversified forms of ownership to the marketplace that were to provide a sphere for efficient economic exchanges. Along this logic, several institutions that had previously only been seen in capitalist economies, including share-holding companies and stock markets, were introduced into China's economic system. It was the first time that state firms were recognized as independent entities on the legal basis and operated under the new corporate structure. The breakthrough was attributed mainly to a renewed ideological debate over the direction of the economic reform.[10]

For years, because of the ideological limitations of socialism, Chinese leaders were reluctant to acknowledge that the market was more efficient than central planning in allocating resources. Official recognition of market efficiency, the hallmark of capitalism, was still a political taboo that would risk the CCP's legitimacy. Therefore, leaders in Beijing could only rely on market forces in a non-systematic and segmented manner.

[10] For an excellent discussion on the ideological debate in the reform period, see Ma and Ling (1998).

Such an attitude was intensified by the Tiananmen Incident and persisted in subsequent years due to the tense political atmosphere. In the early 1990s, frustrated with a slowdown in the reform momentum, Deng Xiaoping provoked another political storm, by which the compatibility between socialism and market were widely debated. In an attempt to reinvigorate the reform phenomenon, he rebuked the Leftists' contention that the market economy destroyed the purity of socialism. After his famous southern tour in 1992, in which Deng won a victory over his conservative rivals led by Chen Yun, a socialist market economy became the overarching goal of China's economic reform.[11] Officially adopted in the 14th Party Congress in 1993, China's socialist market economy is based on the modern enterprises system (*xiandai qiye zhidu*) in which public ownership plays a dominant role.[12] To be specific, the modern enterprise system is expected to reach four goals: a transparent property rights regime, a clear accountability system, the separation of government functions from enterprise management, and scientific corporate management.[13] At the same time, the socialist nature of China's economy is manifested by the principle that the market is employed to allocate resources under the state's macro-control.

This is the first time that the Chinese state formally abolished the planning system altogether. From this time onward, numerous reform measures aiming to foster a full-

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[11] After his official retirement, in early 1992 Deng paid a visit to several southern cities, including Guangzhou, Shenzhen, and Zhuhai, and spent the New Year in Shanghai. During the trip, Deng made several public speeches to endorse market-oriented reform programs, which later earned support from rank-and-file Party members. For details, see Ma and Ling (1998).

[12] See "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure" promulgated at the Third Plenum of the Fourteenth Congress of the Chinese Communist Party on November 14, 1993.

[13] See Jiang Zemin's speech on 15th National Party Congress.

fledged market began to emerge; these later proved to be failures in inducing corresponding managerial market-oriented behavior. The first and foremost reform program was the reorganization of SOEs into share-holding entities with a well-defined ownership structure, by which most large and medium state firms were restructured into joint stock companies with multiple owners established under the Company Law. Then according to the guideline of diversification of the ownership structure, large SOEs started to appear on the Shanghai Stock Exchange, which was established in 1990, and the Shenzhen Stock Exchange, which was established in 1991, meaning that state firms had started to raise capital from the non-state sector.

Another important reform program was "grasping the large and letting go of the small" (*zhuada fangxiao*), which was proposed in the ninth five-year plan (1996-2000) and continued to be one of the primary SOE reform policies in the tenth five-year plan (2001-2005). The policy components included measures to consolidate state control over large SOEs with valuable assets and to privatize loss-making small SOEs. Namely, on the one hand, unlike large SOEs which were protected from competition by the state, small SOEs suffered from their sluggish productivity when facing competition from similar-sized non-state firms. Privatizing these unproductive state firms, which were considered a tremendous liability to the state, paved the way for building robust public ownership as "the pillar of the economy." On the other hand, because of the political implications, large SOEs were too important, if not too large, to fail. By providing large SOEs with various preferential treatments to build up their competitiveness, the state spun off their non-productive units and put productive assets under control of these firms. Together with the ongoing program of organizational restructuring, corporatization has been largely introduced into the state sector. Most of the remaining SOEs were corporatized as limited liability companies or limited liability shareholding companies.

Again, it is clear that political, not economic, logic determined the direction of market-oriented reform. From the perspective of the CCP leaders, SOEs should be of use to national policy objectives, especially those under the management of the central government. As a result, except for a few large local SOEs, valuable and strategic assets were concentrated in the hands of central SOEs. To enhance national economic competitiveness in a globalized economy, reformers encouraged central SOEs in related sectors to further form enterprise conglomerates (*qiye jituan*) through mergers and acquisitions.[14] Moreover, in addition to the employment of market mechanisms, the state used administrative means to reorganize strategic industries monopolized by central SOEs, such as the petroleum and chemical industry and the military engineering industry. As Huang (2008) notes, most Western studies on Chinese political economy are preoccupied with their neoliberal concern for the program of privatization. Yet the direction of China's industrial policy is exactly the opposite. He suggests that "the industrial policy agenda shaped China's privatization agenda. The purpose of 'letting go of the small' was to limit the scale of privatization" (Huang 2008, p. 169).

During this period, the market was established and corporatization was introduced. Yet SOEs' market-resistant behavior remained. In the late 1990s, China's state sector, including the state-owned banking system and industrial SOEs, teetered on the brink of

[14] See Jiang Zemin's report delivered at the 15th National Party Congress of the Chinese Communist Party in 1997.

bankruptcy (Holz 2001). Except for the common practice of soft budgets which gave managers incentives to abuse production resources, the deterioration of SOE performance was also a reflection of intrusive state intervention. Rent-seeking activities and state predation were prevalent within the state sector, rendering SOEs' property rights insecure or even de facto nonexistent (Steinfeld 1998). In other words, central command in the bureaucracy has been dismantled; however, political control over firms' activities has not. In a Party-state, such hierarchical control was necessary for decision-makers to employ SOEs for non-economic goals. For example, as will be discussed below, government-initiated overseas expansion of state firms was proposed at this reform stage to achieve broader national economic and security objectives. Yet political control over SOEs' activities ran counter to principles of good corporate governance. The consequence of this hierarchical control dwarfed managers' economic motivations, which took place in two fronts: the prevalence of insider control and continued state interference.

The way that Chinese reformers restructured SOEs' ownership during the process of corporatization directly led to the present ineffectiveness of SOE corporate governance. The ownership structure in corporatized SOEs was unique in the sense that only about one-third of shares were tradable among general investors. The other two-thirds of outstanding shares were non-tradable on the market, which were further categorized as state shares and legal personal shares held by state firms. Under this arrangement, general investors were minority shareholders and were given little leverage over corporate management. The state appointed a wholly state-owned firm or a state-owned investment company as the controlling shareholder of a listed SOE. In most situations, firms that were appointed as the controlling shareholders were under the control of a few key individuals. Thus, these individuals were both the representatives of state shares and the senior management of the listed SOE (Wu 2003, pp. 149-150). The problem of insider control led to the abuse of minority shareholders and the failure of corporate monitoring system. One typical example of managerial corruption in China's state sector is the channeling of funds out of the listed SOEs through related party transactions by the controlling shareholders.

The high state shares also mean that political interference from the state still plays a critical role in corporate decision-making. This is especially vital when the boards of directors were under the control of the state and the CCP. When the state employed SOEs as an instrument to serve certain political functions, the board usually made decisions at the expense of firms' economic performance. Consequently, managers continued to flatter their political superiors rather than pay attention to their firms' business activities.

Table 3.2 The Ratio of State Shares, Legal Person Shares, and Tradable Shares in the SOE Sector, 1999-2002

	Total Shares (billion)	State Shares (billion)		Legal Person Shares (billion)		Tradable Shares (billion)	
		Shares	%	Shares	%	Shares	%
1999	3088.95	1745.78	56.52	189.54	6.14	1079.65	34.95
2000	3791.70	2165.40	57.11	214.21	5.65	1354.27	35.72
2001	5218.01	3121.10	59.81	214.25	4.11	1813.16	34.75
2002	5875.46	3493.36	59.46	299.70	5.10	2036.77	34.67

Source: China Securities Regulatory Commission, quoted from Zhou and Ding (2005, p. 248).
Unit: RMB billion.

In sum, although this stage witnessed the changing role of state firms from a part of the bureaucracy to an independent economic entity protected by the Company Law, the relationship between the state and SOEs was still characterized by dependence and subordination. Chinese reformers choose to corporatize SOEs in the hope of inducing market-oriented management and improving firms' financial performance. Organizational restructuring, however, did not necessarily improve the problem of bureaucratic intervention that was the main underlying reason for SOEs' low productivity. The way that state firms have been corporatized is equally as important as whether state firms have been corporatized. In other words, as long as the CCP makes the preservation of its political control the priority in reforming the state sector, corporatization of SOEs is bound to fail in bringing about changes in managerial behavior.

4. Deepening Corporate Governance and Building up a New State-owned Asset Management System, 2003- Present

Throughout the course of SOE reform, Chinese policymakers have sought to establish an accountable management system in which managers of state firms respond to market signals to maximize the firms' profits. At the same time, reformers insisted that this goal must be accomplished under the supervision of the Party-state, which was the source of extensive bureaucratic intervention that impeded the efficient operations of SOEs in the previous three stages of reform. The political control over SOEs' activities, however, continues to be present in the latest stage of SOE reform. Unlike the other three stages, ideological issues do not play a critical role in shaping SOE reform direction during this period. Decreasing ideological interference in the reform process means that as long as the dominance of public ownership is guaranteed, the Chinese economy is still socialist in nature. Nevertheless, the Party-state once again exercises administrative rather than economic leverage to maintain the leading position of public ownership in the national economy,

At this stage, Chinese reformers re-introduced the separation of ownership from management, an agenda first initiated in the 1980s. The 16th National Party Congress of the CCP in 2002 identified that under the precondition of the dominance of public ownership, state-owned assets would be better managed through a specialized government body. Along with this recognition, China began to introduce another round of SOE reforms by institutionalizing the separation of the government's functions as owners and investors of state assets from its functions as public managers of society as a whole. The creation of the SASAC in March 2003 represented such an effort.[15] The SASAC's mandates are limited to management of industrial state firms under the reign of the central government, most of which are gigantic conglomerates and oligopolists in the sectors in which they operate.[16]

[15] While the SASAC is designed to exert owners' rights of the central SOEs on behalf of the central government, local SASACs at various administrative levels are bestowed the same rights over local SOEs without being subordinate to their national counterpart. See also ft. 4 in this chapter.

[16] With the progress in restructuring SOEs, the number of central SOEs under SASAC's jurisdiction has shrunk steadily, from 196 in 2003 to 128 in early 2010.

Table 3.3 The Share of Central SOEs to the Whole SOE Sector, 2004

	Number of Enterprises	Total Assets	Revenue from the Core Businesses	Profit	Submitted Tax	Value Added
SOE	138,000	223,000	123,000	7,525	10,107	34,029
Central SOE	15,000	91,000	56,000	4,880	4655	17,392
The Ratio (Central SOEs/SOE)	10.9%	41%	45.4%	61.9%	46.1%	51.1%

Source: SASAC (2006, p. 245).
Unit: RMB billion.
Note: The number of central SOEs includes their subsidiaries at the first, second, and third levels.

Following the establishment of the SASAC, the central government began to pay attention to three reform agendas: concentrating state capital in strategic industries, building up business conglomerates as "national champions," and strengthening corporate governance. While the overarching goal is to turn central SOEs into independent market players, China's industrial policy preserves leeway for political discretion in intervening in the firms' activities. For example, to further liberalize the economy, Chinese reformers began to encourage the prosperity of non-state firms in competitive industries that have less strategic significance for the national economy, such as the manufacturing industry.[17] Correspondingly, the central government remains the controlling shareholder in central SOEs operating in "pillar" industries: civil aviation, coal, electricity, military engineering, oil and petrochemical, shipping, and telecommunications.[18] In these pillar industries, the

[17] This reform agenda, widely described as "the state sector advances, the non-state sector retreats" (*guotui minjin*), was originally initiated at the Fourth Plenary Session of the CCP Fifteenth Central Committee in 1999 and continues to be one of the important SOE reform guidelines. The global financial crisis in 2008, however, has led to a comeback of the state sector in competitive industries due to the state's financial backing behind these firms.
[18] State-owned Assets Supervision and Administration Commission of the State Council (SASAC), *Zhongyang Qiye Buju he Jiegou Tiaozheng de Zhidao Yijian* (*The SASAC's Instruction concerning the*

SASAC continues to promote the formation of "national champions" composed of a group of giant central SOEs, with the ultimate goal of cultivating about 30-50 globally competitive Chinese enterprises.

Contrary to the official claim that market logic rules the merger process, the SASAC merger program is fraught with political struggle and tension.[19] Facilitated by their bureaucratic connections and newly-gained corporate autonomy, a group of colossal central SOEs have challenged the SASAC's authority in deciding which firms are the top three in their respective industries and thus which will be allowed to stay. For example, the SASAC involved several mega-ministries including the National Development and Reform Commission (NDRC) to push the restructuring program in the telecommunications industry.[20] At the same time, in order for these "national champions" to be globally competitive in the post-WTO era, the central government continues to grant these firms various preferential financial treatments, including no-cost loans.

Furthermore, in spite of the fact that managerial appointment in central SOEs falls under the SASAC's legal purview, the powerful principle of "the Party manages state cadres" (*dangguan ganbu*) continues to rule. That is, given the powerful *nomenklatura* system discussed in the previous chapter, the selection and removal of the executives of

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Arrangement and Structural Adjustment of Central SOEs), 2007.

[19] An official report reveals that during the 5-year period from 2002 to 2007, 95 central SOEs underwent a total of 47 restructuring projects, reducing the firm number from 195 to 150. See "Li Rongrong: Wunianlai " [Li Rongrong: During the Five-year Period, 95 Central SOEs Underwent a Total of 47 Restructuring Projects], *Zhengquan Ribao*, http://ma.sasac.gov.cn/bgrz/gdfw/zfjggdft/2008/313/083138037KEE2H3BC4D89DA961908.asp, accessed March 18, 2009.

[20] It is worth noting that *Guanyu Shenhua Dianxin Tizhi Gaige de Tonggao* (*The Announcement on Deepening the Reform of the Structure of the Telecommunications Sector*) was jointly issued by the Ministry of Industry and Information, the NDRC, and the Ministry of Finance in May 2008. In this official document, the SASAC did not play a direct role.

central SOEs is still managed by the CCP Central Organization Department. Under this condition, the SASAC only plays a secondary role in personnel decisions. A common practice in central SOEs is that the board of directors consists of Party officials who are also members of the Party committees, rendering the corporate monitoring system impotent. In order to strengthen the effectiveness of the board of directors, beginning in 2004, the SASAC began to experiment with a system of outside directors and independent directors in a pilot study with six wholly state-owned enterprises. Nonetheless, most outside director positions are taken by retired executives of central SOEs, rendering the pursuit of independent boards of directors largely futile.

Admittedly, under the SASAC's management, central SOEs have become the most profitable firms in China. A report issued by the SASAC states:

> The central SOEs' total assets averaged an increase of 1.5 trillion yuan each year; the sales revenue grew by 1.3 trillion yuan on average each year; the profits achieved increased by 150 billion yuan on average each year and the taxes-paid grew by 100 billion yuan on average each year. In 2007 the taxes-paid by all SOEs in China registered 1.77 trillion yuan which accounts for 34.5 percent of the total fiscal revenue. In the world's top 500 published in 2008, there are 26 mainland enterprises, which are all state-owned or state-controlled, 15 more than that of 2002.[21]

However, what these buoyant figures cannot tell us is how these profits were made. As mentioned above, central SOEs are the primary beneficiary of China's industrial policy, which gives firms privileged access to debt relief, public listing, policy lending, and tax

[21] The statement is an excerpt of SASAC's report prepared for government press conference. See http://www.sasac.gov.cn/n2963340/n2964712/5349959.html, accessed on October 22, 2008.

breaks. Moreover, in strategic sectors listed above, the central government used administrative measures to develop the SOEs into *de facto* monopolies in the marketplace. As will be discussed in Chapter 4, CNPC's remarkable revenues come mainly from administrative protection rather than improvements in productivity. In sum, while Chinese reformers introduce various measures into the operations of central SOEs to strengthen corporate governance, they maintain political discretion in channeling resources to support the firms' operations that they consider to be in the state's best interests. As many scholars have pointed out, however, the incompatibility between the state's political control and SOEs' profit-seeking objectives has been at the core of weak corporate governance in China's state sector.[22] The lack of market discipline in the state sector, therefore, goes beyond corporate governance. It is an issue of whether or not the Chinese state can find a solution to bridge two competing objectives imposed on its firms: commercial benefits and national interests.

II. STATE-OWNED ENTERPRISES' "GOING OUT"

From the previous section, it is clear that the very foundation of the CCP's legitimacy – public ownership and SOEs' political role – gives rise to the issue of the incompatibility of SOEs' political and economic functions. Because SOEs' political functions are important instruments with which the CCP strengthens its legitimacy, Chinese leaders have no incentives to release SOEs from their policy burdens. In this context, rather than

[22] See for example, Clarke (2003) and Koppell (2007).

as an end in itself, the transnationalization of state firms was initiated to achieve broader national interests.

Although the evolution of overseas expansion of China's state-owned enterprises can be traced back to the beginning of the economic reform in 1978,[23] it was not until the late 1990s that the "Going Out" strategy became part of the national agenda. The official advocacy of the strategy reflects how Chinese reformers responded to the looming challenges posed by a globalized economy. Like in other policy areas, SOEs, especially those under the purview of the central government, have become the main agent to spearhead the global expansion for the sake of national security and economic interests. Without a doubt, state management plays a critical role in cultivating SOEs into multinational corporations, which can be divided into two different stages: the period of particularism, from 1979 to 1997, and the "Going Out" strategy, from 1997 to present.

It needs to be stressed that the two stages of SOEs' overseas expansion are characterized by a divergent state-SOE relationship. During the period of particularism, SOEs followed the state's lead in venturing abroad. Nevertheless, the implementation of the "Going Out" strategy has coincided with changes in the SOE operational environment and heralded changes in the way government agencies interact with SOEs. To put it more precisely, in this post-corporatization period, SOEs with their growing economic autonomy from political interference are capable of pursuing corporate interests that might not be in the state's best interests. Moreover, the lack of a coherent monitoring scheme over SOEs' activities (mentioned in Chapter 2) facilitates SOEs' maneuvering to

[23] The first project of overseas investments after the "open-door" policy was a joint venture between Beijing Friendship Commercial Service Co. and a Japanese corporation in Tokyo.

gain state financial support without being held accountable for their cross-border conducts.

1. The Initial Stage of Transnational Operation of China's State-owned Enterprises and Particularistic Policies, 1979-1997

Immediately after the initiation of economic reform, the State Council issued a document titled "Fifteen Measures Concerning Economic Reform" in which the official support of "operating enterprises abroad" (*chuguo ban qiye*) was mentioned. This was the first official attempt to encourage Chinese firms to venture in international markets. Nevertheless, at a time when China still lacked any kind of commercial entities in the real sense, only a few state-selected SOEs went overseas to establish foreign affiliates. In the mid-1980s, the Ministry of Foreign Economic Relations and Trade (1982-1993) formulated regulations that transformed the governance framework over the transnationalization of Chinese firms.[24] The old regulatory regime had the State Council license overseas projects on a case-by-case basis, while this new regime gave general administrative review and approval authority to the Ministry of Foreign Economic Relations and Trade. Moreover, in certain areas, the authority was further decentralized to provincial and municipal governments. For instance, only overseas projects greater than one million dollars had to be submitted to the Ministry of Foreign Economic Relations and Trade. With the help of a more relaxed regulatory framework, more cross-border

[24] The primary one was "*Guanyu zai guowai kaishe feimaoyixing hezi jingying qiye de shenpi chengxu he guanli banfa*" [The Review and Approval Procedure and Regulation concerning Setting up Non-trade Joint Ventures Abroad].

ventures were created. At the same time, the particularistic and preferential treatments targeting large SOEs encouraged more transnational projects that had national strategic importance.

Nevertheless, capital flights as well as a dearth of China's foreign exchange reserves led the State Council to withdraw its policy support of firms' overseas activities in 1993.[25] During the period of re-centralization, the Ministry of Foreign Trade and Economic Cooperation (1993-2003, the successor of the Ministry of Foreign Economic Relations and Trade) was the lead agency to manage the general policy toward the transnationalization of businesses and to coordinate regulations from various central regulators. In addition to the direct superior agencies' review and approval authority, other primary authorities included the supervision of State Planning Commission (1952-1998) over the feasibility of projects, the control of the State Administration of Foreign Exchange (SAFE) over foreign exchange transactions, and the oversight of the Bureau of State-owned Asset Management over SOEs' overall activities abroad. Furthermore, the Ministry of Finance promulgated the first document on financial management of overseas investment in 1996.

Along with this restrictive regulatory framework, the state simultaneously mobilized resources to support overseas projects that had strategic implications for national interests. This particularistic support (*zhongdian fuchi*) was given on a firm-

[25] In 1993, the State Council issued a document on "*Guowuyuan guanyu zhanting shougou haiwai qiye he jinyibu jiaqiang haiwai touzi guanli de tongzhi*." [Circular of the State Council concerning Postponing the Acquisitions of Foreign Enterprises and Further Reinforcing the Management of Overseas Investment].

specific basis.[26] The designated SOEs enjoyed a variety of preferential treatments, which can be broadly categorized into three types- preferential loans, tax exemptions and reduction, and easy access to foreign exchanges (Yan 2006, pp. 206-208). For example, during the last years of this stage, offshore ventures in natural resources were especially encouraged and more easily gained government aid. As I show in Chapter 4, the initiation of CNPC's preliminary transnational projects was just a part of the national security strategy, rather than a search for corporate commercial interests.

While there was no meaningful breakthrough in terms of the overseas expansion of Chinese firms, two developments deserve special attention. First, the first phase of transnationalizing Chinese firms, from 1979 to 1997, was a time when SOEs were experiencing a drastic transition from administrative units to commercial units. During this transition period, SOEs' commercial interests had yet to be fully developed, so state policy-makers were inclined to use administrative decrees to command SOEs' transnationalization when it was necessary for national objectives. This tendency became more evident when the Chinese economy suffered from the political setback of the Tiananmen Incident in 1989. After the incident, the U.S., which China had become increasingly dependent on for its market and capital, played a leading role in the sanction based on the human rights issue, resulting in an economic downturn in the Chinese domestic market. Faced with the crisis, Chinese leaders came to realize the danger of relying solely on advanced capitalist countries to drive economic growth.[27] The country

[26] For example, see Zhang Yongjin's (2003) study on The China International Trust and Investment Corporation, Sinochem Corporation, and Shougang Group.

[27] See for example, Deng Xiaoping's speech, "*Disandai lingdao jiti de dangwuzhiji*" [Urgent Task of China's Third's Generation of Collective Leadership].

needed its own multinationals that would enable the Chinese economy to avoid the trap of international division of labor and to upgrade its industrial structure. For example, in his report to the 14th CCP National Congress in 1992, Jiang Zemin pointed out the importance of fostering Chinese firms' transnational operations and overseas investment.[28] This statement paved the way for the relentless pursuit of creating a group of "national champion" SOEs capable of competing in the world market.

In addition to the particularistic support for large SOEs, the other development worth noting is the result of the recentralization of authority over firms' offshore activities. As mentioned earlier, in 1993, the state re-introduced a restrictive regulatory framework by involving more regulators to oversee every detail of proposed overseas projects due to widespread capital flight. As in so many of the Chinese public policies, however, governance over SOEs' offshore activities focused too much on ex ante licensing procedures and fell into the trap of feuding among multiple bureaucratic actors. Only the Bureau of State-owned Asset Management exerted ex post supervision on SOEs' overseas expansion.[29] Yet the ex post regulation existed only on paper because of the rank of the Bureau as a vice ministerial agency and the shortage of support from other departments.

