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Developmental State and Corporate Governance in China

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ABSTRACT China's state-guided economic miracle has revitalized a long-standing and unsettled debate about the role of government in transformative economic development. In a firm-level study of corporate governance we examine whether direct state involvement actually makes a positive contribution to the economic performance of newly incorporated firms in China's urban economy. We show that direct intervention into the governance of firms is likely to yield negative economic effects at the firm level. We infer from our findings that it must be other types of government intervention external to the firm that explain the success of China's developmental state in promoting rapid economic growth.

KEYWORDS firm performance, fiscal federalism, market transition, politicized capitalism, soft-budget constraint, state-firm relations

INTRODUCTION

China's market transition from a poor agrarian state socialist economy to a dynamic capitalist engine of global economic growth has riveted attention on the role of government in promoting transformative economic development. Frye and Shleifer (1997) depict the Chinese state-guided economic reform as the role model of a 'helping-hand state'. This 'helping-hand' explanation of China's economic miracle has gained broad acceptance in the comparative analysis of economic transition. As Stiglitz observed, the contrast between Russia's transition, which was designed by Western economists and international economic institutions and that of China's self-help state-guided approach could not be greater: 'While in 1990 China's gross domestic product (GDP) was 60 percent that of Russia, by the end of the decade the numbers had been reversed. While Russia saw an unprecedented increase in poverty, China saw an unprecedented decrease' (2002, p. 6). According to the World Bank (2004), transformative economic growth in China resulted in a population of 170 million moving out of absolute poverty, accounting for more than 75 percent of poverty reduction in the developing world from 1990 to 2000.

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China's explosive economic growth appears to have self-sustaining momentum. By 2040, the *Economist* (16 September 2006, p. 10) predicts China will emerge as the largest economy in the world. Not surprisingly, international economic institutions now view China as the latest entry in the pantheon of successful developmental states, along with South Korea, Taiwan and Japan (Stiglitz, 2002).

China's policy model clearly resembles core features of the dominant paradigm for the development of East Asian Newly Industrialized Countries (White and Wade, 1988), building on a strong authoritarian national leadership and an elite state bureaucracy pursuing developmentally oriented policies, including the direct means of governing the market (Wade, 1990). In Japan's post-war economic development, the Ministry of International Trade and Industry (MITI), for instance, intervened both at the firm level and at the level of macroeconomic policy to facilitate Japan's export-driven growth strategy (Johnson, 1982). However, which type of government action actually promoted transformative economic growth remains underspecified in the developmental state literature (Evans, 1989; Evans et al., 1985). In this sense, as Wade (1990, p. 26) rightly criticizes, developmental state theory has little to say 'about the nature of policies and their impact on industrial performance'.

Similarly, the causal mechanisms of China's economic success are not yet well understood. Is China's economic success due to the government's organizational capacity to monitor and intervene in firms' decisions? Walder's (1995) version of 'local state corporatism', characterized by Peng (2001) as the 'corporate governance approach', explains the success of China's rural industry as the effect of fiscal decentralization on the incentives for lower-level government officials to promote economic performance in their jurisdiction. According to this view, when government has clear incentives and the ability to monitor firms and enforce their interests as owners, government officials can replace the entrepreneur as the mechanism driving improvements in firms' economic performance. Or is China's success, quite to the contrary, built on: the gradual liberalization of product and labour markets; increasing openness to foreign trade; investment in infrastructure and institutional reforms such as property reforms; and quasi-privatization? These would provide individual actors with sufficient security for planning, investing and economic risk taking.

Building on the long-standing debate on government intervention, we test whether government involvement at the firm level has positive effects on the firm's performance. In particular, we engage in a micro-level study of state-guided economic development in China, investigating whether government officials' involvement in monitoring and intervening in corporate decisions actually make a positive contribution to the economic performance of firms. We focus on China's newly incorporated listed firms which have organizational features and incentive structures previously identified as crucial characteristics of China's rural industry. As described in Walder's (1995) state-centered approach on rural township-village