The absence of effective governance over SOEs' capital outflows, together with the lack of market discipline in the whole state sector mentioned earlier, finally led to the

[28] See Jiang Zemin's report, "*Jiakuai gaige kaifang he xiandaihua jianshe bufa, duoqu you zhongguo tese shehui zhuyi shiye de gengda shengli*" [Speed up the Pace of Reform, Opening, and Modernization, and Win Greater Victories in the Cause of Socialism with Chinese Characteristics], in October 12, 1992.

[29] The Bureau of State-owned Asset Management, a vice ministerial agency subordinate to the Ministry of Finance, promulgated "*Haiwai qiye, jigou qingchan hezi gongzuo fang'an ji qi youguan guiding*" [The Proposal and Regulation on Verifying the Asset Values of Enterprises and Institutes Operating Abroad].

loss of state assets on an unprecedented scale in the 1990s. The central government tried to investigate the severity of the situation, but it did not disclose the census data.[30] This was partly because no single government agency had an accurate number of the state assets invested abroad, making it virtually impossible to assess the degree of money loss caused by the transnationalization of state firms. Nonetheless, from several related public policy debates, it could be confirmed that venturing into foreign markets under this situation opened another window for the blind expansion of SOEs' inefficient operations.[31] In addition, it was not rare for SOE managers to take advantage of policy loans or to register foreign state assets under personal accounts, which benefited private individuals at the expense of firms' performance.[32] All together, the disappointing performance associated with SOEs' OFDI was a heavy blow to state finances which were on the verge of collapse in the late 1990s. In short, economic losses caused by capital outflows from the state sector during this period were just an extension of the domestic SOE governance dilemma.

While the preceding discussion focuses mostly on SOEs' capital outflows, the evolution of SOEs' international contracting can better reflect firms' political functions. China's international contracting originated from its foreign aid to African countries during the Cold War period. In other words, from the very beginning, political, not economic, considerations shaped official decisions about which contracting projects should be pursued. In the early years of the economic reform, CSCEC, one of the case-

[30] See "*Sibuwei xingdong paicha wanyi jingwai zichan*" [Joint Action of Four Departments: Investigation on Overseas State Assets], *21st Century Business Herald*, April 10, 2007.
[31] For a good review of this issue, see http://www.nfcmag.com/articles/1531, accessed July 10, 2009.
[32] See, for example, Ding (2000b).

study firms in this dissertation, was given the responsibility of implementing international economic cooperation policy. Together with offshore projects run by the other three construction SOEs,[33] CSCEC's international contracting represented the Chinese state's effort to return to the international community in the 1980s after ending a long-term hostile approach toward international economic cooperation under the guidance of socialist internationalism.

Although the state also adopted a restrictive and hands-on regulatory approach to overseas contracting, SOEs' international contracting projects seldom received the same preferential treatments as OFDI projects. Again, the domestic industrial landscape largely explains this difference. Compared with state firms engaged in outbound investment, especially those in the energy and natural resources sectors, construction SOEs, which are the agents of China's international contracting projects, did not occupy an important position in the industrial policy. Thus they were not a priority in state funding. In addition, as will be detailed in Chapter 5, since the 1980s reformers have gradually liberalized the construction industry by allowing competition from non-state firms on relatively equal footing. The financial performance of construction SOEs that were already burdened with the provision of social welfare worsened further with the new entrants in the industry. In a nutshell, during this period, the lack of financial advantage prevented construction SOEs from extending their activities beyond regional operations. Chinese contractors concentrated their businesses in the Middle East in the 1970s and Southeast Asia in the 1980s (Xin 2008). Not until the establishment of the Export-Import Bank of China (China

[33]They were Civil Engineering Construction Corporation, China National Complete Plant Export Corporation, and China Road and Bridge Engineering Corporation.

Exim Bank) in 1994, which was tasked to provide loans for overseas contracting, did construction SOEs operate on a global scale with an institutionalized funding source.

Overall, the state-SOE interaction associated with SOEs' transnationalization at this stage was characterized by state management. More often than not, with the assistance of easy state funding, SOEs carried out the prescribed policy goals regardless of financial implications. This tendency ran counter to the goal of market-oriented reform in the SOE sector. The problem of SOEs' competing organizational objectives – their economic and political functions – became even more acute in the next period when SOEs' commercial motives were established in the process of corporatization.

2. Government-initiated Overseas Expansion and the "Going Out" Strategy, 1997-present

> Do a better job in opening up by "bringing in" and "going out". In response to the new situation of economic globalization and China's entry into the WTO, we should take part in international economic and technological cooperation and competition on a broader scale, in more spheres and on a higher level, make the best use of both international and domestic markets, optimize the allocation of resources, expand the space for development and accelerate reform and development by opening up.
>
> Jiang's report at the 16th CCP National Congress on November 8, 2002.[34]

> Most of our central SOEs tightly connect with the international market. We aim to foster these firms' international competitiveness. Therefore, by letting central SOEs compete abroad, we hope that they face international competition first…Relatively speaking, overseas markets are more disciplined, which can perfect Chinese firms' corporate

[34] For the full content of the report, see http://english.peopledaily.com.cn/200211/08/eng20021108_106479.shtml, accessed March 20, 2009.

governance…That said, “overseas first, domestic later” [first float initial public offering overseas and then list them on the domestic market] also favors the development of our domestic market.

Li Rongrong, Chairman of the State-owned Assets Supervision and Administration Commission of the State Council, 2005[35]

Learning from the hard lesson of the Asian financial crisis in 1997, the Chinese central government embarked on a new round of administrative reforms, laying the groundwork necessary for a general governing framework for Chinese firms’ overseas expansion. In the same year, the notion of “taking full advantage of both markets” - the domestic and the foreign - was proposed at the 15th CCP National Congress and later dubbed the “Going Out” strategy. Later, at the Second Plenary Session in February 1998, the then-president Jiang Zemin publicly proposed that the state should systematically organize and support a group of competent state firms to invest abroad, mainly in Africa, Central Asia, Middle East, Eastern Europe, and Latin America. In the following years, Jiang Zemin noted the importance of venturing in foreign markets on several occasions, referring to it with the term of “going out.” The term of “going out” is contrary to the inward foreign direct investment that had been considered the engine of China’s economic growth in the first two decades of reform.

Meanwhile, government efforts to meet the requirements of WTO membership sped China’s embrace of the global economy and the adoption of more systematic regulations for Chinese firms’ offshore ventures. Zhu Rongji, the then-prime minister,

[35] See http://news.xinhuanet.com/fortune/2005-12/22/content_3955232.htm, accessed November 6, 2009.

delivered a statement at the Ninth National People's Congress that projects of overseas processing and assembling with materials from China should be officially advocated and aided. Building on the preceding momentum, in 2001, the Chinese government made the "Going Out" strategy one of the main goals of the 10th Five-Year Plan. In 2002, Jiang Zemin's report at the 16th Party Congress further indicated that China should actively participate in the global economy by both "Going Out" and "Bringing In" (*yinjinlai*). Since that time, the State Council has again made numerous preferential policies to encourage Chinese firms, especially large SOEs, to engage in the following overseas activities: OFDI, international contracting, and international labor and service cooperation.

How do the Chinese state and SOEs interact with each other in the policy area of "Going Out?" Are there any changes in the state-SOE relationship compared to the previous stage? As noted earlier, the "Going Out" strategy was initiated at a time when SOEs were gradually acquiring their corporate autonomy from political interference. SOEs are not simply a policy instrument to serve national interests. When prescribed cross-border deals run counter to firms' financial objectives, SOEs will and are able to ignore such commands. To put it differently, when SOEs' political and economic functions in a given transnational project conflict with each other, SOEs will choose to meet their economic interests, not their political ones as they did in the earlier stages. I examine this dynamic in greater detail in the case studies of CNPC and CSCEC. Here, I focus on three broader transformations introduced by the "Going Out" strategy: the licensing process, governmental financial support, and particularistic policies.

In terms of the licensing process, efforts have been made to decentralize the review and approval authority. The central government either transferred part of its regulatory power to local governments or simplified the procedure of review and approval. For instance, in 2004, the NDRC issued a document for resource-related ventures stating that only projects greater than USD 30 million have to submit for NDRC's inspection. Similar projects that are less than USD 30 million go to provincial governments for inspection or the firms have the right to decide which regulatory avenue of approval to seek, depending on the significance of the projects. In 2009, the Ministry of Commerce (MOC) on behalf of other central government departments released the new regulation concerning overseas investment, which further decentralized the governing system over Chinese firms' overseas expansion.

The licensing process, however, has become yet easier due to fragmentation among the different regulators. Immediately after the idea of "Going Out" was proposed in 1999, related central regulators issued six different circulars regarding the details of implementation from different policy concerns. According to the official scheme after the introduction of the "Going Out" strategy, at least seven central agencies were to be involved in the licensing procedure – the MOC was charged with firms' registration; the NDRC with project licensing; the SAFE with foreign exchange control; the Ministry of Finance with special funds; the SASAC with central SOEs' ventures; the China Exim Bank with loans and credit insurance; and the China Development Bank with industrial investment funds. Like other policy areas, incompatible stipulations among these regulators often cause bureaucratic conflicts with no single agency dominating the implementation of the “Going Out” strategy. Such division of labor without institutionalized coordination has long been accused of delaying transnational projects and thus missing important investment opportunities. Nonetheless, it is important to note that for certain large SOEs with a ministerial-level bureaucratic rank, such as CNPC, the fragmented regulatory framework actually makes the licensing process easier. This is because these politically powerful SOEs have more leverage to take advantage of regulatory fragmentation in favor of their cross-border deals.

Table 3.4 China’s approved outward FDI, by type of enterprise, 2003 and 2004

Types of enterprises	Percentage of total enterprises	
	2003	2004
State-owned enterprise	43	35
Limited liability corporation	22	30
Limited liability stock corporation	11	10
Private enterprise	10	12
Foreign corporation	5	5
Cooperative corporation	4	3
Hong Kong, Macao and Taiwan-based corporation	2	2
Collective-owned enterprise	2	2
Joint venture enterprise	1	1

Note: The strategy that the Chinese government employs to restructure ownerships of SOEs is to gradually turn SOEs from wholly state-owned to share-holding entities, with the state as the dominant shareholder. In this table, it bears noting that limited liability and limited liability stock corporations are categorized in the public sector, and thus investment coming from these two types of firms should be treated as coming from SOEs. For the details of different ownership arrangements of Chinese SOEs, see Lin and Zhu (2001).

Source: Ministry of Commerce (2004 and 2005).

Table 3.5 China's approved outward FDI, by sector of investment, 2003 and 2004

Sectors	Percentage of total amounts		
	2003	2004	2005
Manufacturing	21	13.8	18.6
Wholesale and retail	13	14.5	18.4
Business service	10	13.6	40.3
Construction	1	N/A	N/A
Transport and storage	3	15.1	4.7
Agriculture, farm, forestry, and fishing	3	5.3	N/A
Mining	48	32.7	13.7
Electricity, coal and water	1	N/A	N/A
Others	N/A	5	4.3

Source: Ministry of Commerce (2004, 2005, and 2006).

Regarding financial support, the Chinese government delegates the China Exim Bank to provide low-interest loans necessary for expanding firms' operations abroad. Within the institution, a leading group for the "Going Out" strategy was set up in 2004. This group is responsible for the promotion, coordination, and management of policy loans for firms' offshore expansion. From its establishment through April 2004, the China Exim Bank loaned a total amount of 23.2 billion Reminbi to 100 OFDI projects and a total amount of 31.88 billion Reminbi to 150 international contracting projects. The amount of the policy loans that China Exim Bank has made reflects the state's increasing support for SOEs' global expansion. For instance, in 2005, in the Bank's business of the export seller's credit, the shares of financing OFDI projects and international contracting projects were both 16 percent, meaning that almost one third of the Bank's lending was used to facilitate the implementation of the "Going Out" strategy (Yan 2006, p. 230).

Given the cut-rate loans the China Exim Bank has provided, it is tempting to conclude from the growing governmental financial support that the Chinese state strengthens its subsidies to domestic firms to buy up strategic assets abroad, especially when most loans go to state firms. Yet two facts should be pointed out: economic logic still plays a role in the China Exim Bank's lending, and this policy lending is not unconditional. In China, due to easy bank credit, SOEs have a tendency to over-invest, and quite a number of investments concentrate on activities not related to productivity improvements (Huang 1996). In order to curb blind overseas expansion, the Bank adopted a principle of so-called "double large" (*shuangda*) – concentrating its support to large enterprises and large projects – in the belief that large firms are more likely to have a sound risk-resistance capability and thus profitability (Gan 2005, p. 39; Yan 2006, p. 269). This standard applies to both SOEs and non-state firms, though qualified borrowers tend to be under state ownership due to the legacy of the command economy.

The China Exim Bank's lending principle, however, actually exposes itself to the predation of large SOEs, particularly central SOEs. Because it is a government policy bank, firms' financial performance is not the only factor that influences the China Exim Bank's lending decisions. Non-economic determinants, such as firms' bargaining leverage and the government's policy preference, wield even more influence on the making of state financial support. SOEs lobby relevant decision-makers with the assistance of their ties to the bureaucracy. As will be shown in Chapters 4 and 5, state-subsidized loans become another source of rent, which encourages state firms' blind overseas expansion.

When talking about funding sources for overseas expansion of Chinese firms, discussion usually focuses on governmental backup. Yet raising capital in stock markets also plays a critical, even more important, role. For a long time, China has implemented a relatively strict foreign exchange governance system. Under this condition, overseas stock markets provide firms with a stable channel of obtaining foreign exchanges and capital necessary to expand their cross-border activities. Beginning in the late 1990s, numerous SOEs went public in the stock markets in Hong Kong, London, and New York.[36] This trend has also been encouraged by state regulators who perceive the "discipline effect" of the foreign stock market on state firms. The requirements imposed by foreign regulators in order for stocks to be listed leave no room for Chinese SOEs to hide any details of their operations. This reveals essential information about production that is rarely exposed in the partially-reformed Chinese market. In discussing SOEs' fund raising, the head of the SASAC, Li Rongrong, repeatedly claims that the central government advocates SOEs to "first float initial public offerings overseas and then list on the domestic markets."[37]

In addition to the preceding relaxed regulatory measures, the state maintains its particularistic policy towards resource extraction projects, which is the most controversial aspect of China's rise.[38] The NDRC issues a guiding catalogue each year to specify the target destination of overseas resource ventures. Firms that expand to the state-selected

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[36] The first Chinese firm listed in the New York Stock Exchange and the London Stock Exchange is Tsingtao Brewery Company Limited in 1993. With the implementation of the "Going Out" strategy, more Chinese companies went public in Western stock markets after 2000.

[37] See http://english.mofcom.gov.cn/aarticle/newsrelease/commonnews/200512/20051201152822.html, accessed January 20, 2009.

[38] See, for example, Friedberg (2006).

destination economies are provided with tax incentives and preferential loans. Because resource-related industries are dominated by state firms, especially those under management of the central government, this state-managed approach delivers an impression that SOEs follow the state's lead in deciding their transnational operations.

To some extent, the observation is true.[39] However, it is not the whole story. Despite the fact that the state sector is the backbone of Chinese socialist economy with its political mandate, corporatized SOEs have transformed to behave in ways consistent with their commercial interests. That is, on the one hand, it is not rare for SOEs to take advantage of preferential treatment in fulfilling their commercial goals, regardless of the negative political consequences for the state. On the other hand, facing corporatized SOEs' strong commercial motives, the regulatory fragmentation mentioned above hinders relevant bureaucratic actors from taking immediate action in response to SOEs' opportunism. For instance, it was found that CNPC and Sinopec had competed with each other in a pipeline construction project in Sudan to advance their commercial gains at the expense of the state's interests. Yet fragmented regulators failed to make the cooperation between the two oil giants happen (Liou 2009). Seen in this light, the tension between corporatized SOEs' economic and political functions reduces the effect of particularistic policies that aim to strengthen SOEs' international competitiveness for the reason of politics. Nonetheless, commercial-driven SOEs have every incentive to capture the implementation of particularistic policies in favor of their economic, not political,

[39] In the wake of the recent global financial crisis in late 2008, the SASAC selected 10 SOEs to engage in overseas acquisition in resource extraction projects with a variety of government financial support. See http://www.21cbh.com/HTML/2008/12/22/HTML_HE39R5J4KNB3.html, accessed January 20, 2009.

objectives.

Before concluding how the “Going Out” strategy evolves in the context of a socialist transition economy, a general picture of the overseas expansion of Chinese firms would be helpful. The regulatory reform pertaining to the “Going Out” strategy is still a work in progress. Thus far, the global reach of Chinese firms has witnessed rapid growth, with heavy reliance on SOEs’ ventures. Because of the visible hand of Beijing in the “Going Out” strategy, such development has caused widespread worry in the international community. Moreover, China’s high-profile resource diplomacy, first embarked on in early 2000s, reinforces this uneasiness.

By any measure, however, China’s OFDI and international projects are still in their infancy. More importantly, the statistics on the global expansion of Chinese firms hardly fit in with political charges made by other major global powers. For example, in the decades since the central government first advocated global operations, most capital outflows are concentrated in Asian economies, with Hong Kong as the top destination market. This is a result of China’s preferential policies toward foreign capital. Motivated by preferential treatments, a large amount of Chinese capital funnels out of China and then returns masked as FDI - so called round-trip FDI.[40] The same logic applies to the other two top destinations of Chinese capital, the Cayman Islands and British Virgin Islands, which are well-known tax havens. In order words, although international suspicion of China’s “Going Out” strategy is not without foundation, the distribution of China’s OFDI should make the associated “China threat” argument less appealing. After

[40] For a succinct account of China’s round-trip FDI, see Huang (2003, pp. 37-41).

all, the “Going Out” strategy is not only shaped by the international environment but also by China’s domestic institutions.

III. Conclusion

In examining the evolution of China’s SOE reform, I have shown how it has advanced with ideological breakthroughs. To preserve the distributional function of state firms for regime legitimacy, the CCP intentionally holds its grip on the SOE sector while attempting to impose economic discipline on it. The history of China’s SOE reform reflects Chinese reformers’ continuous search for strategies that can accommodate two goals – SOEs’ function as welfare providers on the one hand, and SOEs’ function as for-profit entities on the other. In theory, these two objectives are not inherently in conflict with each other. Yet, in practice, the way that the Chinese state controls SOEs for the reason of politics makes it difficult to induce SOEs’ market-oriented behavior. As the previous chapter notes, the state cadre scheme offers the CCP a systematic arrangement to control managerial appointments and thus SOE operations. However, such a control tool literally makes the state itself available for managerial lobbying against the progress of reform. This is a constant challenge for the CCP leaders as long as the legitimacy of the regime lies in the dominant role of public ownership in the economy. It is against this backdrop that the “Going Out” strategy was initiated and advocated. Government-initiated SOEs’ global expansion again mirrors reformers’ habitual thinking of using SOEs as instruments to serve national security and economic interests. Nevertheless, in the absence of effective monitoring, SOEs extend their market-resistant behavior to overseas operations. This explains why the “Going Out” strategy was bound to face a rocky start.

Table 3.6 China's approved FDI outflows, top 30 destinations, 1979-2002
(Millions of dollars)

Rank	Economy	1999		2000		2001		2002		1979-2002	
		N of projects	Value	N of projects	Value	N of projects	Value	N of projects	Value	N of projects	Value
1	Hong Kong	24	24.5	15	17.5	26	200.7	40	355.6	2025	4074.3
2	United States	21	81.1	15	23.1	19	53.7	41	151.5	703	834.5
3	Canada	1	0.1	8	31.7	4	3.5	4	1.2	144	436.0
4	Australia	3	1.7	13	10.2	6	10.1	15	48.6	215	431.0
5	Thailand	3	2.0	6	3.3	9	121.3	5	3.9	234	214.7
6	Russia Fed.	12	3.8	14	13.9	12	12.4	27	35.5	482	206.6
7	Peru	1	75.7	1	0.001	2	3.1	..	..	20	201.2
8	Macao	3	0.2	4	0.5	6	2.4	2	2.0	229	183.7
9	Mexico	2	97.0	1	19.8	1	0.2	1	2.0	45	167.4
10	Zambia	4	6.7	3	11.6	3	4.3	1	0.3	18	134.4
11	Cambodia	13	32.8	7	17.2	7	34.9	3	5.1	61	125.0
12	Brazil	1	0.5	3	21.1	4	31.8	8	9.3	67	119.7
13	South Africa	14	12.8	17	31.5	2	12.4	3	1.7	98	119.3
14	Rep. of Korea	1	0.1	5	4.2	2	0.8	7	83.4	62	107.8
15	Vietnam	2	6.6	17	17.6	12	26.8	20	27.2	73	85.0
16	Japan	1	19.0	2	0.3	6	1.7	11	18.2	236	82.1
17	Singapore	6	2.9	6	1.0	3	0.4	6	2.1	172	71.7
18	Myanmar	1	6.6	7	32.9	3	1.8	5	15.8	38	66.1
19	Indonesia	0	19.0	1	8.0	2	0.6	6	3.7	59	65.0
20	Mali	1	1.2	1	28.7	..	..	..	..	5	58.1
21	Mongolia	15	40.3	12	5.4	7	4.5	7	3.4	69	56.6
22	Germany	1	0.3	1	1.6	3	3.5	6	2.8	150	51.5
23	New Zealand	..	..	..	..	2	0.9	2	0.9	26	48.7
24	Egypt	5	3.8	3	9.7	2	1.4	3	16.3	27	48.5
25	Oman	..	..	..	..	..	..	1	17.5	70	47.2
26	Papua NG	..	..	1	0.9	..	..	..	..	20	44.7
27	Nigeria	2	1.6	1	2.6	8	6.4	9	11.4	49	44.3
28	Tanzania	3	16.3	1	1.0	..	..	2	0.4	19	41.3
29	Kazakhstan	7	17.2	5	7.7	1	0.3	3	26.9	51	39.6
30	Lao PDR	1	2.0	2	24.4	1	1.2	2	61	18	36.6
	Total	220	590.6	243	551.0	232	707.5	350	982.7	6960	9340.0

Source: Ministry of Commerce of the People's Republic of China, *The Almanac of China's Foreign Trade and Economic Cooperation*, 2000-2003; quoted from UNCTAD (2003).
Note: The number of projects refers to approved investment projects involving Chinese enterprises.

Table 3.7 China's approved outward FDI, top 20 destinations, 2003- 2007
(Millions of dollars)

Rank	2003		2004		2005		2006		2007	
	Economy	Value*	Economy	Value*	Economy	Value*	Economy	Value*	Economy	Value*
1	Hong Kong	24,630	Hong Kong	30,393	Hong Kong	36,510	Hong Kong	42,270	Hong Kong	68,780
2	Cayman Islands	3,691	Cayman Islands	6,660	Cayman Islands	8,936	Cayman Islands	14,209	Cayman Islands	16,810
3	British Virgin Islands	533	British Virgin Islands	1,089	British Virgin Islands	1,984	British Virgin Islands	4,750	British Virgin Islands	6,630
4	United States	502	United States	670	S. Korea	882	United States	1,238	United States	1,880
5	Macao	446	Macao	625	United States	823	S. Korea	949	Australia	1,440
6	Australia	416	S. Korea	562	Macao	599	Russia	930	Singapore	1,440
7	S. Korea	235	Australia	495	Australia	587	Australia	794	Russia	1,420
8	Singapore	165	Singapore	241	Russia	466	Macao	612	Canada	1,250
9	Thailand	151	Bermudas	185	Sudan	352	Sudan	497	S. Korea	1,210
10	Zambia	144	Thailand	182	Bermudas	337	Germany	472	Pakistan	1,007
11	Peru	126	Sudan	172	Singapore	325	Singapore	468	United Kingdom	950
12	Spain	102	Vietnam	160	Germany	268	Mongolia	315	Macao	910
13	Malaysia	100	Zambia	148	Kazakhstan	245	Kazakhstan	276	Germany	850
14	Mexico	97	Japan	139	Vietnam	229	Saudi Arabia	273	South Africa	700
15	Japan	89	Germany	129	Thailand	219	Zambia	268	Indonesia	680
16	Germany	83	Peru	126	Pakistan	189	Vietnam	254	Nigeria	630
17	United Kingdom	75	Mexico	125	Malaysia	187	Algeria	247	Kazakhstan	610
18	Denmark	74	Spain	123	Algeria	171	Thailand	233	Mongolia	590
19	Russia	62	Russia	123	Zambia	160	Indonesia	226	Sudan	570
20	Cambodia	59	Malaysia	123	Japan	151	Japan	224	Japan	560

*: cumulative value

Source: Ministry of Commerce (2004, 2005, 2006, 2007, and 2008).