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enterprises (TVEs), listed firms are operating under hard budget constraints and state representatives in charge of administering government-owned shares are benefiting from greatly improved monitoring and screening devices compared with the management of traditional state-owned enterprises. Similar to TVEs, the structure of corporate governance of listed firms enables the government jurisdiction that owns a share in the firm to monitor and intervene actively in the firm. Listed firms comprise China's key enterprises, singled out to be the mainstay of economic development and emerging capitalism (they comprise the whole spectrum of sensitive key sectors of the national economy with firms being involved in power generation and distribution, telecommunications and natural resources processing). As large-scale, modern corporations, China's listed firms represent the classical target of state monitoring activity, the big business groups and conglomerates in core industries (as in Japan and South Korea). Briefly, the listed firms are a core component of China's industrial landscape and will critically determine national competitiveness on global markets and national development prospects. For example, firms leading China's bid as a global economic power, such as China National Offshore Oil Corporation, are listed on the Shanghai Stock Exchange. The crucial role of listed firms as a development tool is acknowledged by Article 3 of the 'Preliminary methods for state asset management of listed firms', which emphasizes the need to develop firms in line with industrial policy programmes and national investment priorities.[1] Controlling shares in most of the previously wholly state-owned firms remain in government ownership.

Our study seeks to clarify whether or not China's success in state-guided economic growth can be attributed to direct government intervention in corporate governance. To address this question, we examine the effect of government intervention in the corporate governance of firms listed on the Shanghai Stock Exchange. The paper proceeds as follows. The next section gives a brief coverage of the debate on government intervention. We will then specify why China's state-guided approach to economic development shares the core components of the East Asian developmental state. The following empirical part will test whether direct government intervention yields positive economic effects at the firm level.

HYPOTHESES

The Debate on Government Intervention

In the liberal political economy since Adam Smith's *Wealth of Nations* (Smith, 1776), the government monitors and enforces the regulatory environment in which firms compete for survival and profits, but should not directly be involved in a firm's decisions and transactions. Multiple explanations have been advanced to account for why state control over economic activity will lead to economic

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failure. Public choice theory calls particular attention to the self-interested behaviour of bureaucrats who seek to maximize their own budgets (Niskanen, 1971) and politicians who give priority to securing political support (e.g., votes) in order to increase their chances for staying in power (Buchanan et al., 1980). Further, the rent-seeking activities of organized interest groups and politicians override the idea of a Benthamite welfare state as a neutral arbitrator (Krueger, 1974; Shleifer and Vishny, 1994). Another vein of the economic literature warns that direct involvement of state officials who impose on the firm multiple political interests (e.g., job creation) dilutes profit-making motives when social objectives collide with the firm's profit goals (Sappington and Stiglitz, 1987). A weakening of profit motives may also result from the government's willingness to share entrepreneurial risks with the private economy. Risk sharing by government (via state ownership, state guarantees, or the provision of preferential treatments) may lead to soft budget constraints, with the well-known negative effects on the firm's efficiency (Kornai, 1980). Finally, informational asymmetry and uncertainty critically limits the effectiveness of government coordination of economic activity at the firm level. While the existence of market failures that could be improved by some kind of sectoral policy is not ruled out, scepticism remains about whether or not politicians and bureaucrats are willing and able to mitigate those deficiencies without creating even greater market distortions.

It is impossible, Hayek (1945) argues, for government to have the requisite information to plan and coordinate economic activities effectively. Although bureaucrats might be suitably chosen to command the best knowledge available, this professional expertise will not suffice. This holds whether the government unit is a central ministry or local government bureau insofar as no individual government official has the requisite knowledge to outperform the market mechanism. Successful planning requires unorganized knowledge of the particular circumstances of time and place that 'never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which the separate individuals possess' (1945, p. 519). It is the market, through the price system, which serves as the only effective communication mechanism, coordinating relevant facts and promptly signalling changes in the economic structure and the emergence of new profit opportunities. To the extent that societal planning distorts the entrepreneurial-competitive discovery process, either on a society-wide scale or by means of discretionary intervention, government officials 'are at the same time both smothering the market's ability to transcend the basic knowledge problem and subjecting themselves helplessly to that very problem' (Kirzner, 1984, p. 416).

In sum, liberal political economy asserts:

Hypothesis 1: Government involvement in the firm results in negative consequences on the firm's performance.

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In contrast, political sociologists have generally viewed state intervention in economic life in a positive light. Weber ([1922] 1978) argued that bureaucracy in its rational-legal form was a core institution of modern capitalism because it enabled government to intervene to support markets with technical efficiency and rigorous calculation. In his debate with economics on the effects of state intervention, Evans (1989) criticizes public choice theory for its neo-utilitarian vision of the state as driven by self-interested maximizers. Such a one-sided focus on the self-interest seeking of politicians cannot explain the state's sustained long-term commitment to corporate goals. Evans's own discussion of the developmental state integrates Weber's insights on the close positive relationship between bureaucracy and markets with central themes of development economics contributed by Gerschenkron (1962) and Hirschman (1958). While Evans does not rule out opportunistic behaviour and the justified concerns of the public choice school, he points to specific structural features of bureaucratic organization that serve to constrain the abuse of power and enable beneficial state involvement. In his version of the developmental state, as he conceives it, this bureaucracy has sufficient autonomy so that bureaucrats can pursue long-term objectives, while being connected enough to private capital to be responsive to how changing economic realities affect entrepreneurial interests (Evans, 1995). This quality of 'embedded autonomy' enables state actors to inform long-term development goals with up-to-date information gained from ongoing connections with key economic actors. Asserting that 'entrepreneurial activity on the part of the state is a necessary part of economic transformation' (1989, p. 562), Evans calls attention to Japan's MITI to illustrate how a highly disciplined elite state bureaucratic organization can motivate and guide firm development, with bureaucrats directly involved in the strategic action of firms. He refers, for example, to Okimoto's (1989, p. 157) observation that the 'deputy director of a MITI bureau may spend the majority of his time with key corporate personnel' (Evans 1989, p. 574).

Walder's (1995) explanation of China's economic miracle highlights the anomaly that rapid economic growth was led by public enterprises. This departure from the East Asian developmental model points to an even larger role for government in motivating and guiding China's industrial growth. While he – as does Evans – admits the general risk of soft budget constraints for public enterprise as specified by Kornai (1980), Walder claims that there is no inherent reason that public enterprise led by government officials cannot achieve the high levels of economic performance of a private enterprise economy. The soft-budget constraint problem identified by Kornai in Walder's view is rooted in weaker financial incentives for government officials and difficulty in securing firm-level information of higher administrative units of government. According to Walder, lower-level governments are to a far lesser extent troubled with problems such as weak financial incentives, the pursuance of non-financial objectives (as employment provision and provision of social welfare and housing) and weak monitoring

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capacities commonly associated with central ministries. Local government officials are therefore well positioned to intervene in a growth-promoting and entrepreneurial way in 'virtually all major decisions regarding the hiring and compensation of managers, the establishment or closing of firms, the mobilization of investment capital, changes in production line and marketing strategies' (Walder, 1995, p. 271). On the one hand, government officials act as 'market-oriented agents' due to stronger financial incentives (as a result of fiscal federalism) and weaker political constraints that prevent the closure of firms; on the other hand, local government officials have superior information and monitoring capacities due to close proximity to the rural small and medium-scale industrial firms. While Walder developed his state-centered argument to explain the rapid growth of China's TVEs, his theoretical logic is not restricted to rural areas. His explanation for why government can act in an entrepreneurial style to promote rapid industrial growth 'bears upon the *incentives for government officials*' and the capability for localized access to firm-level information and capability for effective monitoring (Walder, 1995, p. 265). The helping-hand version of the developmental state argument therefore suggests the general claim:

> *Hypothesis 2: Given appropriate reforms providing both fiscal incentives and appropriate monitoring capabilities, firm-level involvement by government officials yields positive effects on the firm's performance.*

State Interference in China's Firms

While developmental state theory does not provide a clear-cut specification of the defining institutional features and policies (Wade, 1990, p. 26), China's current economic policies resemble common features of the various veins of the developmental state literature. Three mutually reinforcing organizational and institutional changes define crucial incentives and government capabilities, which frame the interactions between government officials and firm-level economic actors.

Strengthening bureaucratic organizational capacity after Mao. Rebuilding and modernizing China's bureaucracy has been the government's priority since the start of state-guided economic reform. The decade-long tumultuous upheaval of Mao's Cultural Revolution had demoralized and crippled China's state apparatus. At the outset of market-oriented reforms the leaders realized that modernization of the bureaucracy was essential to effectively implement their ambitious new policies. As a result of the administrative reforms carried out in the 1980s, government regulations and procedural guidelines have become more and more precise and transparent (Yao, 2001). This has increased the predictability of bureaucratic decisions and reduced the uncertainty of economic planning.