Chapter 4. China National Petroleum Corporation

When mentioning the state-owned enterprise (SOE) reform program in China, few state firms are more controversial than the three oligopolistic national oil companies (NOCs), among which China National Petroleum Corporatization (CNPC) is the leading player. At first glance, the corporatized CNPC represents a model of modern industrial organization desired by leaders in Beijing. With the establishment of the shareholding system and the operation of multinational projects, CNPC seems to have organizational characteristics that make them internationally competitive. In addition to ranking in the first tier of the Fortune list of top 500 companies based on sales revenue,[1] CNPC has occupied the leading position among domestic firms demonstrating outstanding profitability.[2]

Yet, instead of being the result of the improvement in resource allocation, CNPC's remarkable financial surplus comes mainly from debt relief, easy access to public listing, policy lending, state subsidies, and tax preferences. Chinese central reformers restructured the industry and created oligopolistic competition among three NOCs in the hope that these firms will respond directly to market signals. At the same time, in return for corporatized NOCs' compliance to their political roles in maintaining a secure energy supply and cheap energy prices, state regulators granted the firms the privilege to monopolize the market as compensation for policy-induced losses. Nevertheless, because

[1] For the Fortune 500 List for 2009, see http://money.cnn.com/magazines/fortune/global500/2009/snapshots/10939.html, accessed March 10, 2010.

[2] For example, see the evaluation of the State-owned Assets Supervision and Administration Commission (SASAC) on CNPC's performance, http://energy.people.com.cn/GB/71895/7748674.html, accessed March 10, 2010.

the state controls energy prices without simultaneously establishing an institutionalized compensation mechanism, NOCs' production is not a reflection of demand and supply in the market. Rather, it is predicated on political struggle between the firms and state regulators. Consequently, while being favored with state-granted market privileges, NOCs, facilitated by their administrative ties, successfully forced state regulators to provide more state subsidies and preferential treatments in the name of redressing their policy responsibilities. The continuation of NOC managers' bureaucratic ranks, the control tool that Chinese policymakers utilize to enforce the firms' compliance, has indeed invited more defiance.

This chapter aims to explore how the preceding state-SOE interactions shaped the transnationalization of CNPC. First, I examine the evolution of the institutional environment in which CNPC operated during the reform period. I then discuss firm-level behavior in response to institutional changes brought about by the economic reform. Special attention is given to CNPC managers' conduct in their effort to balance their political and economic interests in a transition economy in which the Communist Party still dominates their career prospects. Finally, I look at how CNPC managers transnationalized the firm's business in response to the state-initiated "Going Out" strategy.

I. BACKGROUND

The oil and petrochemical industry is one of several strategic sectors, generally known as "pillar" industries, over which the Chinese state intends to maintain its control. Despite the far-reaching political salience of the oil industry, the central state lacks a consistent framework governing energy-related issues. Frequent restructuring of state institutions has complicated China's energy governance, creating a group of state actors with conflicting agendas. In this situation, market-oriented reform faces resistance from powerful vested interests.

1. The History of China's Oil and Petrochemical Industry

Before the reform, the oil industry in China was characterized by a military-oriented state management that had resulted from several rounds of massive exploration campaigns (*da huizhan*). The central government controlled all oil-related activities with the help of the Ministry of Petroleum Industry and the Petroleum Administrative Bureaus of numerous oilfields. On the eve of economic reform in the late 1970s, this centralized management system faced the serious challenge of decreased oil production, which started China's long journey to a market-oriented oil industry.

In response to poor performance and fiscal pressures, the central government decentralized its control over the oil industry by implementing a "comprehensive contracting system" (*dabaogan*) in 1981. Under this system, the Ministry of Petroleum Industry was allowed to retain the revenue earned from trading oil that was in excess of one billion tons of crude oil. Similarly, the Ministry of Petroleum Industry then contracted with each subordinate Petroleum Administrative Bureau to set a production target for their oilfield, granting the latter discretion to utilize funds earned from above-target selling. In 1982, China National Offshore Oil Corporation (CNOOC) was set up to engage in offshore oil and gas businesses. Unlike the Petroleum Administrative Bureaus that simultaneously operated comprehensive social welfare systems,[3] CNOOC was China's first oil company to focus only on oil-related business. In 1983, the central state established Sinopec to manage the affairs of oil refineries and petrochemical production, which were originally under the authority of the Ministry of Petroleum Industry and the Ministry of Chemical Industry. In 1988, the Ministry of Petroleum Industry was transformed into CNPC, which was directly led by the State Council. Since then, China's oil market has been dominated by these three NOCs – CNPC, Sinopec, and CNOOC.

While only three major players in China's oil market, establishing an effective governance infrastructure has never been easy. Central authorities have repeatedly centralized and decentralized governance in their efforts to enhance administrative efficiency (See Table 4.1). Yet the oscillation of China's energy governance between centralization and decentralization has created a diverse array of stakeholders with conflicting interests, making coherent government supervision even more difficult. In the beginning of the economic reform, the State Energy Commission was created as a lead energy agency in 1980 to govern three energy ministries – Petroleum, Coal, and Electricity. However, it did not have the authority to set prices and license projects; these fell under the jurisdiction of the State Planning Commission. Most of time, the three

[3] Before the 1998 restructuring, China set up a Petroleum Administration Bureau in each oilfield to manage core oil business and non-core business including social welfare functions. Under this arrangement, a Petroleum Administration Bureau was a self-contained work unit, running like a mini-society. This system was called "big and comprehensive" (*da er quan*). Under each Petroleum Administration Bureau, various second tier units also operated as a self-contained system, called "small and comprehensive" (*xiao er quan*). For details, see Zhang (Zhang Jin 2004).

energy line ministries looked to the State Planning Commission for policy guidance rather than the State Energy Commission. Two years later, the State Energy Commission was dissolved and China's energy governance was again decentralized to individual ministries in specific industrial sectors.

The Chinese government undertook another effort to set up a centralized governance structure by creating the Ministry of Energy in 1988.[4] Yet by the time the Ministry of Energy was established, Sinopec and CNPC had been created as administrative oil companies that functioned as both government agencies and for-profit entities. CNPC and Sinopec still assumed a role in making oil-related policies as their organizational predecessors did under the planned economy. Namely, the regulated were the regulators themselves, creating organizational confusion that hinders efficient government supervision. Furthermore, Sinopec and CNPC had evolved from a part of the central bureaucracy and still maintained a bureaucratic rank equivalent to the Ministry of Energy. Taken together, the efficient function of the centralized energy policy-making system faced a severe challenge due to the NOCs' administrative capabilities. As a result, only the power industry was under the regulatory authority of the Ministry of Energy.

The governance confusion was soon resolved however with the abolition of the Ministry of Energy in 1993, leading to the situation of "three divisions and four

[4] The latest attempt to establish a single institution responsible for national energy policy-making was the creation of the National Energy Administration during the 2008 administrative restructuring program. The attempt was expected to be a solution to the long-term problem of ineffective governance over the energy sector. The National Energy Administration was transformed from the Energy Bureau of National Development and Reform Commission (NDRC), with enhanced authority due to its higher administrative rank at the vice-ministerial level. However, understaffed and without the right to set energy prices, the effectiveness of the new energy governance framework remains to be seen. For details of the new energy agency in China, see Downs (2008).

oligopolists" (s*an fen si tong*).[5] The "three divisions" defined the division of labor among the involved four oligopolistic administrative companies: "between onshore exploration and production and offshore exploration and production," "between upstream business and downstream business," and "between domestic trading and international trading" (Zhang Jin 2004, p. 101). Under this functional framework, CNPC and CNOOC were responsible for onshore and offshore exploration and production respectively; Sinopec was in charge of refineries and petrochemical plants; and Sinochem Corporation (SINOCHEM) engaged in international trade of crude oil and chemical products. Except for SINOCHEM which was designated as a trading company, the three NOCs were administrative companies with dual roles – oil companies and ministerial-level administrators – before corporatization was introduced into the industry.

[5] China National Star Petroleum Corporation, which existed from 1997 to 2000, was another NOC transformed from the exploration unit of the defunct Ministry of Geology and Mineral Resources. In 2000, it was merged with Sinopec.

Table 4.1 The Evolution of China's Energy Governance, 1949- present

Period	Lead Central Energy Agencies	Governance Structure[1]	Rationale for Change
1949-1955	Ministry of Fuel Industry	Centralization	Consolidate control of the new communist regime over energy resources.
1955-1970	Ministry of Petroleum Industry	Decentralization	Handle growing demand for energy supply.
	Ministry of Coal Industry		
	Ministry of Electrical Power (1955-58) Ministry of Water Resources and Electrical Power (1958-1979)		
	Third Ministry of Machine-Building Industry (1956-1958) Second Ministry of Machine-Building Industry (1958-1982)		
1970-1975	Ministry of Fuel and Chemical Industry Ministry of Water Resources and Electrical Power (1958-1979)	Centralization	Transfer most energy management to local governments and leave a few energy decision-making authorities at the central level in response to the ideology advocated by the Culture Revolution.

1975-1979	Ministry of Petroleum and Chemical Industry (1975-1978) Ministry of Petroleum Industry (1978-1988) Ministry of Chemical Industry (1978-1998) Ministry of Coal Industry Ministry of Water Resources and Electrical Power (1958-1979)	Decentralization	Stimulate energy production destroyed by the Cultural Revolution.
1980-1983	State Energy Commission	Centralization	Develop a comprehensive energy policy in response to the initiation of economic reform.
1983-1988	Ministry of Petroleum Industry (1978-1988) Ministry of Coal Industry Ministry of Water Resources and Electrical Power Ministry of Nuclear Industry[2]	Decentralization	Reduce administrative intervention and respond to the reform strategy of separation of ownership from management.
1988-1993	Ministry of Energy	Centralization	Replace energy line ministries with state-owned energy companies.
1993-1998	Ministry of Coal Industry (abolished in 1998) Ministry of Electrical Power (abolished in 1998) Various administrative state-owned energy companies in the petroleum and nuclear	Decentralization	Respond to strong opposition from administrative state-owned energy companies over

	industries		a unified energy management system.
1998-2008	State Development and Planning Commission (1998-2003) National Development and Reform Commission (2003-)	Decentralization	Administrative reform in 1998 and 2003, aiming to transform China into a regulatory state.
	National Energy Leading Group (2005-)[3]		
	State Electricity Regulatory Commission (2003-)		
2008-present	National Energy Administration[4] National Energy Commission[5] State Electricity Regulatory Commission (2003-)	Centralization	Effectively regulate state-owned energy companies; search for coherent energy policy and ensure energy security.

Note: 1.Governance structure refers to whether a single government body, with the mandate to coordinate energy policy-making among various central agencies, is established. During the period of centralized energy management, there may be another government bodies with the same bureaucratic rank parallel to that of the coordination body.

2. The Ministry of Nuclear Industry was transformed from the Second Ministry of Machine-Building Industry.

3. The National Energy Leading Group headed by Premier Wen Jiabao was created in May 2005 to play the role of lead coordinator across line ministries.

4. The National Energy Administration was transformed from the Energy Bureau of the National Development and Reform Commission (NDRC). Compared to its predecessor, the National Energy Administration enjoys higher bureaucratic rank at the vice-ministerial level. Yet, similar to the energy management system of the previous period, the energy price-setting authority still belongs to the Department of Price at the NDRC.

5. The National Energy Commission was transformed from the National Energy Leading Group in March 2008. While the National Energy Administration, ranked at the vice-ministerial level, is mandated with energy policy coordination, the National Energy Commission under the direct leadership of the State Council is a high-level coordination and discussion government agency that has adequate authority to address disagreements between the National Energy Administration and other stakeholders. See http://news.xinhuanet.com/misc/2008-03/12/content_7769550.htm, accessed on June 9, 2009.

China’s quest for WTO accession in the late 1990s made it imperative that the Chinese government restructure its industrial governance infrastructure to accommodate WTO rules (Yang 2004). The organizational arrangement for the administrative oil companies, which are both government regulators and commercial entities, did not meet the international standard. At the same time, Chinese reformers worried that once the market was opened to international oil majors, NOCs’ operations -- limited by the functional division of labor -- would lose their edge. In light of this, Chinese decision-makers initiated a restructuring program in the oil and petroleum industry along with a sweeping governance reform in 1998.

By expanding their operations into both upstream and downstream businesses, CNPC and Sinopec were transformed into vertically integrated oil companies, terminating the division of labor under the industrial management of a centrally planned system. The restructuring program represented the central government’s attempt to introduce a modern enterprise system into the oil industry, aiming to divest NOCs’ administrative responsibilities and to transform them into market-oriented entities. While the central government intended to improve the efficiency of the oil and petrochemical industry by subordinating its operation to market mechanisms, it was skeptical about free competition among various domestic firms. Therefore, in 1998, the central government decided to partially liberalize the petroleum industry by creating oligopolistic competition among three giant NOCs, with CNPC and Sinopec dominating the onshore oil market and CNOOC monopolizing offshore oil-related activities.

After the State Economic and Trade Commission produced a report proposing to set up two super-large oil and petrochemical conglomerates, the State Council initiated the restructuring program in which the assets of CNPC and Sinopec were reallocated along geographical lines.[6] According to the administration, CNPC would now dominate oil-related operations in northern and western China, and Sinopec would control oil-related activities in southern and eastern China. The border demarcation between the two NOCs does not apply to their marketing activities, including gas station services. With the reorganization, CNPC and Sinopec swapped subordinate companies that were in each other's territories.

The 1998 restructuring was the largest reorganization in China's industrial history, involving the rearrangement of 2.7 million employees and RMB 850 billion. To some extent, the restructuring program was a compromise between two broad bureaucratic goals attached to NOCs: the improvement of market efficiency and the political task of national security. In the past, when the three NOCs had the exclusive right to tap the state's oil reserves, private gas stations had easy access to oil products from both private and state refineries. Yet in 1999 the government issued a document giving CNPC and Sinopec monopoly rights to the wholesale market for refined oil in the name of energy security.[7] Local and private refineries have to turn their products over to the two NOCs and are not allowed to engage in the distribution business. Given that the two NOCs are also players in the downstream market, they have every incentive to make it difficult for their private rivals to access the oil supply.

[6] For details on NOCs' organizational restructuring, see Lin (2007).

[7] "*Guanyu qingli zhengdun xiao lianyouchang he guifan yuanyou chengpinyou liutong zhixu de yijian* (Opinion Concerning Restructuring Small Refineries and Disciplining the Distribution of Crude and Refined Oil)" (General Office of the State Council [1999] No. 38).

One example is that the two state oil firms raise the wholesale prices, which make private gas services less competitive compared to national gas stations. In order to make a profit, more and more private players either sell their businesses to the two NOCs or adopt the model of forming a joint business with them. Although the Ministry of Commerce (MOC) promulgated a new regulation in 2006 which conditionally opens the market of the refined oil business,[8] strict requirements for market entry have little effect on breaking NOCs' dominance.[9] One year later, CNOOC acquired the license for operating in the wholesale market of refined oil products, further reinforcing the dynamic of oligopolistic competition in China's oil industry. Together with NOCs' administrative leverage, such an industrial structure has proved to be the major hurdle to promoting market-oriented reform in China's oil industry.

2. China National Petroleum Corporation after the 1998 Restructuring

CNPC, which evolved out of the Ministry of Petroleum Industry in 1988, is the largest NOC in China. Its total employment was about 1.5 million before the 1998 restructuring and has been maintained at over 1 million.[10] In 1997, it produced about 88 percent of China's total oil and gas outputs, with total assets of RMB 405 billion. CNPC inherited not only assets formerly controlled by the Ministry of Petroleum but also its bureaucratic authority. By 1997, ranked as a ministerial-level administrative state firm, it proposed,

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[8] "*Chengpinyou shichang guanli banfa* (Regulation for Refined Oil Products)" (Ministry of Commerce [2006] No. 23).

[9] For example, the requirements include a refining capacity of above 1 million tons and a minimum annual output of refined oil or diesel of 500,000 tons.

[10] As CNPC continues to downsize its redundant workforce, CNPC's total employment has decreased to 1,078,000 in 2005. See CNPC (2006).

formulated, and executed oil industry policies. At the same time, it was granted the right to conduct onshore upstream oil and gas exploration and production. Because of the geographic concentration of its major oilfields, CNPC dominated the oil market in north and northwest China.[11]

Before the 1998 restructuring, CNPC, as a socialist administrative NOC, was run like a self-sufficient system left over from the central planning period. In addition to its core oil-related businesses, CNPC also established non-core service companies, covering surface engineering, transportation, and social welfare units including hospitals and schools. Such a self-sufficient system, described as "big and comprehensive" (*da er quan*), was duplicated in each subordinate unit, called "small and comprehensive" (*xiao er quan*). Overlapping oil-related technical service units and social welfare burdens deterred CNPC from managing its production activities based on cost and profit efficiency. Thus, one year after the official initiation of the restructuring program in 1998, CNPC carried out internal restructuring to break down the existing self-contained arrangement.[12] Four reform steps were taken in the internal restructuring program: (1) separating core and non-core businesses, called "*fenkai*"; (2) establishing independent financial accounts for each subordinate company, called "*fenli*"; (3) downsizing the workforce, called "*fenliu*"; and (4) splitting social welfare functions, called "*fenli*."[13] Along with implementing these reform strategies, CNPC concentrated profitable assets

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[11] CNPC owns and operates 14 oilfields in China: Daqing Oil Province, Jilin Oil Province, Liaohe Oil Province, Jidong Oil Province, Dagang Oil Province, Huabei Oil Province, Changqing Oil and Gas Province, Yumen Oil Province, Qinghai Oil Province, Tuha Oil Province, Xinjiang Oil Province, Tarim Oil Province, Southwest Oil and Gas Province, and Zhejiang Oil Province.

[12] For details of CNPC's internal restructuring, see Lin (2003).

[13] Shiyou qiye guanli (1999, p. 9).

under core oil-related companies, while unprofitable assets including social welfare institutions were put under non-core companies.[14]

At the same time, the internal restructuring also changed CNPC's management system. In the past, CNPC had adopted the system of multi-tier legal person (*duoji faren*), with each subordinate company having independent legal person status and being held responsible for its own profits and losses. Yet the old arrangement imposed enormous difficulties on CNPC headquarters in coordinating production activities. With independent legal status, each subsidiary had its own commercial goals and production plans without taking into account CNPC's long-term development. The internal reorganization program withdrew subsidiaries' legal person status and transformed them into "cost centers" and "profit centers" of CNPC, facilitating the emergence of a coherent corporate strategy.[15]

In November 1999, CNPC's core businesses, including 480,000 employees, were transferred to the newly-established PetroChina Company Limited (popularly known as PetroChina), a joint stock company with limited liability. Then, in order to enhance the competitiveness of their core businesses, CNPC and PetroChina signed a non-competition agreement. In 2000, the initial public offering of PetroChina in the New York and Hong Kong stock exchanges traded 10 percent of the company's total shares and collected a total of US$2.89 billion. The remaining 90 percent of PetroChina's equity

[14] Core companies mainly refer to oil and gas enterprises, refining and petrochemical enterprises, and marketing enterprises. Non-core companies mainly refer to service enterprises, supporting enterprises, diversified enterprises, and social institutions. For detailed description of each category, see Zhang (Jin Zhang 2005, pp. 111-114).

[15] The new organizational relationship between CNPC and its subordinate companies can be modeled as the dynamic among three poles: the CNPC headquarters as the decision maker, oilfields and refineries as cost centers, and marketing enterprises as profit centers.

were controlled by CNPC.

Since 2000, PetroChina's businesses have experienced strong growth and achieved impressive profits, propelling CNPC among the top on the list of most valuable firms in the world market. For instance, in 2007, PetroChina raised $8.9 billion by selling 2.18 percent of its expanded share capital in the Shanghai Stock Exchange and became the largest listed company by market value. Meanwhile, CNPC retained non-core businesses that had suffered chronic financial losses due to low efficiency and overlapping non-commercial obligations. This financial difficulty can be best illustrated by a set of numbers. In 1999, a total number of 4646 non-core diversified enterprises (*duozhong jingying qiye*), with average total assets of around RMB 10.3 million, fell into a debt that amounted to RMB 29.32 billion (Chen and Liu, 2001). In tandem with the flotation of PetroChina, the non-core, unlisted part of CNPC went through a series of internal mergers and restructuring, aiming to streamline organizational management and to improve productivity.

From the preceding overview, it is clear that the 1998 restructuring program and ensuing internal reorganization have transformed CNPC into one of the most valuable firms not only by domestic standards but also by global measures. It controls China's largest listed oil company and reaps tremendous profits from oil-related activities. On the surface, every financial indicator demonstrates the efficient operation of the reformed CNPC. Yet when delving into firm-level data and analysis, it becomes immediately clear that the reform and associated organizational rearrangement in the late 1990s did not fundamentally alter CNPC's non-market behavior. As will be shown in the next section, its bureaucratic origins and predominant market position granted by the government continue to protect CNPC's irresponsible business decisions from market discipline. As a result, state funding and market dominance created by political forces still retain important roles in CNPC's lucrative business, despite the restructuring program.

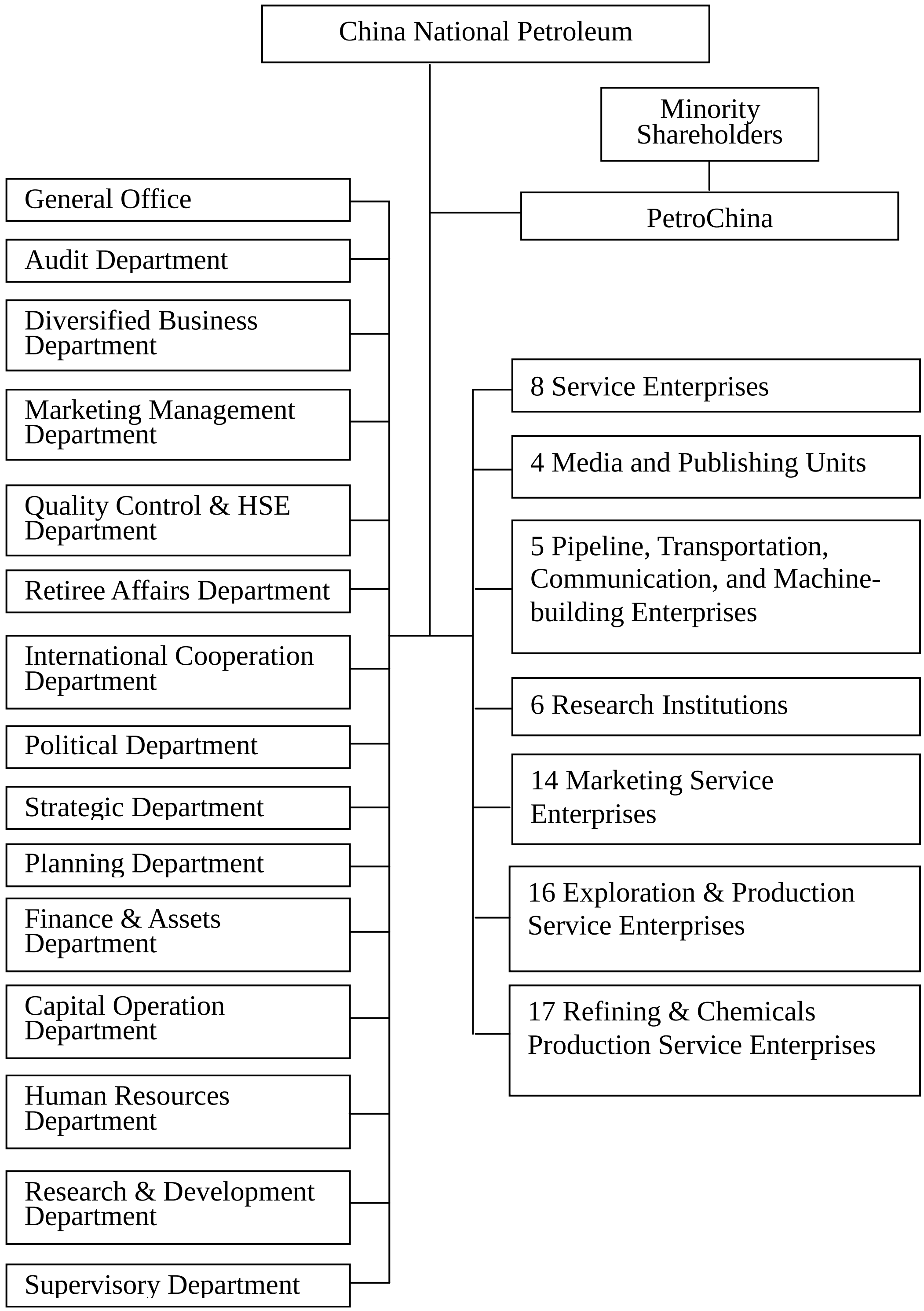

Figure 4.1 CNPC’s Organizational Structure

II. MARKET REFORM AND MANAGERIAL BEHAVIOR

Given pressing energy shortages, Chinese reformers decisively pursued the programs of the 1998 restructuring and corporatization of NOCs in hopes of transforming them into efficient profit maximizers. To what extent did ownership realignment and organizational restructuring lead to a change in firm-level behavior? Corporatization and the associated adjustments in the ownership structure have successfully turned CNPC into a profit-driven business organization. The establishment of CNPC's commercial motive did not in and of itself translate into the market-conforming behavior in a partially liberalized oil market, however. In a market economy, prices are determined by demand and supply. Nonetheless, the state control over prices of finished oil products hindered the emergence of reliable market signals that would determine CNPC's outputs. The conditions of the compensation for policy-induced losses were subject annually to negotiation between central regulators and the politically-ranked CNPC, which exposed the firm's operation to political struggle. Furthermore, CNPC forced the government to compromise on the issue of price-setting by using its managers who had administrative ranks higher than that of the involved state agencies in the negotiation process. In other words, without simultaneously terminating CNPC's bureaucratic ties, corporatization gives CNPC an incentive to manipulate bureaucratic infighting to maximize its economic gains.

1. The Creation of Commercial Interests and Non-Market Behavior

Since restructuring and corporatization, there has been a growing tendency for CNPC to behave in ways consistent with its commercial interests despite being a state firm with a national mandate. While what Kornai (1992) labeled "soft budget constraint" was abolished by the CNPC corporatization agenda, state subsidies have persisted in the form of compensation for policy-induced liability. The commercially-driven CNPC constantly exploited this compensation to cover losses resulting from mismanagement. Consequently, CNPC continues to make irresponsible economic decisions as it did under the command economy.

In tandem with the organizational realignment, CNPC senior and middle managers in the core businesses began to enter performance contracts (*jixiao hetong*) with various specified financial targets such as return on capital and net income. According to this new incentive system, CNPC managers who achieve contracted targets are awarded bonuses and stock appreciation rights. At the same time, they are responsible for their businesses' decisions and conduct, meaning that the failure to meet targets will incur penalties including wage cuts and other forms of financial penalties. In other words, the operation of CNPC subsidiaries is now under the hard budget constraint without state bailouts. All of the preceding reform measures, directly and indirectly, contribute to CNPC's independent commercial motives.

Though commercial interests have become a driving force behind CNPC's behavior, the state has not relinquished its grip on the oil industry. While central reformers have achieved their goals of hardening budgets and introducing profit motives, other parts of the bureaucracy have ensured that NOCs are retained as vital policy instruments for the sake of energy security. Like CNPC, Sinopec has also experienced similar reform processes that turned its operation into profit-driven transactions. However, in the absence of a proper regulatory scheme capable of governing NOCs with bureaucratic origins, strong commercial motivation combined with the legacy of the central planning system finally led to destructive and chaotic competition between CNPC and Sinopec. The contest between the two oil majors for gas station businesses nicely illustrates this point.

Due to the specific legacies of both firms' genesis under the planned economy, CNPC only occupied a small fraction of the domestic downstream market when it began to function as an integrated oil company. For instance, in 2000, Sinopec controlled over two-thirds of the refinery businesses and had a dominating position in sales for most of the refined petroleum products, supplying 51.7 percent of gasoline, 55.7 percent of diesel fuel, and 57.3 percent of kerosene (Sinopec 2006). Given that it takes time to develop refinery capacity, CNPC decided to expand its gas station businesses as the first step to compensate for its disadvantages vis-à-vis Sinopec.

A common practice is to provide similar gas station services in a place where Sinopec had already built up its own marketing network by either opening a new gas station or acquiring local private stations. CNPC concentrated its effort in the populous eastern and southern coastal areas which make up Sinopec's territory as prescribed by the 1998 restructuring program.[16] In December 2000, CNPC and Sinopec competed against each other in bidding for four gas stations belonging to the Shenzhen Nanyou Group; the

[16] CNPC spent RMB 5 billion and RMB 6 billion in 2000 and 2001, respectively, in expanding its marketing network. In response, Sinopec injected RMB 35 billion to consolidate its leading position in gas station services.

gas stations had an estimated value of RMB 89.9 million. During the course of the 50-minute auction, more than 100 bids were received from the two oil giants, and Sinopec outbid CNPC in buying the gas stations with an offer of RMB 290.5 million. From a cost-effectiveness perspective, the deal was irrational in that Sinopec could not make any profit within 10 years. Yet it was a symbolic deal in many ways. Shenzhen was the manufacturing hub for the Chinese economy and Sinopec had controlled the majority of gas stations in the area. CNPC's growing presence in Guangdong province had threatened Sinopec's privilege in the Southern coastal area. In the hope of deterring CNPC's piecemeal expansion, Sinopec was determined to get the deal at all costs.

The Shenzhen case was by no means a rare phenomenon. In March 2002, the oligopolistic competition for gas stations along two freeways in Henan province finally resulted in violent conflict. Sinopec arranged for a series of attacks on the construction sites of gas stations run jointly by CNPC and the Bureau of Freeway Construction and Management in Shengchi county. Aiming to take over CNPC's projects, Sinopec further exerted political pressure on the Henan provincial government in the hope of ceasing the joint ventures.[17] While claiming that the contract of the joint ventures was commercial in nature, CNPC also maneuvered to ensure the implementation of the joint projects. Meanwhile, Sinopec made a breakthrough in another part of Henan. Despite being in violation of the central restructuring agenda, the Luoyang city government issued a document stating that Sinopec has the exclusive distribution right in its jurisdiction.

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[17] "Shihua Jutuo Henan Huopin 3.22 Baoli Shijian Zhengdong Gaoceng" [Oil Giants Fight for Gas Stations in Henan: Violent Conflicts on March 22 Shock High-level Officials], *Nanfang Zhoumo* [*Nanfang Weekend*], http://business.sohu.com/33/08/article200490833.shtml, accessed June 17, 2009.

As illustrated by the case of the turf wars over gas stations, organizational restructuring and ownership realignment did not lead to NOCs' market-oriented attitude. Theoretically, after ownership restructuring, NOCs' subsidiaries with inefficient operations are under the threat of closure. Practically, NOCs' bureaucratic ties as the instrument of state control over the firms' political functions have provided political shields for the subsidiaries' non-market behavior. Both CNPC and Sinopec exploited their status as ministry-level SOEs to bully and circumvent provincial and lower-level regulators seeking to ensure proper market competition and transparency. Moreover, state subsidies for enforcing cheap energy prices readily made up the costs of the firms' blind expansion that could not be covered by their subsequent operations.

The State Development Planning Commission (1998-2003; the predecessor of the National Development and Reform Commission) has constantly kept the domestic prices lagging far behind the rising international energy prices. The rationale behind this low price policy is that NOCs' losses in downstream activities could be offset by excessive profits from their exclusive right to upstream production. Yet CNPC and Sinopec claim that their domestic refineries, reliant on imported crude oil, operate at a loss under this price scheme. Such cost, as they contend, comes from "policy burden" (*zhengcexin fudan*) rather than any mismanagement in their operations. Thus, both NOCs regularly request government subsidies to make up their refining losses. Take Sinopec, China's largest oil refiner, as an example. In general, about 70 percent of Sinopec's crude oil is imported, making Sinopec especially vulnerable to the price distortion. In 2005 and 2006, the firm received state subsidies valued at RMB 10 billion and 5 billion respectively. In the first half of 2008, Sinopec suffered its first net income drop due to the excessive loss caused by its refining businesses. The amount of RMB 34 billion was given to cover 73 percent of its refining loss, which kept Sinopec's operation profitable.[18]

Nevertheless, when subsidies are not able to catch up with spiraling international energy prices, they either intentionally lower refining capacity or export oil products for higher return. Facing the artificial oil shortage caused by NOCs' manipulation, the National Development and Reform Commission (NDRC, the successor of the State Development Planning Commission) has been forced to raise the benchmark retail price on many occasions. The manipulation of the oil product shortage has been a common strategy for NOCs to counter price distortion caused by the state policy.[19]

Corporatization and ownership restructuring alone did not bring an end to NOCs' non-market behavior. Firms abused their political leverage to protect overexpansion and adjusted their production capacity in line with administrative rather than market signals. Nevertheless, and despite many lingering problems and political interference, the reforms of the late 1990s, succeeded in making commercial interests a driving force behind NOCs' operations for the first time. What motivated China's NOCs to become more commercially-oriented organizations? The answer, as I will elaborate in the next section, lies in the transformation of managerial incentive patterns.

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[18] See "Zhongshihua Lianyou Kuisun Tanyuan" [The Origins of Sinopec's Refining Losses], *21 Shiji Jingji Baodao* [*21st Century Business Herald*], http://www.21cbh.com/HTML/2008/8/26/HTML_JWO2HL8QUE71.html, accessed June 17, 2009.

[19] See, for example, "*Chan 'qi' di*, '*qibuzu*'" [Natural Gas-producing Areas Suffered Natural Gas Shortage], http://news.xinhuanet.com/focus/2005-04/03/content_2758416.htm, accessed June 17, 2009.

2. CNPC's Post-corporatization Performance and the Dual Roles of CNPC Managers

The previous sections have referred extensively to corporatized NOCs' commercial interests and how their non-market strategies serve these interests. It is worth recapitulating that NOCs seek to fulfill their commercial interests through tactics that either expand their market shares or strengthen their profitability, whichever brings NOCs more rent gains created by the government-enforced monopoly in the oil market. In order for NOCs to carry out important policy functions, the Chinese government administratively limits the entry of private firms that can compete with NOCs. Yet cases in the foregoing analysis also reveal that NOCs' political and economic functions are hardly compatible. NOCs' non-market behavior cannot be easily eliminated from the corporate strategy as long as the state retains its control over the firms' operations for reasons of national welfare. Meanwhile, NOCs are by no means passive actors that carry out official decisions and policies faithfully. Rather, NOCs' opportunism is protected by their political clout. Given all of these negative effects on firms' economic efficiency, how exactly has the corporatized CNPC performed?

According to various financial indicators and official evaluations, CNPC's post-corporatization performance has been impressive in comparison to other SOEs in China. PetroChina, as CNPC's largest listed subsidiary, saw dramatic growth in profit a year after was created in 1999. Its net profit in 2000 was about RMB 55.2 billion, an increase of 104.6 percent compared to 1999 (PetroChina 2001). The financial performance of CNPC has improved at an incredible rate. Since the State-owned Assets Supervision and

Administration Commission of the State Council (SASAC) was created in 2003 as the main agency to monitor state firms' activities, CNPC has been the top SOE in terms of net profit and windfall tax submitted to the central government. Its ranking in terms of revenue on the Fortune 500 list has ascended rapidly in a short timeframe, from 73 in 2004 to 25 in 2008.

Table 4.2 CNPC's Financial and Operational Indicators, 2001-2008

		2001	2002	2003	2004	2005	2006	2007	2008
Revenue (RMB billion yuan)		343.5	379.2	475.29	570.68	693.70	868.48	1000.68	1273.00
Net profit (RMB billion yuan)		15.09	23.57	37.02	72.48	106.11	129.85	149.64	91.65
Crude oil production (million tons)	Domestic	106.556	107.464	109.544	104.551	105.95	106.63	107.72	108.25
	Overseas	8.29	10.11	12.88	16.42	20.02	28.07	29.92	30.50
Natural gas production (billion cubic meters)	Domestic	20.58	22.53	24.88	28.66	36.67	44.21	54.25	61.75
	Overseas	0.58	0.78	1.39	2.59	2.91	3.80	3.51	4.66

Source: CNPC Annual Reports 2003, 2005, 2008

Careful scrutiny reveals that CNPC's remarkable success has mainly resulted from its government-enforced monopoly rather than improvements in productivity and efficiency. Because domestic oil prices are set by the state, policymakers subsidize CNPC when its operation costs cannot be covered. In order to obtain this subsidy, politically powerful CNPC constantly overstates its policy-induced losses.[20] With an eye on the political benefits of a monopolized oil market, policymakers more often than not tolerate CNPC's rent-seeking behavior and grant huge subsidies to "secure a stable supply of crude oil and refined oil products."[21] In the year 2008 alone, CNPC received a subsidy amounting to about RMB 15.7 billion. Policy responsibility provides CNPC with a ready excuse to cover up its mismanagement. Sometimes CNPC even ascribes a decrease in profit to the heavy burden incurred by the windfall profit tax. Such manipulation has been common in China for decades, but new incentives induce managers to seek subsidies in order to augment profits rather than only to stem losses.

Internal performance monitoring is a key component of CNPC's efforts to establish the "modern enterprise system" proposed by central reformers. As a pilot company in the state sector, CNPC signs performance contracts with middle and senior managers in both the core listed PetroChina and non-core unlisted subsidiaries, stating primary economic targets. Presented with a flexible income scale including salary, bonuses, and stock appreciation rights, PetroChina managers are provided with incentives to comply with various assigned targets. Since 2008, CNPC has imposed a uniform

[20] See, for example, http://finance.people.com.cn/GB/7733905.html, accessed October 30, 2008.
[21] See the speech given by Li Rongrong, the head of the State-owned Assets Supervision and Administration Commission of the State Council, at an industrial meeting in Sichuan, http://finance.people.com.cn/GB/1037/4238443.html, accessed June 17, 2009.

system of performance evaluation on both PetroChina and non-core unlisted subsidiaries. Under this framework, managerial performance is monitored through a number of indicators, including enhancement of value of the company's assets, quality management and safety, and sustainability.[22]

Nonetheless, the effectiveness of such economic incentives must be assessed in the broader context of China's cadre system. As the appointment and removal of CNPC executives is still dominated by the CCP, managerial behavior change will not happen unless it impacts executives' career promotion. Although CNPC's production activities had moved away from the centrally planned system, a Party Group (*dangzu*) was established by the Central Organization Department of the CCP (COD) to administer personnel management. Generally speaking, the general manager and the first deputy general manager hold concurrent posts as the secretary and deputy secretary of the Party Group, respectively. The other members of the Party Group are composed of the rest of CNPC's top management, including the chief of the Department of Party Discipline and Inspection. While the COD remains the main Party agency responsible for the appointment of CNPC's top management, the SASAC has played an increasingly important role in the nomination and recommendation of the list after its creation in 2003.

The Party's influence over personnel selection and appointments extends to every level of management in each of CNPC's departments. For instance, in 2005, the personnel decisions of CNPC's Party Group included reshuffling 29 leadership teams

[22] See "Zhongshiyou Tongyi Shangshi yu Feishangshi Qiye Jixiao Kaohe" [CNPC Unifies the Performance Appraisal of Listed and Non-listed Subsidiaries], *Shanghai Zhengquanbao* [*Shnaghai Securities News*], http://ccnews.people.com.cn/GB/87336/6808427.html, accessed July 6, 2009.

(*lingdao banzi*) and appointing 174 senior managers (CNPC 2006, pp. 255-256). Such a personnel system exhibits characteristics of a political organization, rather than a typical industrial organization. CNPC's managerial positions are controlled by the *nomenklatura* system and are simultaneously assigned administrative ranks in addition to their posts in the company. For example, among CNPC's personnel reshuffle in 2005, 49 managers were ranked at the bureau-level.

As Waterbury (1993) indicates, managers in state firms are simultaneously political and economic actors, with the subordination of the latter to the former. Moving up the political ladder is still the priority for CNPC senior management who seek to increase their influence and rank as political figures. Nevertheless, managers' political and economic interests are not clashing with each other as they did during most of the uncorporatized period. Instead, their economic achievement has become an indispensable asset competing for political advancement since CNPC was corporatized as a last resort to impose market discipline. Consequently, CNPC managers tilt toward their economic roles not for pecuniary rewards but for better political prospects.

This is better understood from the career paths of the three CNPC general managers during the first decade of the postcorporatization era– Ma Fucai, Chen Geng, and Jiang Jiemin. Despite their concurrent party posts, each of them defends CNPC against state policies that have negative implications for the firm's financial record. Yet none of them suffer from career setbacks. For example, Ma Fucai's political capital accumulated quickly as he determined to push through the 1998 restructuring program and the corporatization of CNPC. In 1998, he was selected by the COD to be the first

General Manager of corporatized CNPC and the Chairman of the Board of Directors of PetroChina. Since then, Ma Fucai had gradually shifted his role from a politician that assisted central reformers in restructuring the oil industry to a leader of a corporate entity. As the ministerial-level head of CNPC, Mr. Ma was also given a prominent position in the CCP – the Alternate Member of the Sixteenth CCP Central Committee. Yet, in a rare interview, Mr. Ma kept stressing the economic role of CNPC as a company throughout the conversation and required the media to dilute possible political contentions regarding CNPC's operation.[23] The image that he wanted to deliver to the public largely explained CNPC's controversial corporate strategy when competing with Sinopec.

CNPC, under Mr. Ma's leadership, had constantly challenged the central energy policies mentioned earlier without incurring any political setbacks. This is because he actually accumulated more political assets for being an adherent of the necessary reform. Zhu Rongji, the then premier and "economic czar," forcefully pushed the reform agenda in the oil industry because he thought the national interests in energy security could be best served there.[24] The belief that China, in their search for energy security, should and could rely on corporatized NOCs with market discipline is actually widely held in the policy circle. Therefore, Ma's emphasis on his economic identity built the foundation of CNPC's corporate role, which is a desired goal under the reform guideline of "separation of enterprises from the government." In 2004, Ma Fucai was forced to resign due to a deadly gas blowout accident in Chongqing Municipality, which claimed the lives of 243

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[23] See "Sanshinian Bugai de Shiyou Qingjie: Zhongguo Shiyou Jutou Ma Fucai" [Thirty Years' Experiences in the Petroleum Industry: CNPC's Head- Ma Fucai], *Jinji Cankaobao* [Economic Information Daily], http://news.xinhuanet.com/fortune/2004-02/09/content_1305381.htm, accessed July 6, 2009.
[24] See Guoqi Zhenghan Bianweihui (2001).

people from toxic fumes at the end of 2003. Although Ma's resignation was interpreted as an issue of political responsibility, CNPC's extraordinary economic achievement during his tenure as General Manager earned him a higher position in the bureaucratic hierarchy – as the Vice Director of the Office of the National Energy Leading Group led by Premier Wen Jiabao.

Similar situations occur at the middle management level. For example, Su Shulin, General Manager of China's top refiner Sinopec and the Chairman of the Board of Directors of Sinopec Corp since 2007, had been the Deputy General Manager of CNPC from 2000 to 2006. His stellar performance in CNPC earned him the top post of Sinopec when he was only 45. Importantly, CNPC under these several executives routinely resisted government regulation of its investment activities in both domestic and overseas markets. Why is managerial challenge to state regulations not penalized?

It should first be noted that similar to other policy areas, the regulatory framework for the oil industry in general and NOCs in particular is extremely fragmented. In general, there are about 10 government bodies involved in oil-related regulation: the NDRC; the National Energy Commission (the successor of the National Energy Leading Group under the State Council from 2005-2008); the National Energy Administration (the successor of the Energy Bureau of the NDRC but with higher administrative rank); the Ministry of Commerce (MOC); the SASAC; the Ministry of Land and Resources; the Ministry of Finance; the Ministry of Construction; the State Environmental Protection Administration; the Administration of Work Safety; and the Administration of Quality Supervision, Inspection, and Quarantine.

Making the regulatory scheme even more complicated and segmented is that the NDRC regulatory power is further diffused to its subordinate units such as the Department of Price, which is in charge of price-setting for refined oil products. Other central regulators come into play, depending on what kind of business CNPC engages in. For example, when CNPC's operation is involved in cross-border projects, the State Administration of Foreign Exchange (SAFE) has an important role in the process of "review and approval" in addition to the MOC, the NDRC, and SASAC. While all of the preceding agencies exert different degrees of leverage on regulating CNPC's projects, with the NDRC and the SASAC as lead organs, there was no effective institutional mechanism coordinating their governance before the National Energy Leading Group was created in 2005. Even when the National Energy Leading Group, under the leadership of premier Wen Jiabao, was established, its effect has been debated due to its informality in the institutional setting.

Intra-bureaucratic conflicts and protracted bargaining at best delay regulation and at worst sap the state of its ability to govern the firms' conduct at all. Two institutional dynamics can explain this tendency – institutional legacies of the planned economy and the above-mentioned cadre system. CNPC as the organizational successor of the Ministry of Petroleum Industry monopolizes oil-related technical knowledge and a huge amount of manpower. Though central reformers have made tremendous efforts to reinforce energy governance, CNPC still maintains superior capacities vis-à-vis regulators, making effective monitoring almost impossible. Regulatory authorities even relied on CNPC's expertise in oil-related supervision. It was not rare to find CNPC involved in setting national energy policy in the early years of post-corporatization.

Also, since CNPC senior managers all retained state bureaucratic ranks, their relations with regulators were not simply interactions between officials and businessmen. Rather, they were bargaining between two bureaucrats. On some important issues such as price-setting, during process of negotiation, CNPC involved its executives with administrative ranks higher than the ranks of officials in the NDRC's Department of Price. The other strategy CNPC employed was to lobby high-level leaders within and outside the NDRC to discourage regulation from the Department of Price. The unequal position often times forced the Department of Price to compromise its policies.

In conclusion, China's fragmented bureaucratic apparatus is ineffective at monitoring the oil industry. In fact, NOCs manipulate information and power asymmetries to their advantage to ensure political and regulatory support for their profit-maximizing and rent-seeking behavior. Without an effective monitoring mechanism in the domestic market, CNPC has strong incentives to circumvent governmental supervision while their inefficient conducts are largely protected. The incorporation of CNPC managers into the bureaucratic hierarchy gives them political leverage over state regulatory bodies plagued by departmentalism.