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As in other East Asian developmental states, the formulation and implementation of industrial policy is a central pillar of the state's development strategy. The first so-called industrial policy (*chanye zhengce*) guidelines were implemented in 1989,[2] when the government perceived that the old planning apparatus was no longer appropriate to steer economic – particularly industrial development – priorities in China's liberalized market environment. Since then, the government has frequently revised and reformulated industrial priorities in an effort to single out future winners and losers in the ongoing structural transformation of the economy. Common instruments such as market entry regulation, taxation and loan decisions are part of government's tool-kit to influence the direction of structural transformation (Lu, 2000).

In parallel, administrative reforms in the 1980s introduced strict retirement ages for government officials and a one-time buy-out strategy to retire old veterans as a means to push out Maoist bureaucrats who were impeding progress in market-oriented economic reforms. Reformers also sought to build a modernized bureaucracy by implementing merit-based entrance exams and promotion schemes (Li, 1998; Li and Lian, 1999; Nee, 2000). Average education levels increased tremendously with university graduates meanwhile being the majority of new entrants.

A high turnover in bureaucratic personnel reduces the risk of bureaucratic inertia and commitment to the old planning mentality of state socialism (Lipton and Sachs, 1990). Moreover, merit-based appraisal of government officials and performance-based incentive schemes reinforce incentives in the bureaucracy to improve economic development (Chen, 1999; Li and Lian, 1999). Recent empirical evidence for the period between 1978 and 1995 confirms that the likelihood of promotion of provincial leaders actually increases with a province's economic performance while the likelihood of termination decreases (Li and Zhou, 2005).

Fiscal federalism. The theory of state and local finance has long stressed that competition among government jurisdictions has a disciplining effect on government action and provision of public goods (Tiebout, 1956). Two main mechanisms embedded in jurisdictional competition impose constraints on government economic policies and spending (Qian and Roland, 1998). First, under the assumption of factor mobility, Weingast's (1995) federalist model shows that competition among local governments increases opportunity costs of bail-outs and any activities leading to inferior enterprise performance. Government jurisdictions unable to provide a hospitable business environment risk failure in competitive bidding for investments and resources needed to promote local economic growth. Hence, competition between government jurisdictions in a federalist system eventually limits discretionary authority, predatory behaviour and rent seeking. Secondly, in federalist systems, fiscal decentralization may harden the budget constraints of government jurisdictions and provide incentives for the efficient provision of public goods. Qian and Roland argue that their model of local federalism explains the

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emergence of institutionalized competition in which local governments compete to build a business environment favourable to private capital.

In the mid–1980s China's fiscal reform led to a key institutional innovation that altered the relationship between levels of government. The policy of fiscal decentralization strengthened the economic incentives of municipal and provincial governments to support market-oriented economic reform. First, enterprises were to be taxed according to a fixed rate, with the residual left to the enterprise to improve incentives for managers of state-owned enterprises. Secondly, the tax revenue collected from enterprises by a government jurisdiction was also assigned a fixed rate, according to which local government was given residual claim above the contracted amount to be turned over to the next higher level of government (Oi, 1992; Wong, 1992). The more local firms prosper, the faster the economic growth of the region, the greater the size of the residual available to the government jurisdiction (Walder, 1995). In other words, lower-level governments increase their revenue to the extent that they succeed in promoting economic development in their jurisdiction. In this sense, fiscal federalism is a central precondition for why local level governments are indeed motivated to intervene and manage local firms in an entrepreneurial style (Li, 1998; Montinola et al., 1995; Oi, 1992; Walder, 1995; Wong, 1992).

Company Law of 1994. In the 1990s, state-crafted institutional change established the framework for the conversion of state-owned enterprises into public corporations. The objective was to transform loss-making state enterprises into profit-making firms through corporatization and listing on stock exchanges. Listed firms gained ready access to investment capital and the legitimacy conferred by the legal status of a public corporation. With the Company Law (1994), the government sought to bring organizational standards in line with Western-style corporate governance (Guthrie, 1999). A vision of corporate governance clearly modelled after the modern corporation replaced the old state socialist model of party and government managerial control over the firm. As in the West, the board of directors and the CEO now play a crucial role in the company's management (Wong et al., 2004).