III. The Overseas Expansion of China National Petroleum Corporation

Many observers, especially those in Western countries, associate the "Going Out" strategy with China's high-profile energy diplomacy.[25] From their perspective, the "Going Out" strategy represents the Chinese state's effort to engage in a world-wide hunt for resources. Certainly, CNPC made oil-related deals for the Chinese government during the 1990s when its actual role was as an administrative company. Yet, since its corporatization, it is a firm that pursues its own commercial interests, often at the expense of the government's political interests. It is evident that in the transition of CNPC from an administrative to a corporatized SOE, the CNPC's role in making cross-border transactions is simultaneously transformed from an arm of the Chinese government to an independent deal-maker. Contrary to the conventional wisdom, CNPC's global outreach under the framework of the "Going Out" strategy reflects more of the firm's pursuit of commercial gains and less of the state's quest for energy security.

At the same time, CNPC's "going out" bears fruit in that it created a group of foreign stakeholders independent of domestic political and vested interests. Foreign investors and Chinese regulators shared a common interest in transparent and effective management of CNPC's assets. Overseas, foreign stakeholders were even able to serve as monitoring agents over CNPC's operations.

1. The "Going Out" Strategy and the Evolution of Overseas Projects by China National Petroleum Corporation

State support for CNPC's overseas expansion has gone through three stages: 1) initial

[25] See, for example, Friedberg (2006).

exploration from 1993 to 1997; 2) the pursuit of profitability from 1998 to 2002; and 3) expansion of the scale of its operations between 2003 and 2010 (Zhou 2004). When China became a net importer of oil in 1993, central leaders worried about obtaining reliable access to oil, given increasing consumption in China's domestic market. At that time, only CNPC and CNOOC were upstream operators, with the former being much larger than the latter in terms of operational scale.[26] As a late comer to the global oil market, CNPC relied heavily on government subsidies. As major oil companies in Western developed countries dominated the global oil market, CNPC began its international expansion from relatively peripheral areas that were outside the established territory of these Western oil majors.

For example, CNPC acquired the Banya Block in Thailand as its first cross-border oil-producing asset in 1993. Over the next two years, CNPC established its presence in Latin America with the Talara Oilfield in Peru, which became CNPC's first overseas exploration project. In 1995, the Sudanese President Omar al Bashir visited China and invited Chinese companies to develop the Sudanese petroleum industry jointly. With then President Jiang Zemin's delegation, CNPC undertook its first project, Block 6, and continues to play a leading role as agent of the Chinese central government in the Sudanese energy sector. Yet, due to the nature of the Sudanese regime, CNPC's long-term role in and relationship with Sudan later proved to be troublesome when it sought listing on overseas stock markets.

Thus, before 1998, CNPC's overseas ventures were mainly dictated by the state's

[26] Thus, while it still functioned in an organizational mixture as both a government organ and a for-profit entity, CNPC had become the main agent searching for offshore oil-related projects.

interest in acquiring secure access to strategic natural resources. Political, not economic, logic dominated CNPC's activities in the international market. As such, the central government poured a large amount of capital into supporting CNPC's global search for oil, which usually concentrated in oilfields that were either not attractive to Western oil companies. Without market incentives, the investment behavior of the administrative CNPC was grossly oblivious to considerations of profit and loss. For national security reasons, CNPC aimed at making a deal rather than making a profit. A CNPC manager's remark is illustrative: "No matter how small our first step was, it represented that we Chinese broke up the world oil monopoly controlled by a few Western oil companies." Such politicization of its activities often hindered CNPC's bottom line, however.

Its first project in Kazakhstan was a good example. Two months after the Chinese-Kazakh Agreement on Cooperation in the Oil and Gas in September 1997, CNPC rushed into a pipeline development project with an eye on oil coming from Russia and Central Asia. CNPC purchased 60 percent of the shares of the Aktobemunaigaz firm of Kazakhstan for US$325 million. Yet production capacity was much lower than CNPC had expected, and the cost was barely covered by selling crude oil generated from the project.

During the second stage of CNPC's overseas expansion from 1998 to 2002, its global presence expanded at a remarkable pace as the "Going Out" strategy became the overarching policy guidance for the internationalization of Chinese firms. While the concern for national energy security was still an important driving force behind the CNPC's hunt for foreign resources, the firm's burgeoning commercial interests gradually came into play as a result of changes in the domestic industrial structure and ensuing corporatization. That is, for the sake of security, the state, mainly through the Export-Import Bank of China and China Development Bank, still provided CNPC with cheap capital to boost its overseas presence. Yet the means to expand the oil and gas portfolio outside China was now largely decided by the firm's business strategies. The motivation of commercial interests in CNPC's overseas expansion was evident in the discord among three NOCs over foreign projects.

Like its domestic rivals, Sinopec and CNOOC, CNPC accelerated its "going out" in an attempt to compensate for declining outputs of its domestic oilfields. NOCs usually fought each other over overseas market share at the expense of state funding. As a CNPC overseas project manager indirectly admitted, "Abundant funding sources enable us to acquire businesses with more flexibility." At the same time, China's regulatory framework was going through a transition period between two rounds of administrative restructuring in 1998 and 2003. No single government agency was held responsible for the ex-post review of the performance of CNPC's foreign operations. Weak administrative monitoring and a lack of institutional coordination caused the central government to worry that its foreign policy objectives would be undermined.

While Sudan continued to be the top destination of CNPC's outbound investments, CNPC began to search for possible acquisitions in Central Asian countries such as Azerbaijan and Turkmenistan while maintaining its ongoing deals with Kazakhstan.[27] CNPC also entered the Indonesian market by purchasing shares of Devon Energy in 2002.

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[27] For the details of the evolution of CNPC's projects in Kazakhstan, see Blank (2005).

Yet CNPC's expansion encountered consistent difficulties in obtaining projects in Russia. This was partly because CNPC's corporate strategy, focused on equity investment, ran against Russian energy policy, which aimed to retain control over domestic energy resources.[28]

Since 2003, CNPC's overseas expansion has entered a more mature period while being bolstered by the state's high-profile energy diplomacy. An urgent need for all aspects of energy security keeps Chinese leaders travelling to resource-rich countries. For instance, in 2003, President Hu Jintao, together with CNPC's top management, made official visits to Russia and Kazakhstan in May and June, respectively, reaching energy cooperation agreements with the two countries' governments. By the end of 2006, CNPC extended its operations to 22 countries and operated 5118 kilometers of overseas oil and gas pipeline, with the capacity to transport 25 million metric tons of crude oil per year. In 2006, CNPC overseas projects produced 35.82 million tons of oil and 4.02 billion cubic meters of natural gas, of which CNPC's shares were 20.02 million metric tons and 2.9 billion cubic meters respectively (CNPC 2007, p. 179).

[28] CNPC's failed bid for Slavneft in December 2002 was a good example.

Table 4.3: CNPC's Overseas Projects, 1993-2009

Country	Projects
Africa	
Algeria	• Adrar Upstream and Downstream Integrated Project • Block 102a/112 • Block 350 • Block 438b
Chad	• Block H • N'Djamena Refinery
Equatorial Guinea	• Block M
Libya	• Block 17-4
Mauritania	• Block 12 • Block 20 • Block Ta13 & Ta21
Niger	• Agadem Upstream and Downstream Integrated Project • Block Bilma and Block Tenere • Zinder Refinery
Nigeria	• Blocks: OPL 298, 471, 721, and 732
Sudan	• Block 1/2/4 • Block3/7 • Block 6 • Block15 • Khartoum Refinery • Pipeline to Sudan Port • Polypropylene • Retail Services
Tunisia	• Kufpec-NK Block • SLK Oilfield
Middle East	
Iran	• MIS Oilfield • Block 3
Iraq	• Al-Ahdab Oilfield • Rumaila Oilfield
Oman	• Block 5
Syria	• Gbeibe Oilfield • Al-Furat Project
America	

Canada	• 8 oil and 9 gas blocks, operate 3 of them
Ecuador	• Amazo Project • Andes Project
Peru	• Block 1-AB/8 • Block 6/7 • Block 111/113
Venezuela	• Caracoles and Intercampo Oilfield • Orimulsion Project • Orinoco Heavy Oil Belt • Zumano Oilfield
Central Asia-Russia	
Azerbaijan	• Gobustan Oilfield • K&K Oilfield
Kazakhstan	• ADM Project • Aktobe Munai Gas • KAM Project • North Buzachi Oilfield • Petro Kazakhstan Project • Sino-Kazakh Oil Pipeline • Sub-salt Kenijak Reservoir • Zhanazhol Oilfield
Russia	• Oil Pipeline • Gas Pipeline
Turkmenistan	• Amu Darya Natural Gas Project • Gumda Oilfield
Uzbekistan	• Aral Sea Block • Mingbulk Oilfield Project
Asia-Pacific	
Indonesia	• 7 oil and gas blocks, operates 6 of them
Mongolia	• Block 19 • Block 21 • Block 22
Myanmar	• Bagan Block • IOR-4 Block • Three Deep-Water Blocks: AD-1, AD-6, and AD-8
Thailand	• Banya Development Block • L21/43 Risk Exploration Block

Sources: *CNPC Annual Reports* (various years).

2. The State-SOE Interactions in CNPC's "Going Out"

As Downs notes, "when it comes to deciding which overseas assets to acquire, the NOCs are in the driver's seat and the Chinese government is often just along for the ride with little idea of the final destination" (Downs 2007, p. 53). After CNPC was encouraged to venture abroad to advance national security objectives, central reformers introduced the corporatization reform agenda that changed the firm's incentive structure without weakening its political clout. This institutional context allowed CNPC, a beneficiary of China's partial reform, to use its political position to engage in rent-seeking behavior at home while it also sought to capture market share abroad. Interestingly, in the process of securing its market share, CNPC has adapted itself to the demands of the market abroad and acted as a market player even when it went against the wishes of the more conservative branches of the Party-state. From three perspectives, I show that CNPC's corporate interests increasingly triumph over national interests in transnationalizing its businesses: the imbalance of manpower and resources between CNPC and central regulators, the selection of venture destinations, and the interactions with China's other NOCs.

Given CNPC's bureaucratic origins as a ministry-level organization, there is insufficient regulatory capacity to govern the firm's global expansion. Official policy instead becomes an instrument to serve corporate interests. Compared to CNPC, which has research institutions that specialize in the firm's global development strategy, such as the Institute of Overseas Investment at the CNPC Research Academy of Economics and Technology, central decision-makers are facilitated by their departmental research agencies that focus on China's overseas ventures in general, such as the Research Department of Foreign Economic Relations at the Development Research Center of the State Council. Although the National Energy Administration (the successor of the Energy Bureau of the NDRC, 2003-2009) acts as the lead agency to chart the course of China's global hunt for energy, CNPC and its research institutions still dominate the agenda-setting because of their advantages in manpower and industry-specific knowledge.

Zhang Guobao, the head of the National Energy Administration and the chief vice chairman of the NDRC, admits that despite the recent expansion of the *bianzhi* personnel system, its energy-governing capacity of about one hundred staff is like "little ponies pulling big cars" when facing gigantic energy SOEs which have about one million employees.[29] Together with its research institutions that had once been official think tanks, CNPC accumulated abundant experience in dealing with foreign projects when it was still an important part of China's bureaucracy. In light of this, central regulators constantly request policy proposals from CNPC or delegate policy research projects to CNPC's research institutions. As a result, similar to the domestic regulation of the petroleum industry, central regulatory agencies relied on NOCs' input - especially those from CNPC - to formulate policy guidance for the transnationalization of NOCs.

The domination of corporate interests in the process of transnationalizing CNPC's transactions is also reflected in the tendency for CNPC to become more selective on foreign deals, though the NDRC has issued policy recommendations concerning project

[29] See "Guojia Nengyuanju Juzhang Zhang Guobao Xiangjie Zhongguo Nengyuan Fazhan Zhi Lu" [The Governor of the National Energy Administration Zhang Guobao Detailed China's Energy Development], http://big5.lrn.cn/gate/big5/www.mlr.gov.cn/xwdt/bmdt/201003/t20100303_138522.htm, accessed March 14, 2010.

destinations that accommodate long-term security interests. Three Catalogues of Overseas Investment Guidance were issued in 2004, 2005, and 2007, in which a number of countries were identified as recommended destinations for oil-related capital outflows.[30] By encouraging firms to invest in specific countries and regions, policymakers in the NDRC intended to promote geographic diversification of the energy supply. Nonetheless, CNPC's executives will not follow the state's suggestions if there is insufficient profit to justify the investment decisions. After all, the NDRC is not even the only political boss that CNPC has to satisfy. As one CNPC manager pointed out, "if we operate a loss-making project in one of the suggested countries, we will still face troubles from the SASAC."

From the perspective of CNPC, transnationalizing its operations is not only a response to the official promotion of venturing abroad but also a natural development of the commercially-driven corporate strategy. China's NOCs have been plagued by low oil reserve-to-production ratios (R/P ratio). Given that China's domestic oilfields have passed their peak production levels,[31] the issue of low R/P ratio is especially vital to CNPC, which makes most of its profits from upstream activities (Xu 2007). Thus, CNPC's project initiatives were to continue to seek venture destinations abroad that would enhance its R/P ratio; these initiatives later became part of the official plan for global outreach during the above-mentioned process of policy consultation. This is what Downs (2007) mentioned as the "bottom-up" driving forces behind the

[30] For example, nine countries were recommended on NDRC's list in 2007: Kuwait, Qatar, Oman, Morocco, Libya, Niger, Norway, Ecuador, and Bolivia.
[31] See, for example, Höök (2009).

transnationalization of China's NOCs.

The competitive nature of interactions among China's NOCs is additional evidence that CNPC's transnationalization was shaped more by its corporate interests than national interests. Competition over overseas projects between CNPC and the other two NOCs is still a headache for the Chinese government. Bitter rivalries over foreign ventures might strengthen the NOCs' positions in the global market at the individual level, but aggregate-level Chinese strategic interests are damaged. For instance, instead of working with CNPC, Sinopec, as a minority shareholder, chose to cooperate with companies from other countries in bidding for pipeline projects in Sudan and Libya in 2004.[32] Such destructive head-to-head conflicts decreased with the creation of the National Energy Leading Group in 2005. Since then, Chinese NOCs at times have managed to form consortiums in venturing overseas.

Yet, this is not to say that relations among the three NOCs are now more cooperative than competitive. While the National Energy Leading Group offers a place for the three NOCs to reach agreements, it also gives them opportunities to lobby for resources in favor of their own businesses. As such, cheap capital and political support have become new targets of competition. With superior technical know-how and political clout, NOCs are even sometimes said to "hijack China's foreign policy."[33] CNPC managers constantly complain, however, that their firm now has to share diplomatic support and associated financial packages with Sinopec and CNOOC. In the past, these

[32] For the case study of the clash between CNPC and Sinopec over the Sudanese pipeline projects, see Liou (2009).

[33] See http://www.ft.com/cms/s/0/7af9baa8-f3c4-11dc-b6bc-0000779fd2ac.html?nclick_check=1, accessed on March 18, 2008.

policy resources were CNPC's privilege due to its longer history of internationalization. In other words, unlike the conventional wisdom that takes state financing as evidence to challenge the commercial nature of Chinese NOCs' cross-border deals,[34] state aid packages were actually exploited by the firms to advance their corporate goals. Even though NOCs' overseas activities frequently ran against the state's directives, policymakers have consistently chosen to build up NOCs' support packages.

Overall, CNPC adopted a dual strategy to respond to China's official calls for "the best use of both international and domestic markets" – maximizing profits through rent-seeking at home and maximizing market share through state-backing abroad. On the domestic side, facilitated by its bureaucratic leverage over policy choices, the firm and its managers quite successfully lobbied government decision-makers to protect their monopolistic interests. In the meantime, bureaucratic fragmentation worsens the problem of information asymmetry, which prevents central regulators from effectively monitoring CNPC's operations. On the international side, CNPC's commercial motives go a long way towards explaining its decisions concerning overseas projects. When the state's security agenda is not compatible with CNPC's corporate objectives, the firm's commercial interests trump the national interests in deciding the direction of overseas expansion.

Unexpectedly, such a dual strategy increasingly imposes market discipline on CNPC managers' behavior abroad. In the Chinese domestic market, CNPC's inefficiency and non-market behavior are well protected by its bureaucratic leverage. In this sense,

[34] See, for example, International Crisis Group (2008).

CNPC's business strength is embedded in the context of a partial reformed market. Outside this context, it is hard to say how much of a role bureaucratic privilege can play in assisting CNPC's operations. This is especially true when considering the fundraising instrument that enables CNPC to invest abroad. From the beginning of the 1998 restructuring, central reformers had repeatedly emphasized the importance of international listing in resolving NOCs' financial difficulty and in building up a modern oil company. For example, the then Chinese Premier Zhu Rongji indicated that initial public listings of NOCs on international capital markets were a key step to transforming Chinese NOCs into world-class corporate entities.[35] In 2000, PetroChina, which was CNPC's new share-holding subsidiary with core assets, traded 10 percent of the company's total shares on the New York and Hong Kong Exchanges. The immediate impact of global listing is the imposition of an information-revealing mechanism on NOCs' operations.

Since then, PetroChina and even its parent company CNPC have been accountable to not only the Chinese central government but also foreign investors. That is to say, in addition to the interaction with Chinese central regulators, there is another agency relationship that subjects CNPC's operation to foreign investors' monitoring. The information disclosure system required by international capital markets serves the function of revealing CNPC's operational and financial information, which is hardly exposed by domestic market mechanisms. Since its inception, PetroChina has issued annual reports that show corporate information, including financial statements. The

[35] Shiyou guanli qiye (2001).

corporatized CNPC also produces annual reports that help investors analyze and evaluate PetroChina’s performance. For CNPC, the release of company data was a common practice during the period of pre-corporatization; however, the reliability of the information was uncorroborated. Because building a positive international image is critical for fundraising, the corporatized CNPC has a stake in conveying messages that reflect the reality of corporate operations. Consequently, concerns about the corporate image and stock prices shape CNPC’s commercial decisions, which begin to accommodate market forces and financial disciplines.

One good example is China National Oil and Gas Exploration and Development Corporation (CNODC), which is the main subsidiary that exerts a unified management over CNPC’s overseas assets and international projects.[36] In the early stages of CNPC’s internal reorganization in 1999, senior management had intended to transfer CNODC with its core assets of CNPC’s overseas operations into PetroChina. Yet when considering that PetroChina was going to be a listed public company on the New York Stock Exchange, corporate executives decided to let CNODC stay in the parent company. Two market concerns which would leave negative impacts on the initial public offering in the U.S. capital market led to this corporate strategy. First, CNPC’s overseas assets under CNODC’s management were concentrated largely in countries that were prohibited by American laws, such as Sudan and Venezuela. Second, top management worried that the

[36] Before 2005, CNODC was responsible for conducting international projects on behalf of CNPC, and PetroChina International was in charge of PetroChina’s overseas businesses. This organizational arrangement however imposed difficulty in coordinating CNPC’s corporate strategies for overseas expansion, inevitably leading to inefficient operation at the aggregate level. In June 2005, PetroChina acquired 50 percent of the shares of CNODC and transferred all the shares of PetroChina International to the new CNODC.

poor profitability of CNPC's international projects would affect the market's confidence in investing in PetroChina.

As CNPC's international operations play an increasingly important role in redressing the problem of domestic oilfields' declining output, the new monitoring mechanism discussed above helps CNPC's global business decisions become more market responsive. Capital from international stock markets has also become a critical source of funding for foreign projects. With this understanding, CNPC executives make every effort to find commercial justification for their cross-border transactions and pay special attention to any investment plans that may be challenged in shareholder meetings. The case of PetroChina's acquisition of CNODC in 2005 is an interesting example. Because the acquisition was a related-party transaction between CNPC and PetroChina, only minority foreign shareholders which constitute 10 percent of PetroChina's total shares had the right to approve the deal. As such, in order to avoid potential concerns, CNPC intentionally excluded its controversial assets in Sudan from this acquisition.[37]

The tendency for CNPC's behavior abroad to become more adaptive to market forces was not anticipated by central policymakers when developing the "Going Out" strategy to serve national security and economic objectives. Nevertheless, in the course of promoting the transnationalization of Chinese firms, policymakers gradually comprehended this reforming effect, which eases the burden on the fragmented state regulators. For instance, Li Rongrong, the head of the SASAC, has reiterated that the implementation of the "Going Out" strategy strengthens central SOEs' competitiveness

[37] See "*Zhongguo shiyou ruzhu mugongsi haiwaixi*" [PetroChina Purchased the Parent Company's Overseas Assets], *Zhongguo Shiyou Shihua* [China Petrochem], Vol. 13, July 1, 2005, p. 29.

by exposing the firms to advanced management practices.[38] Although there is still a lack of systematic evidence to show that the "Going Out" Strategy has sharpened CNPC's competitive edge, the firm's offshore operations at least have come closer to the standard practices of international markets.[39]

IV. Conclusion

As Hellman (1998) notes, the early winners of partial economic reform benefit from the rent created by the initial price distortion introduced by the gradualist reform strategy. This group of actors is thus motivated to block the process of reform, making the reform dynamics fall in the trap of what he labeled a "partial reform equilibrium." CNPC, an early beneficiary of China's partial economic reform, in many ways tries to retain the market privileges bestowed by the central planning system. Ownership restructuring and corporatization fail to induce changes in firm-level behavior. At the same time, central regulators are unwilling to relinquish political control over CNPC's operations and still include CNPC's senior management in the state cadre system. While regulatory agencies impose both political and economic control over CNPC's operations, they simultaneously leave room for CNPC's bureaucratic leverage to influence the fragmented process of policy-making.

[38] See, for example, http://big5.ce.cn/gate/big5/intl.ce.cn/specials/zxxx/200907/04/t20090704_19460375.shtml, accessed November 19, 2009.

[39] While focusing her study on international environmental and social standards, Shankleman (2009) makes a similar argument that the exposure of China's energy firms to overseas markets make the firms committed to improving performance.

Therefore, when Chinese policy-makers intend to use CNPC’s operation as an instrument to fulfill security goals, the state resources and support provided by the “Going Out” strategy instead become the objective of CNPC’s exploitation. Nonetheless, the process by which CNPC raises funds for its international projects has shown an encouraging sign: a more transparent information environment. Without bureaucratic protection to shield its non-market conduct, CNPC’s private agenda is exposed by the monitoring mechanism brought about by its international listing and overseas expansion.

Chapter 5. China State Construction Engineering Corporation

Unlike the oil sector, Chinese leaders attached relatively little political importance to construction SOEs. This led reformers to liberalize the construction industry as early as the 1980s, by which free competition from non-state firms was introduced.[1] Under this different market structure, construction SOEs and their senior managers held lower bureaucratic ranks and had less privilege to economic rents created by administrative measures. Nonetheless, we can observe a similar pattern of government-business relations. In this chapter, I examine China State Construction Engineering Corporation (CSCEC) to illustrate how the institutional dynamics of partial reform prevent it from being a real market player and how the CSCEC interacts with bureaucratic agencies in the process of its transnationalization.

Although the construction industry is not included on the official list of strategic sectors in which state ownership should play a dominant role, the significance of state-owned construction firms lies in their tasks of building national infrastructure projects. According to the information released by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), nine central SOEs list construction activities as their core businesses. Five of them are vertically integrated construction companies: CSCEC, China Railway Engineering Corporation, China Railway Construction Corporation, China Communication Construction Company

[1] Non-state firms here not only refer to private firms, but also include collective firms, foreign invested enterprises, and joint ventures. Because the legal status of private firms was confirmed by the Chinese Constitution only after 1999, most private construction firms concentrate on small-scale construction projects.

Limited, and China Metallurgical Group Corporation. In addition to their role in improving national infrastructure, these companies are also main agents of the Chinese government to support infrastructure development in less developed countries especially those in Africa and Southeast Asia.

During the course of economic transition, state regulators gradually reduced their control over the construction industry. But more competition failed to turn construction firms into efficient market players. In response to growing competition from non-state firms, construction SOEs burdened with policy responsibilities - such as helping to preserve full employment - turned to use non-market or even illegal strategies to grab market share. For example, by avoiding the formal procurement system and its safeguards, construction SOEs used inferior materials to reduce costs. Firms mobilized their bureaucratic ties to conceal such practices from state monitoring. In the area of government-initiated transnationalization, the combination of construction SOEs' political connections and the economic autonomy acquired from corporatization enable the CSCEC to pursue its corporate interests despite state directives.

I. BACKGROUND

Both the legal and economic barriers to enter China's construction market are low, which allows business entities with various ownership structures to flourish in this burgeoning sector. Private and collective-owned construction companies, as shown in the first national economic census conducted in 2004, reached 52.2 percent and 11.6 percent of the total number of enterprises operating in the sector, respectively.[2] The vibrancy of the sector is also reflected in the growth of the number of construction projects in China. In response to rapid urbanization and industrialization brought about by economic reform, the construction industry has experienced remarkable development. During the reform period, the weight of added value produced by the construction industry in GDP terms is about 6 percent on average per year. Between 1979 and 1998 building projects covered 4.9 billion square meters, among which 2.3 billion square meters were residential houses. The area is four times more than the building development in the first thirty years since the establishment of the Communist regime in 1949.[3]

Along with the enormous expansion of housing units is a massive increase in public infrastructure programs such as roads, railways, bridges, airports, power stations, and dams. In today's China, the whole country can be seen as a huge construction site. Large-scale infrastructure projects are put in operation nationwide in order to keep pace with the need for improvements in transportation and energy supply, which provides essential support for further economic development.[4] For example, the Three Gorges

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[2] For statistical details, see "Jianzhuye yi Chengwei Mingfuqishi de Zhizhu Chanye" [The Construction Industry Has Already Been the Genuine Pillar Industry], http://www.cin.gov.cn/hytj/dtyxx/gjtjjxx/200609/t20060926_160470.htm, accessed August 19, 2009. The analysis in this report is based on the data collected by the first national economic census.

[3] For statistical details which show the rapid growth in the construction industry in the first 50 years since the establishment of the People's Republic of China, see "Xinzhongguo 50 Nian Xilie Fenxi Baogao: Jianzhuye Buduan Zengqiang" [The Analytical Report Series on the Founding of New China for Fifty Years IX: Continuously Strengthen the Construction Industry], http://www.stats.gov.cn/tjfx/ztfx/xzgwsnxlfxbg/t20020605_21426.htm, accessed August 19, 2009. There are certain disparities in the official calculation of the total output value of China's construction industry. During the first decade of the reform period, all categories of construction companies were included in the data. Afterward, only companies that meet quality control standards required by the Chinese government are included in official statistics.

[4] The development of China's government-funded infrastructure projects gained further momentum from China's massive fiscal stimulus package in 2008, which targeted railway, freeways, and infrastructure projects to boost domestic demand.

Dams on the Yangtze River along with its associated infrastructure construction is the largest hydroelectric project in the world. The South-to-North Water Diversion Project, which is still in progress, is expected to solve the water shortage problem in populous northern China. The total amount of investment in city infrastructure during the 1990s added up to RMB 738.49 billion yuan, which is 10 times more than that of the previous decade. According to the Eleventh Five-year Guideline, the total investment on railway construction during 2006 to 2010 will increase by 357 percent compared to the period of the Tenth Five-year Guideline.[5] From the official perspective, the above-mentioned development has contributed to the critical position of the construction sector as one of the pillar industries in the national economy.[6]

1. The Outlook of China's Construction Industry

Compared with the oil industry, the construction industry has fewer implications for state-led industrialization, which explains the differentiation in respective reform measures and market structures. While the oil industry is dominated by a few oligopolistic SOEs, construction SOEs compete with non-state actors while less rent is being produced by administrative discretion. More importantly, construction SOEs and their managers hold lower administrative ranks, the source of managerial bargaining

[5] See the analysis of the development of railway networks during the Eleventh Five-year Guideline, "Shiyiwu Tielu Jianshe Gaodiao Kaichang, Wunian Nei Jianshe Xinxian 20000 Gongli" [The Construction of Railways Gears up for the Start of the Period of the Eleventh Five-year Guideline, 20000 Kilometers of New Railways Will be Developed within Five Years], http://finance.people.com.cn/BIG5/1037/4324868.html, accessed August 19, 2009.

[6] See "Jianzhuye yi Chengwei Mingfuqishi de Zhizhu Chanye" [The Construction Industry Has Already Been the Genuine Pillar Industry], http://www.cin.gov.cn/hytj/dtyxx/gjtjjxx/200609/t20060926_160470.htm, accessed August 19, 2009.

power vis-à-vis state regulators, and are thus less capable of negotiating preferential treatment from firms. The differences, however, are a matter of degree. In China's socialist market economy, state firms as a whole, especially those under the management of the central government, are beneficiaries of ownership-based policy discrimination. Even at this point, after reform was initiated over three decades ago, they still have easier access to bank credit and enjoy advantages in soft lending at the expense of non-state firms.

China's construction industry is one of a few "pillar" sectors in which both state firms and non-state firms are governed by a competitive market. Like all SOEs in other industries, construction SOEs were not commercial-oriented entities under the central planning system. Instead, their operations were determined by the Chinese government's needs for public infrastructure and large-scale construction projects essential for China's industrialization such as the development of railway networks. Under this system, cost control and time efficiency were not core issues of construction management. This situation did not change until the competitive tendering system was gradually introduced into the industry in the early 1980s. After a four-year policy experiment in the Shenzhen Special Economic Zone, in 1984 a national tendering system was adopted to govern the bidding process of construction projects. The introduction of the tendering system represents a significant departure in terms of the project allocation mechanism – instead of taking cues from the administrative command, project allocation is determined by market forces such as price. Official statistics show that in 1998, 40.1 percent of total completed construction projects had employed the competitive tendering procedure, an increase of 19.6 percent compared to 1984.[7]

The construction procurement reform, however, did not lead to more efficient management practice or a more transparent market. Rather, unfair competition as a consequence of corruption benefited construction SOEs. During the pre-reform period, these firms were actually a subdivision of bureaucratic agencies that were responsible for all government-funded construction projects. Even though they were spun off from their supervisory bureaucratic agencies in the reform period, construction SOEs and their middle to senior management still held administrative ranks. As a result, facilitated by their bureaucratic ties, construction SOEs earned the majority of projects, especially those initiated by governmental agencies. Moreover, the competitive tendering system that was designed to foster firms' sensitivity to market forces gave the firms incentives to adopt irresponsible strategies instead. Because price is the only determinant of the bidding outcome under this new system, firms were encouraged to submit the lowest price possible at the expense of quality. This detrimental bidding strategy was especially appealing to construction SOEs which faced fewer financial constraints due to soft lending from the banking system.

In the late 1990s, official corruption associated with construction projects rose to the point that a new round of reform was deemed imperative by central leaders.[8] Both construction SOEs and non-state construction firms competed to bribe officials involved

[7] See "Xinzhongguo 50 Nian Xilie Fenxi Baogao: Jianzhuye Buduan Zengqiang" [The Analytical Report Series on the Founding of New China for Fifty Years IX: Continuously Strengthen the Construction Industry], http://www.stats.gov.cn/tjfx/ztfx/xzgwsnxlfxbg/t20020605_21426.htm, accessed August 19, 2009.

[8] For details on the severity of official corruption on construction projects, particularly at the local level, see Yang (2004, pp. 186-198).

in the issuance of project contracts and land-use rights. With their superior bureaucratic connections and access to inside information, construction SOEs had the upper hand, and officials took bribes and kickbacks to an alarming degree. Among local official corruption incidents, construction-related cases accounted for 40 percent (Yang 2004, p. 187). In 2000, the central government issued the Construction Law and the Tendering Law in the hope that unfair competition could be inhibited. Unfortunately, the promulgation of these legal documents has yet to generate a significant impact on construction management practice.

In tandem with the procurement reform was the urban housing reform, leading to a radical change in the use of urban land. Before 1978, housing was provided by the state through work units and local housing departments. However, the cost of the public housing service further worsened the ongoing financial difficulties that the state faced. In September 1978, Deng Xiaoping suggested that the state allow urban residents to own and sell their own houses, which could lessen the state's financial burden. This was the first time that changes were proposed at the central level. In April 1980, Deng further indicated that urban residential housing should be seen as a commodity rather than a public good provided by the national welfare system. He also encouraged the government to formulate a more flexible policy to finance urban residents' purchase of their own homes.

Deng's speeches marked a major ideological shift and paved the way for the commercialization of urban residential housing in the following two decades. Since then, market mechanisms have been gradually introduced into the housing sector and privatization of home ownership has created enormous demands for new buildings. The booming real estate market has attracted more investment in property development. The proportion of real estate investment to the fixed-asset investment increased from 6.1 percent in 1991 to 26.4 percent in 1999. In addition to the growing number of local construction firms, the role of foreign direct investment (FDI) increasingly played an important role in developing China's real estate market. According to the statistical figures from the State Administration of Foreign Exchange, in 2007 FDI accounted for 15 percent of investment in China's real estate market. Nevertheless, because real estate is a capital-intensive business, state firms, especially central SOEs who have easy access to bank loans, are still heavily involved in the housing market.[9] State firms specialized in other sectors, such as machinery SOEs or even NOCs, are frequently ranked as top national real estate developers.

While various market-oriented agendas, such as the liberalization of the industry and the competitive tendering system, have been implemented, most construction SOEs are still plagued by inefficient performance. As discussed above, the competitive tendering system actually encouraged construction SOEs to make irresponsible decisions. The practice of submitting the lowest price possible further worsened one of the most pressing issues that construction SOEs encounter: the shortage of capital. As a solution to the systematic problem of undercapitalization in the industry, permanent construction workers had not been recruited since 1984. Yet this expedient could not fundamentally alter firms' deteriorating financial situation. State-owned construction firms with the

[9] See, for example, http://big5.ce.cn/cysc/fdc/fc/200908/30/t20090830_19639393.shtml, accessed November 22, 2009.

social obligation to stabilize employment were not allowed to cut redundant workforce based on firms' financial calculations. With more competitors joining the game as the state liberalized the industry, construction SOEs found themselves in a difficult situation as they were forced to sustain excessive personnel expenditures. To find an outlet for labor, construction SOEs tried to maximize their project contracts whenever possible without calculating the actual profitability. Combined with the custom of submitting below-market bids, the strategy for contract maximization meant that the more contracts the firms received the more they lost. This non-market conduct, however, was tolerated due to the practice of soft budget constraints in China's state sector.

It is not unusual for small construction SOEs to not be paid for their services. In the absence of financial incentives, these firms did not even bother to seek redress from China's imperfect legal system. When they were running out of funds from bank loans, some of the firms issued enterprise bonds to their employees in order to maintain operations. In short, the introduction of pro-competition regulations fails to encourage the emergence of cost-efficient behavior at the firm level. This result can be largely explained by the lack of a broader institutional environment that supports more cost-efficient behavior.

There are still a number of profitable construction SOEs; most of them are under the management of the central government. Given that almost all of these firms originated from the central bureaucracy, their bureaucratic ties gave them advantages in bidding for large-scale national projects. For example, China Railway Engineering Corporation and China Railway Construction Corporation, two of the five vertically-integrated central construction companies, evolved from the subordinate agencies of the Ministry of Railway and the People's Liberation Army (PLA), respectively. Both of them are dominant operators in national infrastructure construction, especially in transportation-related projects.

Meanwhile, the policy responsibility of central construction SOEs preserves the right of the central regulator to intervene in firms' operations in accordance with non-commercial agendas. Nationwide acceleration of train speed, which is called the "Massive Acceleration Program" (*datisu*), can best illustrate construction SOEs' non-economic tasks. With the aim to cut travel time between major cities and boost China's transport capacity, the central government initiated the Massive Acceleration Program in 1997 and carried out six rounds of improvements, with the most recent one being a part of a stimulus package in response to the global financial crisis in 2008. In executing their roles as the primary policy agents, China Railway Engineering Corporation and China Railway Construction Corporation benefited enormously from government-led infrastructure spending when the national economy was hit by the economic downturn in 2008.[10] This also means that firms' competitiveness comes from their ability to earn greater bureaucratic preferential treatment rather than their ability to respond to market signals.

Ineffective governance is another reason for the continuation of construction SOEs' inefficient operations. Generally speaking, construction SOEs' domestic operations are governed by a diverse array of bureaucratic agencies: National

[10] See "Shui Hui Fenxiang Guidao Jiaotong Shengyan?" [Who will Share the Transportation Infrastructure Spending?], *Market News*, http://ccnews.people.com.cn/BIG5/8437082.html, accessed August 20, 2009.

Development and Reform Commission (NDRC), the SASAC at the central and local levels, the Ministry of Commerce, the Ministry of Civil Affairs, the Ministry of Housing and Urban-Rural Development (the successor of the Ministry of Construction), the Ministry of Land and Resources, the Ministry of Railway, the Ministry of Science and Technology, the Ministry of Transportation, the Ministry of Water Resources, and the State Administration for Work Safety. Among these government bodies, the NDRC and the Ministry of Housing and Urban-Rural Development are the lead agencies in administering and regulating capital construction projects. Similar to other policy arenas, the governance of China's construction industry has been plagued by the issue of bureaucratic fragmentation. In addition to the frequent organizational restructuring of the NDRC mentioned in Chapter 2, the authorities in charge of the construction industry have experienced several rounds of changes in their organizational settings.[11]

Before restructuring into a supra-ministry named the Ministry of Housing and Urban-Rural Development in 2008, the Ministry of Construction (1988-2008) was the primary agency responsible for regulating construction activities during the reform era. Together with the NDRC's long-term development strategy, the Ministry of Construction provided more detailed regulation concerning construction projects' quality and management. The frequent reshuffling of the administrative framework, however, casts doubt on the effectiveness of governance. Regulatory agencies involved in the construction industry are under constant pressure to adapt to their new organizational

[11] During the pre-reform period, the recurrent adjustment of the governance institutions reflected the institutional instability resulting from the political struggle within the Chinese Communist Party (CCP). For instance, the State Construction Commission was created and removed three times in just seven years between 1954 and 1961.

setting and tasks without developing stable coordination among themselves. The situation of fragmented authorities becomes more acute because similar institutional changes also took place at the provincial and municipal levels. Consequently, China's construction industry is hamstrung by low-quality buildings, the late completion of projects, and the corrupted tendering practice.[12]

2. China State Construction Engineering Corporation (CSCEC)

Although CSCEC was created in 1982, it was composed largely of existing bureaucratic units that had engaged in construction-related activities since the early years of the CCP's rule. Its eight engineering bureaus originated from the Ministry of Building Engineering, which operated in the pre-reform period, and the Capital Construction Engineering Corps transferred from the PLA. Along with the reorganization of construction units was the transfer of the management of four architectural design and research institutes under CSCEC's command. Together with a number of core subsidiaries such as China Overseas Holding Limited, these subordinate firms have contributed to CSCEC's market position as China's largest construction company and international contractor.

While CSCEC has been recognized as the "backbone" SOE in a fully competitive construction market, it was not until the creation of SASAC under the State Council in 2003 that a systematic market-oriented agenda was put in place within this sprawling conglomerate. Before this, the reform agenda of corporatization was unevenly applied to

[12] The 7.9 magnitude Sichuan earthquake leveled thousands of schools and buildings, which brought up the issue of shoddy workmanship and substandard materials to the public. For details, see http://www.caijing.com.cn/2008-06-03/100067212.html, accessed February 6, 2010.

CSCEC's subsidiaries due to their inferior roles in the state's industrial policy. Until 2001, CSCEC still had 1876 subordinate divisions with different sizes and management structures, among which 1466 units were affiliated with the eight construction engineering bureaus.[13] Yet productivity is not positively related to the number of these secondary establishments. It is estimated that about 70 percent of CSCEC's profit came from only one core subsidiary, China Overseas Holdings Limited (China Overseas) based in Hong Kong.[14] Hong Kong-listed China Overseas Land & Investment Limited, a flagship secondary company of China Overseas, has been the leading player in China's real estate market and the most profitable company in the CSCEC Group. Except for the remarkable growth of China Overseas, most subsidiaries still focus on labor-intensive projects with lower rates of return.

Under SASAC's instruction and supervision, CSCEC began to trim its loss-making assets, eliminate unnecessary employment, and shut down inefficient operations. Subsidiaries with overlapping functions, a typical problem of the state sector under the central planning system, either went through a merger process or were simply cut off. The benefit of these measures is obvious. All of the second-tier subsidiaries declared profits in 2005 and the number of unprofitable subsidiaries at the third tiers and above decreased

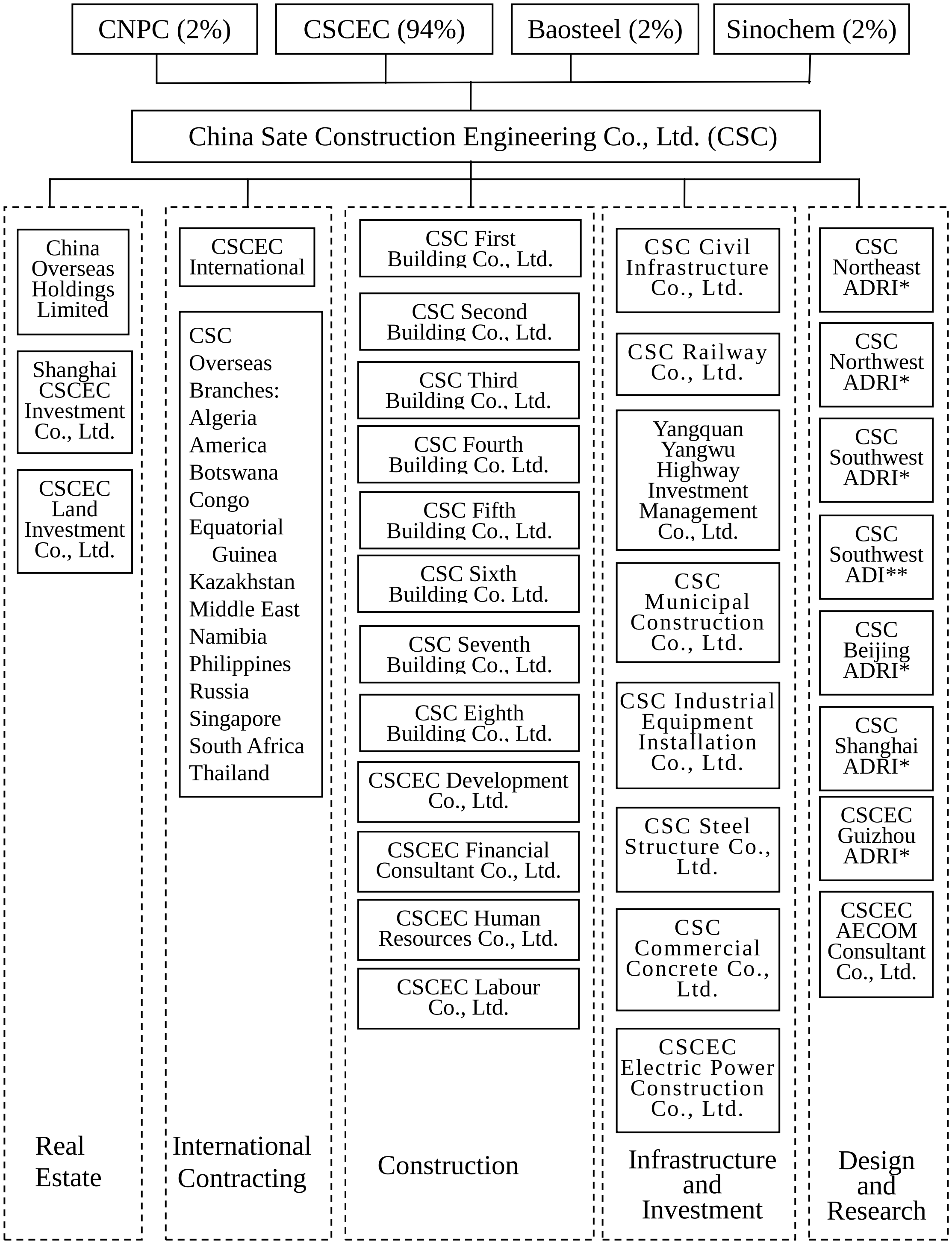
[13] See SASAC's report on CSCEC's reform agenda, "Guoyou Qiye Zai Wanquan Jingzheng Hangye he Kaifang Guoji Shichang zhong Dayoukewei: Zhongguo Jianzhu Zonggongsi Gaige Fazhan Jingyan" [The Achievement of SOEs in a Competitive Sector and an Open International Market: The Reform Agenda and Development of CSCEC], http://www.sasac.gov.cn/gzjg/xcgz/200609280184.htm, accessed September 2, 2009.

[14] "Dazao Zuiju Guoji Jingzhengli de Zhongguo Jianzhu Jituan" [Create a Chinese Construction Conglomerate with International Competitive Edges], *Guoji Jingji Hezou* [International Economic Cooperation], No. 3, 2007, pp.15-20.

from 50 to 23.[15] As China's largest contractor in the global markets, in 2002 CSCEC grouped the overseas assets and domestic businesses under its direct management into the newly-established China State Construction International Corporation, which later became a limited company for the conglomerate's public listing. In 2007, China State Construction Engineering Corporation Limited (China Construction) was created, with CSCEC owning 94 percent of the total shares and CNPC, Baoteel Group Corporation Limited, and Sinochem Corporation each owning 2 percent of the total shares. This is the first time that CSCEC introduced the ownership restructuring program in the hope of fostering firm's commercial behavior. Two years later, CSCEC further diversified its ownership by letting China Construction go public, with an initial public offering on the Shanghai Stock Exchange in July 2009.

It is clear from the preceding discussion that the construction industry has never been nearly as important as other strategic industries recognized as the "commanding height" of the national economy, such as the oil industry. Compared to CNPC, central reformers paid less attention and provided fewer resources to CSCEC's firm-level reform. Nevertheless, CSCEC, as a vice-ministerial-level central SOE, has no shortage of bureaucratic leverage over central regulators, which facilitates its operations in a competitive construction market. As will be discussed below, CSCEC's political clout in many ways protects its non-market behavior.

[15] *Ibid*, p. 19.



*: ADRI - Architectural Design & Research Institute
**ADI: Architectural Design Institute

Figure 5.1 CSCEC's Organizational Structure

II. Market Reform and Managerial Behavior

Most of the reform agendas imposed on the construction industry have been guided by practical concerns. From the Chinese reformers' perspective, pro-competitive policies are introduced as both a solution to the housing issue and a measure to improve construction SOEs' underperformance. In this context, market-oriented reform is largely defined as the introduction of free competition. Yet, when the market is seen as an institution embedded in a particular set of social and political relations, simply promoting competition cannot guarantee the emergence of market-oriented behavior. Instead, the lack of change in the broad institutional environment in which SOEs operate makes the pro-competitive reform agenda fall short of its goal. CSCEC's performance problem in many ways demonstrates this observation.

1. Pro-competitive Reform and Non-market Behavior

Most of time during the reform era, central reformers pursued the agenda of liberalization, with an aim to facilitate the effective operation of the construction market. They expected the participation of non-state competitors to create alternatives in the marketplace, giving construction SOEs the impetus to change their inefficient business behavior to survive. Yet with the political function of construction SOEs and the corresponding soft-lending practice still in place, pro-competitive measures only invited more inefficient use of resources. Since its creation, CSCEC has been one of the main agents of national fixed-capital investment programs, including airport, railway, refinery plants, power plants, and construction projects of the Shanghai World Financial Center and the Shenzhou Space Center. Although the central authority has regularly emphasized that CSCEC is a model state firm that succeeds in an open and competitive market, CSCEC's bureaucratic rank as a vice-ministerial SOE guarantees its preferential access to public projects without having to worry about non-state competitors.