The implementation of the Company Law has altered both the quality and intensity of government intervention in firms, depriving the government of its former unchallenged monopoly rights and control over former state-owned enterprises. Corporatization and stock exchange listing has reduced the average state shareholding in firms listed on the Shanghai Stock Exchange to about one-third of firms' total shares. Consequently, the bureaucrats representing the state's equity interest on the board of directors are members of a mixed committee representing diverse stakeholder interests, although minority shareholders are still underrepresented. In order to professionalize the management of state-owned property, the management of state assets was decentralized. Locally, there are basically three

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types of organization responsible for the management of state assets – business groups, state asset operating companies and local finance departments. These agencies benefit from a higher level of professional specialization and the improved monitoring and information capabilities resulting from their clear authority structures, responsibilities and task formulations. In addition, there are fewer firms for government to oversee than in the past. Formally state asset operation companies are charged with the responsibility of preserving and increasing the value of state property. They are external to the firm, but they maintain a direct tie to it through their participation in corporate governance as members of the board of directors representing the government-owned shares. As such, they are entitled to represent the government's interests in a firm's strategic decisions, albeit within the framework of an advisory capacity as stipulated by the rules of corporate governance of the Company Law (1994). Thus while the firm's top executive – the CEO – has full control over its management, government has a voice as a shareholder – the more so the larger its ownership share in the firm – and votes on strategic decisions. Essentially, corporatization and listing of state firms, coupled with the decentralization and professionalization of state asset management, resemble core features of rural industry management, where public assets were professionally managed and administered by local government bureaus in charge of industry development (Oi, 1992; Walder, 1995).

Through these post-Mao structural reforms, the Chinese state has evolved into a developmental state similar in its core features to its East Asian counterparts in Taiwan, South Korea and Singapore. However, it differs from these states insofar as the Chinese Communist Party (CCP) retains coordination rights alongside the government bureaucracy. For this reason, it is imperative in an analysis of state activities to examine the effects of the intervention of both government bureaucrats and party politicians on firms' performance.

In addition to the classical bureaucratic channel of intervention – as common in the East Asian developmental states – local party committees provide a second channel of state involvement in China. Party committees are in essence networks of political actors internal to the firm that the state can draw on to support its policy initiatives and to provide timely and detailed information about personnel and other matters. Their formal position within the firm is guaranteed by Article 17 of the Company Law, which specifies 'the activities of the local branch units of the CCP in a company shall be carried out in accordance with the Constitution of the CCP.' This Constitution particularly delegates the implementation of higher party decisions to local party committees and grants them the right to 'supervise party cadres and any other personnel'. This provision (Article 31) formally confers on the local party committee the right to control personnel decisions in state-owned firms (Bian et al., 2001). In reality, party members usually succeed in remaining involved in almost all domains of corporate decision-making; they generally exercise a stronger influence in the firm than government bureaus.

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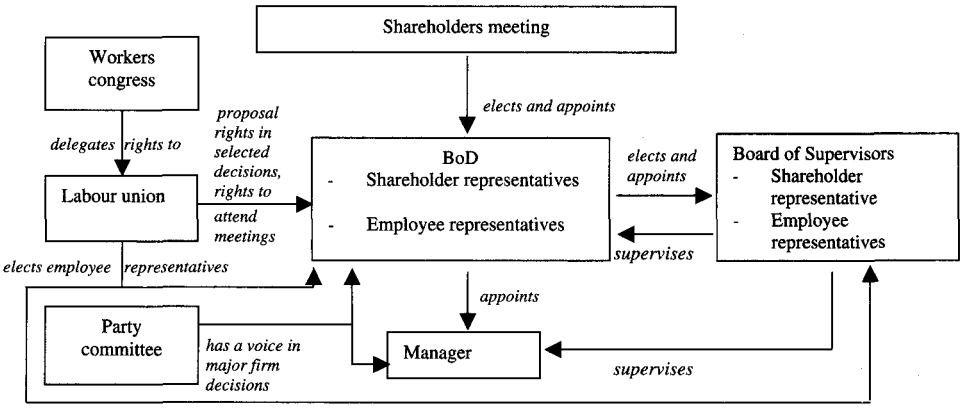


Figure 1. Corporate governance of China's listed firms (according to Company Law)
Source: Nee and Opper 2007.