In addition, pro-competitive reform programs gave rise to a race for market privilege among construction SOEs. Instead of taking a cue from the state under the centrally planned system, pro-competitive regulation means that CSCEC faces challenges from other state firms of the same kind. For instance, China Railway Engineering Corporation, which has a vice-ministerial rank, also enjoys technological capability and bureaucratic leverage to compete for the same projects as CSCEC. Given that the senior management of these construction SOEs are also occupied by important political figures who are motivated to climb the bureaucratic hierarchy, they have an enormous stake in the success of their firms in bidding for governmental projects. In this sense, the pro-competitive reform agenda has successfully transformed construction SOEs from "project takers" to "project seekers," with firms aiming to maximize their market share at the expense of profitability. As a result, state firms struggled with one another to curry bureaucratic favor not only to win contracts but also for more resources to fulfill these contracts.

This predicament is exacerbated by the large number of state firms operating in the construction market. Many government agencies at both the central and local levels had their own construction departments under the command economy and continued to maintain these units under the new guise of corporate organizations during the transition period.[16] Each of these construction SOEs lobbies its principal bureaucratic actors for various preferential treatments, including discount prices of inputs and guaranteed construction projects. For example, construction firms owned by local governments usually undertake construction projects and installation works within their administrative boundaries. Such competition does not only exist between CSCEC and other state firms but also among CSCEC subsidiaries. Within CSCEC, which was created after the initiation of the economic reform, almost all of the subordinate units have organizational predecessors that date from the planned system. These units are more senior than the CSCEC headquarters in terms of the duration of the bureaucratic organizations. Whenever two or more CSCEC subsidiaries were involved in a given project, this organizational feature created a number of management difficulties for the CSCEC headquarters because the CSCEC was deemed to be less authoritative in coordinating corporate affairs. As CSCEC headquarter managers once complained, "It is very difficult to control these subsidiaries and their branches (*zigongsi*, *sungongsi*) which have a longer organizational history than the parent company. This is just like you intending to instruct people who are your grandpa's age!"

This lack of horizontal coordination among the subordinate units prevents CSCEC from making the best use of its resources, especially when these subsidiaries still engage in overlapping construction activities left by the command system. For instance, before

[16] For example, Beijing Municipal Construction Commission restructured its secondary construction units into four main construction companies with hundreds of subordinate units and installation companies. Among these corporate organizations, Beijing Urban Construction Group was the operator of 19 Olympic projects such as National Stadium and Olympic Village in Beijing.

the initiation of the systematic internal restructuring in 2003, there were over 60 third-tier subsidiaries that concentrated on housing projects. Given that CSCEC subsidiaries are financially independent, it is not unusual that they are rivals to each other at the expense of corporate development. The situation of internal strife worsens as state regulators keep channeling resources to bail out the economic failures of these firms. In short, like operating under the command system, construction SOEs in a competitive market are still output maximizers rather than profit maximizers.

Although the multi-criteria scheme was introduced to the procurement process in 2000, China's construction industry is still in the process of adapting to international best practices, where typically the most effective contractors are selected to complete the projects. In China's construction market, however, price is still the main determinant of the bidding outcome. Underbidding is thus still a prevalent phenomenon. When the cost cannot be covered by project revenue, CSCEC project managers will either use inferior materials and equipment to operate the project or more frequently subcontract the work to unqualified but cheap construction firms. The delayed payment of wages is also an inevitable outcome of a shortage of liquidity. Not only CSCEC workers at the construction sites but also lower-ranking staff members charged with non-labor activities are usually unpaid for their work.[17]

As China's largest construction SOE, CSCEC's mismanagement of workers' salaries has set an example for other construction contractors.[18] In 2008, workers'

[17] Starting from 1984, construction SOEs have only recruited workers on a temporary basis to lessen welfare burden. Since then, unskilled migrant workers from the poor rural areas have become the reliable source of cheap labor.

[18] It is a nationwide crisis that has been one of the primary sources of social unrest. Even Premier Wen

grievances approached the tipping point when China Construction Fifth Engineering Bureau, one of CSCEC's second-tier subsidiaries, organized a violent attack that resulted in a migrant construction worker's arm being chopped off after the worker demanded his overdue wages.[19] Ironically, while CSCEC's operation has often been associated with various unfair competition practices and financial undoing, a remarkable growth in turnover has still earned it a leading position in not only China's construction industry but also the SOE sector. However, as an official at the CSCEC headquarters admitted, "All these subsidiaries share a common feature in that the firms operate with high annual turnover volumes but low profitability. Even for subsidiaries which did earn handsome profits, I cannot guarantee that they all abide by market rules. There is still a long way to go to match up with international best practice."

In sum, China's construction industry is by no means a perfectly competitive market in which firms' responsiveness to market forces is encouraged. Simply introducing market-competitive mechanisms cannot change the managerial incentive system and foster commercial-oriented behavior at the firm level. Market-competitive mechanisms need a broad institutional environment to be effective. Such an observation concurs with Steinfeld's (1998) discussion of institutional barriers which prevent steel SOEs from performing efficiently in a competitive and open sector. Taking one step further, my study of CSCEC's economic performance shows that its inefficiency cannot only be judged in terms of profitability, but also in the way CSCEC makes use of

Jiabao helped a construction worker in Chongqing claim overdue wages.

[19] See "'Mingong Taoxin Beikanshou' Zuizhong: Zhongjian Wuju San Zerenren Beiche" [The Follow-up Report: Migrant Worker Who Asked for Unpaid Wages Got His Arm Chopped Off: Three Managers of China Construction Fifth Engineering Bureau Were Discharged], *Yangtse Wangbao* [*Yangtse Evening Post*], http://news.xinhuanet.com/legal/2008-01/23/content_7476708.htm, accessed September 10, 2009.

resources. This is because even in CSCEC's profitable projects, the main source of its profitability comes mainly from economic rents created by bureaucratic preferential treatments, such as the privilege of receiving government-funded projects, and not from the improvement of productivity.

2. The Dual Roles of CSCEC Managers and the Powerful Bureaucratic Lobby

Like their counterparts in CNPC, CSCEC managers who simultaneously have party and government positions gain the upper hand in lobbying regulatory agencies to favor CSCEC's operations. In addition to their administrative ranks being equivalent to those of central regulators, CSCEC senior management hold positions in semi-official industrial associations, which assume a facilitating role in policymaking. With the assistance of these bureaucratic connections in the period of post-corporatization, CSCEC managers are capable enough to pursue corporate interests despite potential negative impacts on national objectives.

CSCEC and its general manager have administrative rank at the vice-ministerial level, with the CCP's Central Organization Department controlling the positions of CSCEC's top management. At the same time, because CSCEC subsidiaries have organizational predecessors that originated under the command economy, the Party Committee (*dangwei)* in each subsidiary is still preserved to manage personnel-related issues under the ultimate authority of CSCEC's Party Group (*dangzu*). Working in China's largest construction SOE, CSCEC managers are politically motivated in the sense that they perform their tasks with an eye to moving upward in the bureaucratic hierarchy.

This also means that managerial behavior is dictated more by political logic than by economic logic. When the two behavioral strategies are in conflict with each other, the former always comes first in managers' minds. The abovementioned managerial pursuit of expansionary turnovers regardless of profitability is a good example.

This is not, however, in any way saying that prioritizing the political function of construction SOEs at the expense of their economic performance is always appreciated by central reformers. As I pointed out in Chapter 2 and demonstrated in the CNPC case study, there is a trend to encourage SOE managers to pursue firms' commercial gains as long as managerial decisions are not grossly resistant to firms' political mandates. CSCEC managers started to tilt towards their economic identities over their political ones when a number of CSCEC subsidiaries were chosen for shareholding experimentation in the mid-1990s.[20] Nonetheless, we should clarify that when CSCEC managers identify themselves as corporate executives who protect the firm's commercial interests, their goals are not limited to pecuniary rewards. To put it more precisely, the ultimate concern of these managers is still political advancement within the CCP, which dominates the key aspects of the resource allocation system. In view of this, excellent economic performance is just another essential accomplishment that CSCEC managers need to mount up the political hierarchy.

A biographical sketch of CSCEC's senior management can tell us something about the typical career pattern that I have mentioned above. The vocational path of Sun

[20] For example, in 1994, China Construction Second Engineering Bureau was transformed into a shareholding entity by the Ministry of Construction as the experiment subsidiary to establish the modern enterprise system.

Wenjie, the President of CSCEC and Chairman of the listed China State Construction Engineering Corporation Limited (China Construction), is telling. Before entering CSCEC's senior management, Sun Wenjie was in charge of China Overseas Holding Limited (China Overseas), CSCEC's subsidiaries based in Hong Kong. During his tenure, China Overseas Land & Investment Limited, the flagship of China Overseas, became publicly traded in Hong Kong, making it the first state-controlled SOE subsidiary to be listed in the overseas stock market. He further built China Overseas into one of the top real estate companies in Hong Kong, which contributed over 70 percent of CSCEC's annual revenue.

Compared to the large number of CSCEC's underperforming domestic projects, Sun's performance is a remarkable economic achievement. Sun's experience in the Hong Kong market, one of the most competitive economies in the world that allows market forces play out fully, was his main asset when central authorities searched for top-level managers who not only had party loyalty but also entrepreneurship experience. In 2001, Sun became the head of CSCEC after defeating other candidates who had devoted much of their career to CSCEC's domestic operations. Meanwhile, Mr. Sun was selected by the CCP to be the member of the National Party Congress. In 2007, when China Construction was created from four giant SOEs[21], Sun Wenjie again took the chief position of this construction arm of the Chinese government.

Admittedly, in China's construction industry there is no parallel to the "oil system" (*shiyou xitong*), an important political faction formed by a group of political figures with

[21] CSCEC controls 94 percent of China Construction's shares, with CNPC, Sinochem Corporation, and Baosteel Group Corporation each retaining 2 percent of the firm's shares.

similar career background in state-owned oil companies.[22] There is also no precedent that the top management of construction SOEs with good performance will move up to central regulatory agencies. Yet this does not prevent CSCEC senior managers from pursuing political advancement. Rather, a closer scrutiny of CSCEC top executives' profiles reveals that a number of them simultaneously occupy important positions in various quasi-official organizations affiliated with the Ministry of Housing and Urban-Rural Development (the successor of the Ministry of Construction). These positions, under the direct and indirect supervision of the Ministry of Housing and Urban-Rural Development, are heavily influential in the making of government policies. CSCEC senior managers with these additional posts are not seen as politically promoted in a formal sense. Yet, when judged from China's political context, their leverage is enhanced with these new titles, which in turn provide the necessary bureaucratic protection for CSCEC's non-market behavior. In this sense, CSCEC top executives constitute a powerful lobby group because their joint affiliations cover almost every aspect of their core businesses, including Expert Committees in the Ministry of Housing and Urban-Rural Development, China Highway Construction Association, China International Contractors Association, and China Association of Trade in Services.

The tight connection between CSCEC and these semi-official organizations means that the governance of the construction market is ineffective. In such an environment, the regulatory scheme that is supposed to monitor and discipline CSCEC's conduct instead shields the firm's mismanagement from accountability. CSCEC's lobby

[22] For details, please see Chapter 4.

is further facilitated by the fragmented structure of the authorities, a hallmark of China's regulatory environment. As noted before, CSCEC's projects usually have to go through multiple "review and approval" processes dominated by a broad array of government agencies. Yet self-preserving bureaucratic agendas among different central regulators lead to regulatory incoherence, leaving room for managerial maneuvering.

A good case was the implementation of the policy "to secure a better balance of development between urban and rural areas and among different regional areas" prescribed in the Eleventh Five-Year Plan starting from 2006. Under NDRC's macro-management with a focus on "development planning" (*fazhan guihua*), the Ministry of Construction (the predecessor of the Ministry of Housing and Urban-Rural Development) was responsible for "urban planning" (*chengshi guihua*), while the Ministry of Land and Resources was in charge of "land management planning" (*tudi liyong guihua*). Specifically, the NDRC divided the whole country into four regions with different development goals to make the best of regional advantages. The execution of these policy initiatives, however, inevitably involved issues of land use and urban planning, which fell under the jurisdiction of the Ministry of Construction and the Ministry of Land and Resources. Ironically, without any substantial concessions after several rounds of negotiation, the only agreement among the three agencies was to maintain the status quo, which means that three sets of conflicting regulation are all applicable.[23]

One might thus infer that CSCEC managers are required to invest endless

[23] "San Da Guihua San Zhang Pi: Fazhan Guihua Xianru 'Chelunzhan' Jiongjing" [Three Sets of Planning with Three Schemes: Development Planning Falls in the Dilemma of 'Wheel Wars'], *Liaowang* [*Outlook Weekly*], http://www.china.com.cn/chinese/sy/1026283.htm, accessed September 15, 2009.

amounts of time in going through the complicated and frustrating bureaucratic process to obtain project licenses. Yet the opposite is true. One CSCEC manager charged with residential building projects put it bluntly: "No matter how complicated the regulation is, maintaining a good connection (*guanxi*) with regulatory agencies is the key. In this respect, you cannot place too much emphasis on CSCEC's bureaucratic ties and administrative rank. For example, the supply of land is now under strict regulation. But we never encounter any difficulty acquiring land that we need."

In conclusion, CSCEC's managerial lobby is facilitated not only by their administrative ranks but also by their joint posts in semi-official organizations. These organizational arrangements, which are a device for the regulators to control activities in the industry as a whole, actually become the shield for managerial opportunism. This mainly explains the continuation of CSCEC's non-market behavior in the post-corporatization period.

III. The Overseas Expansion of China State Construction Engineering Corporation

To the Chinese central government, CSCEC is by no means a faithful policy agent that pursues national goals regardless of potential negative impacts on the firms' financial performance. This is especially true for CSCEC's cross-border projects, where monitoring becomes even more difficult for China's fragmented regulatory system. From the national diplomatic strategy to its own corporate strategy, the distribution of CSCEC's overseas operations increasingly reflects that CSCEC managers engage in rent-seeking at home while capturing market share abroad.

With the emergence of renewed interests in Africa, China's international contracting businesses have garnered increasing attention.[24] It is undeniable that China's approach to the continent has the strategic goal of resource security in mind. And the Chinese central government does make use of infrastructure projects as policy instruments to facilitate its search for resources. Nevertheless, contrary to conventional wisdom, construction SOEs' cross-border operations seem more like a series of destructive head-to-head competitions and less like a cooperative division of labor. It is widely estimated by China's official policy research institutes that each year the fiscal losses incurred by overseas competition among Chinese firms have reached around RMB 2 to 3 billion.[25] Compared to other transnational ventures, China's international contracting sector holds the lowest operating margins and the highest unit costs. At the same time, decision-makers in Beijing are often worried that conflicts among construction SOEs over international projects will leave a negative impact on China's relationships with host countries. Not only in Africa but also in other developing regions, these firms compete to drive the bid prices down to unreasonable levels at the expense of construction quality, a common strategy they use to outbid their domestic rivals.

[24] See, for example, "China's African Adventure," *The New York Times*, November 19, 2006; and "The New Colonialists," *Financial Times*, November 17, 2007.

[25] For details, see, "'Zouchuqu' Qiye jian Xietiao Burong Hushi" [The Significance of Coordination among Enterprises Engaged in Going Out], http://mnc.people.com.cn/GB/5704085.html, accessed September 16, 2009.

1. The "Going Out" Strategy and the Evolution of Overseas Projects by China State Construction Engineering Corporation

From a comparative perspective, China's international construction contracting is still in its infancy. In 2004, China's contractors only contributed to 6 percent of the global market in terms of total turnovers (China International Contractors Association, 2005). By the end of 2005, about 1800 Chinese construction firms obtained licenses to engage in international contracting, but the total turnover was only 17.86 billion dollars. According to the Engineering News-Record (ENR), 47 Chinese contractors which were recognized on the top 225 international contractors list in 2003 had an average turnover of 177 million dollars, compared to European contractors with more than 1.5 billion dollars, U.S. contractors with 400 million, and Japanese contractors with 658 million dollars.[26]

Chinese contractors, mostly state-owned firms, concentrate on small-scale and labor-intensive projects. This is because China's international contracting business is rooted in over 50 years of foreign aid programs, in which the financial outcome was not usually of primary importance. China's international contracting started in Africa in the 1950s, entered the Middle East in the late 1970s, Southeast Asia in the mid-1980s, and embraced the whole global market after the 1998 Asian Financial Crisis (Xin 2008). For almost two decades, Asia was the top destination of construction SOEs' international projects. Only after 2006, did Africa surpass Asia as the largest overseas market for Chinese construction projects (China International Contractors Association, 2007).

The evolution of CSCEC's cross-border operations reflects the preceding trend.

[26] Adapted from an official report released by the Ministry of Commerce; for the details of the report, see http://caitec.mofcom.gov.cn/aarticle/a/m/200601/20060101433420.html, accessed September 16, 2009.

Many of CSCEC's subsidiaries, especially those with military backgrounds, served as government agents for African foreign aid programs during the pre-reform era. When CSCEC was created in 1982, it was one of a handful of state firms allowed to venture into overseas markets.[27] Since 1984, CSCEC has been included in the ENR's list of top 225 international contractors based on offshore contracting revenue, ranking at 17 in 2007 and 21 in 2008.[28] Through foreign aid programs, CSCEC had overseas branches and affiliates in over 150 countries. This so-called "diplomatic arrangement" (*waijiao buju*), guided by China's foreign policy, imposed enormous fiscal burdens on CSCEC. After Sun Wenjie became head of CSCEC in 2001, he moved to shut down loss-making operations. The transition from "diplomatic arrangements" to "economic arrangements" (*jingji buju*) allowed CSCEC to concentrate on profitable markets.[29]

In the meantime, transnational projects once provided a labor outlet for CSCEC's redundant workforce. Before the implementation of the systematic corporate restructuring in the early 2000s, CSCEC was still burdened with an employment provision, which was very detrimental to its financial performance. Compared to the African foreign aid programs operating in an unstable political environment, Southeast Asian contracting projects steadily absorbed CSCEC's excess labor force. CSCEC's operation in Vietnam is a good example. CSCEC entered the Vietnamese market in 1992 and delegated its contracting businesses to the China Construction Second Engineering Bureau, one of CSCEC's first-level subsidiaries, after 1995. Like other construction SOEs, the China

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[27] See http://caitec.org.cn/c/cn/news/2009-08/17/news_1567.html, accessed September 16, 2009.
[28] See http://enr.construction.com/people/topLists/topIntlCont/topIntlCont_1-50.asp, accessed September 16, 2009.
[29] See http://www.fortunechina.com/fortune500/content/2004-10/01/content_9567.htm, accessed September 16, 2009.

Construction Second Engineering Bureau was constrained by capital scarcity, which limited its ability to obtain contracting projects in Vietnam's booming construction market. The corporate executives decided to cooperate with the Central Trading and Development Group, a Taiwan-based Kuomintang Party-owned enterprise, who provided liquidity for a power plant construction project that employed thousands of Chinese workers. Such cooperation finally developed into a long-term partnership and earned the CSCEC market influence as one of the leading contractor in Vietnam.

Nevertheless, this labor export encountered growing objections from local workers who demanded action from the Vietnamese government to protect their employment. Starting from early 2000s, the China Construction Second Engineering Bureau carried out a localization program that replaced the majority of the Chinese workers with Vietnamese workers. At the same time, the management also experienced similar phases of localization, hiring more Vietnamese managers to help improve labor relations that once suffered from violent struggles. The firm aimed to totally localize the labor force and adjust the ratio of Chinese managers to Vietnamese managers as one to five. Actually the program was promoted by the parent company, the CSCEC, and applied to most of its overseas operations, including African projects, in response to increasing pressure from the host countries. The hostility towards Chinese workers, however, has never lessened.[30] One manager at the China Construction Second Engineering Bureau stated the reason for the continuing employment of Chinese workers despite the localization program: "We are under no obligation to provide jobs to Chinese

[30] See, for example, "Uneasy Engagement: China's Export of Labor Faces Scorn," *The New York Times*, December 20, 2009.

workers and they are not necessarily less expensive than local workers. Chinese workers in general are more skilled and diligent. Most importantly, given the same cultural background, they make our management and communication much easier."

CSCEC's international contracting is spread over 100 countries, with concentrations in Asia and Africa. Before the central government targeted the African market after 2000, Asia (Hong Kong in particular) accounted for most of CSCEC's overseas contracts. Today, contracting businesses in Southeast Asian countries still provide CSCEC with a stable financial source. The recent dramatic surge in African infrastructure projects presented another opportunity. Since its creation in 1982, CSCEC has completed over 300 foreign aid projects in 49 countries. Algeria is one of the top host countries for CSCEC's operation. CSCEC entered the Algerian market in 1982 and is involved in massive infrastructure development, housing projects, and the new Algiers International Airport. The tension between Chinese workers and local job seekers is also present in CSCEC's Algerian venture. In 2007, there were still over 400 lower- and middle-level managers and around 9000 Chinese labourers in Algeria, a source of frequent violent clashes between the two parties.

In 2003, CSCEC resumed its operations in Dubai, following a 10-year hiatus from projects in the Middle East. But, with a large number of international contractors from developed countries in the region, CSCEC's labour-intensive operation does not have a competitive edge in bidding for lucrative high-tech projects. The lack of technological competitiveness also prevents CSCEC from extending its global reach to developed regions. In 1989, CSCEC obtained its first U.S. contracting project, the Chinese embassy in Washington, under the name of its overseas subsidiary China Construction America, Inc. While completing over a dozen projects in the United States, CSCEC's turnovers mainly came from building construction and installation and transportation projects.

2. The State-SOE Interactions in CSCEC's "Going Out"

For a long time, CSCEC has been accused of serving the diplomatic interests of the Chinese state. The claim is not without merit. According to this view, CSCEC's transnational operations, which are backed up by governmental soft lending, are at the heart of China's package of infrastructure development in exchange for much-needed resources. Such "infrastructure for oil" deals have increasingly dominated China's interactions with resource-rich African countries. A detailed examination of CSCEC's "going out," however, reveals that the firm's overseas contracting reflects the conscious decisions of the senior management more than the state administrators.

The evolution of China's international construction contracting has been seen as part of a national security strategy due to the positive role of the state in financing cross-border projects. In recent years, China has become the primary investor and financier of African infrastructure projects, mainly through loans from the Export-Import Bank of China (China Eximbank).[31] The "China-Angola cooperation model" can best explain China's strategy to engage with Africa. Reluctant to accept conditions of structural adjustment in exchange for financial aid from the International Monetary Fund, Angola

[31] For a detailed discussion of the role of China Eximbank in financing African infrastructure projects and its implications for the issue of transparency in the African government, see Bosshard (2007) and Kurlantzick (2006).

turned to China instead for assistance in post-conflict reconstruction. In 2004, China offered a concessional loan of 2 billion dollars backed by oil. From then on, similar types of loans were granted on a project-by-project basis to support Angola's recovery program. At the same time, Angola has replaced Saudi Arabia as China's largest oil supplier. The "China-Angola cooperation model" soon became China's official prescription for SOEs' overseas expansion. Yet the lending practice of "no strings attached" worries most international organizations and Western observers. Paying no attention to governance structure in the name of a "non-interference policy," China's lending policy is said to have the effect of strengthening repressive and corruptive regimes in the continent.

To be sure, CSCEC's involvement in Africa is facilitated by favorable Chinese government policy. In addition to project-specific financial backing including export credits and preferential bank loans, CSCEC signed a cooperation agreement with China Eximbank in 2005. In this agreement, CSCEC was awarded 3 billion dollars to subsidize its overseas expansion in the following five years. By offering cheap capital, the central policy-makers intend to use CSCEC's transnational ventures to fulfil China's foreign policy goals. Nonetheless, this is just one part of the story. Given that CSCEC is held accountable to multiple government bodies, diplomatic and security objectives are by no means the only agendas that push CSCEC to go abroad. In other words, CSCEC's venture decisions reflect the careful calculation of CSCEC management in response to three parallel principal-agent relationships.

First, as noted above, CSCEC's offshore expansion is expected to serve China's foreign policy interests as represented by the NDRC, the Ministry of Foreign Affairs, and the Ministry of Commerce. Under the NDRC's macro-level guidelines, the other two agencies cooperate with each other to come up with a substantive working list for CSCEC to follow. At the same time China's embassies, under the instruction of the Ministry of Foreign Affairs, will provide CSCEC with various forms of assistance to enter local markets. And the Department of Aid to Foreign Countries at the Ministry of Commerce plays a critical role in coordination between CSCEC and the policy banks. Indeed, this set of agency relationships is well known to outsiders and is also the source of the impression of "Chinese mercantilism."

Yet CSCEC simultaneously faces the SASAC as its economic principal, which constitutes the second principal-agent relationship. The SASAC, CSCEC's dominate shareholder, has an enormous stake in the profitability of the firm's offshore projects. Profitability and political instrumentality, however, are not always compatible. With the progress of SOE reform, the SASAC is becoming a much stronger and assertive principal over CSCEC's assets. SASAC's growing leverage over CSCEC's decision to venture abroad can be best illustrated by the coordination meetings prepared for Chinese senior officials' trips to Africa. During the meetings, managers from construction SOEs which were selected as development assistance project contractors bargain with related authorities about the terms of the financial packages. Each enterprise has adopted a firm stance to defend their own budget plans and ensure their firms receive the most profitable projects. One CSCEC manager who attended the meetings made an impressive entrepreneurial comment:

> "Now the SASAC is planning to cut the number of central SOEs. We only have two choices: to be the top three in the sector or to be prepared for a takeover. It is just like a game in which your gains are my losses. It is impossible for us to contract an aid project without adequate compensations. Admittedly, it may leave certain negative impressions if we reject cooperation with other central SOEs in carrying out aid projects just because of profitability. Nevertheless, SASAC can decide our destiny. "

Finally, the third set of government principals are the State Council, the NDRC, the Ministry of Commerce, and the China Eximbank representing the state's interests in the expansion of market shares. In the late 1990s, the State Council began to promote international contracting projects, which have an effect of increasing exports of construction machinery and domestic materials. This instruction of "limiting foreign elements" (*kongzhi waiguo chengfen*) has been one of the important guidelines for whether a given project could obtain a preferential loan from the China Eximbank (Li 2001, p. 28).[32] In 2003, the NDRC issued a document advocating Chinese firms' overseas expansion, which can drive the exports of domestic technology, products, machinery, and labor services, with the aim of lessening the domestic pressure of redundant workforce and industrial overcapacity.[33] It should be noted that the sub-agencies within the NDRC and the Ministry of Commerce that pursue the agenda of market expansion through CSCEC's global transactions are different from those that seek to advance foreign policy interests through the same transactions. More precisely, in terms of CSCEC's offshore operation, both the NDRC and the Ministry of Commerce are torn between two different, if not conflicting, state agendas. In the absence of institutional coordination, while the

[32] For the details of how the China Eximbank's export credit business helps China's contractors in venturing abroad, see Lu (2005).
[33] See http://www.nanfangdaily.com.cn/nfzm/200908200119.asp, accessed September 19, 2009.

Department of Outward Investment and Economic Cooperation at the Ministry of Commerce pushes CSCEC to go abroad for the sake of market shares, the Department of Aid to Foreign Countries at the same agency sees CSCEC as an instrument to build foreign aid programs. Similar intra-agency dynamics can also be found within the NDRC's control over CSCEC's transnational activities.

Clearly, there is no monolithic state interest in CSCEC's overseas expansion.[34] Each bureaucratic agency seeks to impose parochial agendas on CSCEC's overseas business decisions. Nevertheless, also being members of China's bureaucracy, CSCEC and its managers have both the political will and the capacity to expand abroad in their own way. This private agenda, however, has led to an extension of the inefficient use of state resources, a common strategy to survive in a domestic market with less-developed monitoring mechanisms. Given the state subsidy accompanied by the official advocacy of construction SOEs' "going out," Chinese contractors tend to use unreasonable bidding prices that are far lower than operating costs to compete in international markets. This bidding strategy caused most other foreign contractors to withdraw from projects where Chinese contractors also participated. This explains why in so many cross-border projects only Chinese contractors stayed in the bidding process to outbid one another at the expense of state funding.

Not a few CSCEC managers acknowledged a popular managerial mentality that allows this inefficiency: "It is totally understandable that the first couple of international projects operate at losses. Our goal is very clear: market shares. We are used to engaging

[34] Gill and Reilly (2007) reached a similar conclusion concerning China's Africa Policy and related business operations.

in a price war with our domestic rivals. We see no reason to change it as long as we grab significant market shares." To a large degree, such a mentality directly results in vicious competition among CSCEC's subsidiaries for international projects, such as building construction in Botswana. Given that the CSCEC headquarters lacks adequate authority to coordinate subsidiaries' activities, such head-to-head rivalry actually had negative impacts on maximizing market shares at the aggregate level while wasting corporate resources directly and state assets indirectly. Policy-makers, therefore, repeatedly call for cooperation and coordination among Chinese contractors. Yet the aforementioned fragmented regulatory framework has little effect on CSCEC's behavior at the firm level.

Nevertheless, an encouraging change in CSCEC's offshore ventures began to emerge. While a substantial amount of evidence shows that initial attempts of CSCEC's transnationalization did nothing but extend its inefficient domestic operational mode, CSCEC managers, like their CNPC counterparts, gradually reformed the firm's practice as they became more involved in foreign markets. That is because managerial opportunism is significant in facilitating CSCEC to venture abroad only to the extent that it has a positive impact on a manager's career promotion. In adapting to international markets where information flows are more transparent, CSCEC managers began to pay more attention to market signals and profitability than turnovers. With the progress of the "Going Out" strategy, it is interesting to note that CSCEC's international projects have higher return rates compared to its domestic projects. China Overseas Land & Investment Ltd. (China Overseas) discussed earlier, is the best example, though the trend is by no means confined to Hong Kong.[35] Indeed, the United Nations Conference on Trade and Development 2006 report on the impact of internationalization of firms on developing countries found that " Its [CSCEC's] profitability is much higher abroad than at home…Thus internationalization has contributed significantly to the company's financial performance" (UNCTAD 2006, p. 174).

Also, several senior executive positions at CSCEC's headquarters are occupied by managers who have working experience with subsidiaries abroad. These managers are expected to foster managerial responsiveness to market forces among middle-level and lower-level managers by bringing international commercial best practices into domestic operations. These efforts are bolstered by public listings on developed stock markets that help improve the information environment in which CSCEC operates. International agencies can play a similar role with regard to operations in less developed countries. This is nicely illustrated by the example of CSCEC's contracting a World Bank-supported Philippine highway project. In 2008, the World Bank's Anti-corruption Department issued a report stating that there was a possible collusion in the 2000-2007 Philippine highway projects and that seven international contractors involved were to be barred from World Bank projects for at least four years. CSCEC was one of the four Chinese companies that were listed on the World Bank's sanction list. After receiving the notification from the World Bank, CSCEC headquarters organized an investigation to refute the charge. Nonetheless, the Ministry of Commerce expressed its concern for the

[35] "Dazao Zuiju Guoji Jingzhengli de Zhongguo Jianzhu Jituan " [Create a Chinese Construction Conglomerate with International Competitive Edges], *Guoji Jingji Hezou* [International Economic Cooperation], No. 3, 2007, pp.15-20; "Lanse Mengxiang: Zhongguo Jianzhu Zonggongsi 'Zouchuqu' Jilue" [The Blue Dream: A Sketch of CSCEC's Going Out], *Jianzhu* [*Construction and Architecture*], May 2007, pp. 18-20

incident and asked for further details from the World Bank.[36]

The point here is that the information asymmetry which favors CSCEC's private agenda is being gradually transformed as CSCEC continues to venture abroad. Facilitated by information circulated in overseas markets, Chinese reformers are exposed to the managerial opportunism detrimental to CSCEC's market-oriented reform. Under this environmental change, CSCEC managers, whose career advancement hinges on the Party-state system, are motivated to comply with market rules. This imposition of market discipline on CSCEC's operations, though unintended in the beginning, is welcomed by the state, who reaps the benefit of contracting out the monitoring process. Central policymakers regularly single out construction SOEs like CSCEC as firms that should take advantage of the learning opportunities offered by overseas markets. SASAC's official stance is representative:

> "Central SOEs' 'going out' needs to properly respond to attention coming from various international organizations, international media, and international research institutes. SOEs should develop good communications, play an active role, cultivate flexible power (*qiaoshili*), and enhance influence…SOEs need to actively study and participate in the making of international standards…In particular, central SOEs specialized in construction, energy development, and labor-intensive production need to strengthen their communication with host countries and their societies."[37]

IV. Conclusion

Although CSCEC does not enjoy a near-monopoly like CNPC does, it is still a

[36] See http://news.163.com/09/0116/02/4VOEEPQM0001124J.html, accessed September 19, 2009.
[37] See http://gongyi.people.com.cn/BIG5/10331107.html, accessed November 25, 2009.

beneficiary of China's partial reform in that its bureaucratic ties enable it to succeed in the market without improving its productivity. Before corporatization, CSCEC's underperforming businesses never faced the threat of market exit. Even after corporatization, when CSCEC was released from the pressure of maintaining full employment, its bureaucratic entanglements remained an obstacle to it's becoming a market-oriented commercial entity. Ironically enough, pro-competition reforms actually made CSCEC more inclined to utilize non-market leverage to compete in an increasingly open market. After all, bureaucratic influence is CSCEC's firm-specific competitive advantage. Together with the fragmentation within China's bureaucracy, CSCEC's bureaucratic leverage and commercial motivation render its "going out" as a strategy to pursue corporate interests but not necessarily national interests.

While unintended, CSCEC's "going out" has an effect of imposing market discipline on CSCEC's operations. Admittedly, it still takes time to subject every aspect of CSCEC's operation to this disciplining effect. Nevertheless, by involving non-state investors and international organizations in monitoring CSCEC's businesses, going out ensures that any non-market interference inevitably invites opposition. In this sense, overseas expansion has not only introduced market discipline on CSCEC's behavior, but also solved the problem of conflicting bureaucratic intervention.

Chapter 6. Conclusion

By focusing on the transnationalization of China's central SOEs in general and on CNPC's and CSCEC's overseas projects in particular, this dissertation attempts to show the political logic behind China's "Going Out" strategy. It begins with asking the question of how the Chinese central state and SOEs interact with one another as the "Going Out" strategy unfolds in the post-corporatization period. Building upon the neo-institutional analysis of the principal-agent relationship, this dissertation finds that unlike most of the accusations leveled against China's "going out," Chinese SOEs' global outreach reflects less of a coherent government strategy and more of the firms' pursuit of corporate interests. It also finds that while security and economic considerations explain why SOEs' offshore projects are initiated, bureaucratic politics associated with the transnationalization of these SOEs provide even more important information about the conditions under which the "Going Out" strategy retains its policy momentum. Most importantly, in examining the interactions between China's bureaucratic agencies and its state firms, this dissertation has developed a complete account of how a new state-SOE relationship emerged from the reform agenda of corporatization. In addition to supplementing the conventional wisdom on the transnationalization of China's SOEs, a more general application of this framework also sheds light on SOE reform in China.

I. SUMMARY OF FINDINGS

As I have demonstrated in the case studies of CNPC and CSCEC, the transnationalization of China's SOEs is imbued with corporate interests despite being initiated by the official desire for national security and economic advantages. To be sure, both CNPC's and CSCEC's initial attempts to venture abroad were made to serve national diplomatic and economic interests when their corporate activities were still subject to administrative hierarchical control. During the 1990s, before the official call for comprehensive transnationalization, CNPC's international ventures were heavily influenced by foreign policy objectives while CSCEC's global operations were simply part of China's foreign aid program. This state-SOE interaction, however, changed with the progress of corporatization, particularly with the implementation of the "Going Out" strategy. The firms' commercial motives and corporate autonomy from the state, which was acquired from the reform process, made it increasingly difficult for official efforts to dictate the course of the firms' "going out." Both CNPC and CSCEC were capable of navigating through China's gigantic bureaucracy to get away with pursuing their own commercial interests, which at times ran against policymakers' preferences and national interests.

Admittedly, there are variations in the ways that CNPC and CSCEC bargain with various state regulators, depending on their respective bureaucratic connections. Endowed with the administrative leverage cultivated by its organizational predecessors, CNPC has the upper hand in dominating the formation of national energy policy, including China's expanding hunt for overseas resources. This is usually bolstered by

CNPC's near-monopolistic market position. Such administrative leverage has enabled CNPC to obtain continuous state subsidies to support the firm's transnationalization whether or not it meets political obligations. In this respect, CSCEC, struggling with other similar SOEs in China's liberal construction market, appears less potent in influencing relevant government agendas. Moreover, not until recently, when CSCEC's cross-border projects became an essential element in China's resource diplomacy, did CSCEC benefit from stable state financial support. Nonetheless, it cannot be denied that the CSCEC's management is also capable of ignoring state directives in order to implement its own corporate strategy. In short, the state-backed "Going Out" strategy is far from state-dominated.

This is not to say that CNPC and CSCEC can simply replicate their inefficient domestic operations to their cross-border deals without worrying about political setbacks. Given that China is still an autocracy where the CCP monopolizes political power, SOE managers who are also members of the state cadre system clearly know that their economic behavior will generate political consequences for the future of their careers. Their mismanagement became noticeable when the problem of ineffective monitoring was rectified by the involvement of stakeholders, who are created over the course of SOEs' overseas activities and do not have a vested interest in SOEs' non-market role. This change in information environment forced managerial commercial decisions to be more transparent, open, and accountable. In examining CNPC's and CSCEC's "going out," such adaptation to international practices increasingly imposes market discipline on the firms. Although the adaptation was unintended and is still its infancy, it has affected their decision-making in regard to their offshore operations. In the meantime, it will still take time to observe whether this reform effect will spill over to both firms' regular domestic businesses. All this discussion of my findings leads us to ask how strong exactly is the Chinese state's control over its firms? As I show in the next section, the answer reveals a negotiated interaction between the state and SOEs.

II. HOW STRONG IS THE STATE'S CONTROL OVER STATE-OWNED ENTERPRISES?

In the introductory chapter, I reviewed the existing literature on China's cross-border ventures, most of which build their arguments on the assumption of the mercantile Chinese state. As these studies observed, the Chinese state places itself in the business of promoting overseas expansion of Chinese enterprises, especially those under the management of the central government. In order to fulfill national economic and security goals, the Chinese state provides SOEs with a variety of policy inducements; this has drawn much of the world's attention to the role that the Chinese state has played behind central SOEs' overseas deals. At the same time, the rapid surge in the global presence of these gigantic state firms, which were in deep financial trouble just a decade ago, further offers evidence for the contention that SOEs' overseas operation is only an instrument for the Chinese state to project its power abroad. These studies unconditionally accept the notion of strong state control over SOEs in the context of a socialist China. What I cannot emphasize enough, however, is the changing relationship between the state and SOEs during the reform era. Therefore, while the traditional state-centered analysis provides a starting point to address the issue of China's overseas investment, this approach does not adequately explain reality.

In China, where the state retains the ultimate authority over the course of economic development, it is easy to find evidence for an argument in support of a strong state. In Chapter 3, we have seen that over the course of the economic reform, Chinese reformers mindfully retained strategic assets under public ownership for the sake of the CCP's political interests. The incorporation of SOE managers into the state cadre system provides the state with a primary channel through which to ensure the fulfillment of SOEs' political functions. Such personnel control, as identified by many China scholars, builds the groundwork for the reign of the Chinese Communist Party (CCP).[1] It also suggests strong state interference in SOEs' corporate affairs - not simply because the state can remove SOE managers from their positions in the firms but, more importantly, because the state has the final say about managerial career prospects along the party/ bureaucratic ladder.

Yet when the preceding personnel appointment system is examined in the context of economic reform intended to foster SOEs' commercial interests, the relationship between the state and SOEs becomes more complex than any existing literature on China's outbound investment will acknowledge. As I have elaborated through the case studies of CNPC and CSCEC, while the selection of SOE senior management is subject to the nomenklatura system, the ensuing managerial administrative ranks actually give

[1] See, for example, Shambaugh (2008).

them considerable bureaucratic leverage to bargain with policymakers. With bureaucratic positions that are equivalent to central regulators, senior managers in CNPC and CSCEC make every effort to protect the firms' market privilege that had been gained from partial economic reform. The tendency becomes even more apparent when SOE managers' economic performance becomes increasingly important in deciding their career advancement.

In the language of principal-agent relationships, this institutional arrangement suggests that agent SOE managers are bestowed equal bargaining power to evade principal regulators' monitoring. Seen from this light, the state's control over SOEs in China's authoritarian political system is not as tight as one might expect. The state's grip on SOEs' operations is further weakened by the conflicting interests of the many bureaucratic agencies connected to the SOEs, frustrating the emergence of a consistent regulatory framework. In the meantime, China's half-way economic reform has invited resource misallocation and price distortion in the marketplace, providing fertile ground for managerial rent-seeking. From this institutional environment comes an apparent paradox. The personnel appointment system which is designed to control SOE managers suggests that effective monitoring over SOEs' operations is nearly impossible. This dilemma is an institutional embodiment of the incompatibility between SOEs' political and economic functions. It is against this backdrop that SOEs' overseas expansion was initiated.

Let me return to the question I raise in the beginning of this section: how strong is the state's control over SOEs in today's China? As I discuss above, it is not an easy question that can be answered from a dichotomous perspective. Rather, it is an issue that needs to be tackled based within a dynamic and fluid framework. When SOE managers form different lobby groups based on their commercial positions, their interests prevail vis-à-vis the national interests represented by central decision-makers and technocrats.

Nonetheless, in my study of China's overseas investment policy as a window to the state-enterprise relationship, central reformers' leverage over state firms is also influenced by the degree of the economy's openness. The more SOEs' operations are integrated into the world economy, the more information is made available that can enable regulatory agencies to monitor SOEs' economic activities. In this sense, the relationship between the state and SOE is best seen as an interaction growing out from constant bargaining and negotiation. The theoretical framework of principal-agent analysis perfectly captures the essence of this dynamic relationship: Both principals and agents involved in China's "Going Out" strategy – state bureaucratic regulators and SOE managers – behaves in a rational way to maximize their utilities under the institutional constraints embedded in the incentive structures of the CCP governing system.

III. A POSSIBLE SOLUTION FOR PARTIAL REFORM EQUILIBRIUM?

My study of China's "Going Out" strategy also raises another important question: how can China escape the partial reform equilibrium that hinders the emergence of a full-fledged market economy? My finding on the embryonic market-disciplining effect of transnational operations suggests that the outcome of the partial reform is by no means preordained. To be sure, China's authoritarian political regime is said to be more likely to be trapped into "partial reform equilibrium" because political power is only distributed among a few actors. China's SOE managers, a powerful and concentrated group of early winners in China's partial economic reform, can easily lobby decision-makers to maintain their privilege (Hellman, Jones, and Kaufman, 2000). Nevertheless, while managerial resistance to market-oriented reform policies has made the economic transition an incomplete one, firms' increasing commitment to overseas markets began to alter the managers' habitual behavior. As shown in the CNPC and CSCEC case studies, there were encouraging signs that managerial rent-seeking was becoming more constrained with the progress of the firms' "going out" -- a shift in behavior that could not be achieved in the domestic market.

While my study only covers CNPC and CSCEC, there are actually a number of SOEs in the oil and construction industries that have been brought under transparency regulations due to their transnational transactions. Sinopec and CNOOC, the other two Chinese oil oligopolies, have become global players that have opened themselves up to international investors. Although the presence of central construction SOEs in international capital markets is relatively recent compared to their counterparts in the oil industry, they have long been involved in international contracting in developing countries, which usually falls under the scrutiny of international organizations.

In addition, it is also useful to take a quick look at the evolution of overall overseas performance in the SOE sector. In the absence of accurate official statistics, a common official comment at the initial stage of the "Going Out" strategy was that only one-third of China's offshore projects claimed to be profitable. Encouragingly enough, the most recent government report released by the Ministry of Commerce declared that over 86 percent of central SOEs have engaged in transnational operations, among which about 80 percent announced a surplus in 2008.[2] In other words, while it remains to be seen how far the reform effect brought about by the "Going Out" strategy can proceed, it represents a fresh attempt to overcome the trap of what Hellman (1998) labeled "partial reform equilibrium."[3] It is worth mentioning that Gallagher (2005) argues that a similar reform effect on the state sector was brought about by FDI in China's domestic economy. Through her study of China's labor reform, Gallagher finds that FDI imposed competitive pressure on SOEs to attract skilled labor in ways that improve their business efficiency. My work adds to her discussion by introducing another condition under which the integration of China's state sector into the world economy will improve SOEs' corporate practices.

Finally, what is the implication of such a state-enterprise relationship for China's future development? I would argue that a strong public ownership sector that is capable of bargaining and negotiating over the terms of the state regulations will become an obstacle to Chinese reformers' expectation for further sustainable development with equity. As Huang (2008, p. 277) pointed out, the Chinese economy nowadays is "a commanding-heights economy, similar to that of many of the developing economies of 1970s vintage…it is a far cry from claiming that the Chinese economy today is based on

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[2] See http://www.gov.cn/gzdt/2009-09/16/content_1419422.htm, accessed September 30, 2009.
[3] For a discussion on the issue of partial reform equilibrium in the Chinese and Vietnamese transition economies, see Shih (2007) and Malesky (2009), respectively.

private-sector dynamism and a market orientation." At the time of this writing, there is a new round of restructuring of central SOEs in China, aiming to concentrate industrial resources in fewer large central SOEs. Chinese reformers have cut the number of central SOEs from 196 in 2003 to 132 in 2009 and continued to encourage SOE mergers to form national flagship business groups. With the East Asian model mainly bearing Japan and Korea in mind,[4] their ideal number of central SOE conglomerates is targeted at 80-100 by 2010, among which 30-50 are to have international competitive edges. "Controlling economic lifelines," as Chinese reformers have announced, is the final goal of the so-called "strategic adjustment and restructuring" of the SOE sector.

This SOE reform agenda in the post-WTO era puts the Chinese state at the core position to engineer economic growth by assigning a dominant role to public ownership. Pei (2006) and Huang (2008) present a large body of evidence that such a development model inevitably encounters the issue of corruption as the state's grabbing hand continues to be empowered. While concurring with their observations, my study further implies that the competitiveness gap between the public and private sectors in China is exponentially enlarged. Compared with the small-scale private firms dwarfed by the domestic market environment, government-favored SOEs further sharpen their business strategies with their international experience.

Such a development need not be a worrying concern as long as the SOE sector performs its distributional role in society. Unfortunately, what happens in China is just the opposite, rendering a dual transition in China implausible for the foreseeable future.

[4] Taiwan's respectable economic take-off during the 1970s mainly relied on a large number of robust private enterprises rather than large business groups.

Dual transition, consisting of economic liberalization and political democratization, has been central in the study of political economy in general and post-communist transformations in particular.[5] According to the neoliberal argument, economic liberalization changes the distribution of power in society and eventually leads to political democratization.[6] Examined against this notion, China's fast-growing economy and the official strategy to maintain a high rate of growth suggest the resilience of the communist regime in China. Heavily relying on politically connected SOEs, China's economic development has never truly cultivated an economically independent Bourgeois class capable of challenging the existing power structure. It is thus ironic to find that a successful escape from the trap of partial reform equilibrium sows the seeds of an unsuccessful transition to democracy.

[5] For a recent review of the relation between development and democratization, see Przeworski, Alvares, Cheibub, and Limongi (2000).

[6] There are two versions of power redistribution during economic development. See Rueschemeyer, Stephens, and Stephens (1994); and Moore (1966). While Rueschemeyer et al. claim that the working class plays a pro-democratic role in the neoliberal economic reform in Latin America, Moore argues that economic development and democracy are primarily associated through the expansion of the middle class in Britain and France.

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