The incentives of local party committees, however, may differ significantly from the local government jurisdictional unit with shareholding interest in the firm. The party committee neither has residual claims nor direct benefits from local tax revenues. Party members, moreover, are insufficiently insulated from patron-client ties and may easily be 'captured' by interest groups or be tempted to maximize their own self-interests. In sum, the party committee presides over a political network in the firm that can be used to mobilize informal opposition to reform policies that threaten vested interests in the firm (Nee, 2005). Figure 1 sketches the internal structure and persisting links between the 'three old committees' [*lao san hui*, i.e. the party committee, trade union and workers congress] and new decision-making bodies [board of directors, manager and board of supervisors].

METHOD

We use data on the corporate governance of firms listed on the Shanghai Stock Exchange, the commercialized and privatized former large-scale state-owned enterprises that comprise the core of China's urban industrial economy. The Shanghai Stock Exchange distributed questionnaires to each of the 483 listed firms. Of these, 257 firms returned the questionnaires (response rate: 53.54 percent). To ensure data quality, we compared the survey data on basic firm characteristics, including listing age and industries, with those provided by annual firm reports. Of the 257 returned questionnaires, we excluded one because it contained inconsistent data. In line with our aim to provide an encompassing measure of direct state intervention at the firm level, we decided to limit our sample to firms providing complete survey data, reducing the total number to 72.[3] We then excluded six firms newly listed in 1999 which did not have lag performance data. Our final

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sample therefore consisted of 66 firms, which still represents 14 percent of all the firms listed by the A-share market on the SSE.

At the end of 1999, 59.45 percent of the firms listed by the Shanghai Stock Exchange belonged to the manufacturing industries, 17.20 percent were conglomerates and 11.67 percent belonged to the wholesale and retail industries (see Appendix I). The top three industries account for 79.61 percent of all the listed firms. Within our sample, 59.09 percent of firms belong to the manufacturing industry, 24.24 percent are conglomerates and 9.09 percent belong to the wholesale and retail industries. Overall, our sample appears to comprise an acceptable representation of the overall industrial structure of the firms listed on the Shanghai Stock Exchange, without a critical response bias, although characterized by an overrepresentation of conglomerates, i.e. large business groups, which indeed play a crucial role in China's developmental strategy (Keister, 1998). Furthermore, the financial leverage (debt asset ratio), firm size (log of sales), ownership structure (percentage of state shares) and return on assets of our sample firms do not show any serious deviation from the mean values of the total population of listed firms at the Shanghai Stock Exchange (Appendix II). Only the profitability measure Return on Equity shows an upward bias, with 0.9 compared with the total population with a mean value of 0.6. A comparison of the respective standard deviation of both measures suggests that our sample is characterized by a smaller proportion of outliers in terms of performance measured by return on equity. Since political intervention is assumed to be closely tied to industrial priorities, firm size, profitability and financial leverage, there is strong reason to suppose that our sample does not suffer from a non-response bias in terms of political interventions at the firm level.

The questionnaire used by the Shanghai Stock Exchange's survey of listed firms asks respondents (secretaries to chairmen of the board of directors)[4] to rate the level of decision-making power (at end-1999) of shareholders (through shareholders' meetings), boards of directors, managers and state actors such as local party committees and the responsible bureaus of government administration in 63 different types of firm decisions, including decisions on finance and investment, appointment and dismissal of key personnel, performance appraisal, organizational change, strategic planning and external relationships. Responses are based on the following scale: 1 (no involvement), 2 (have some influence), 3 (have significant influence), 4 (have decisive influence) and 5 (complete control).[5] The survey includes 74 questions covering almost every aspect of firms' corporate governance. Therefore, it is unlikely that the respondents could have perceived the specific linkage between state intervention and firm performance. Appendix III summarizes the mean values of decision involvement by these various groups.[6]

In general, the survey confirms that the distribution of decision-making power among boards of directors, managers and shareholders' meetings within China's listed firms actually resembles the corresponding distribution among Western-style

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firms. Across the 63 decision areas (last row of Appendix III), the board of directors is most heavily involved in decision-making (mean = 3.61), followed by managers (mean = 3.02), followed by shareholders (mean = 2.66). Nonetheless, party committees (mean 1.65) and government bureaus (mean 1.25) remain directly involved in the decision-making, although state control is significantly weakened since the pre-reform era.

Measures

State involvement. We use data on party and government involvement over 63 corporate decisions to construct four measures of state intervention. For each firm, we construct an index of overall party (PI_A) and government intervention (GI_A) by averaging the level of involvement of the local party committee and the responsible government bureaus, respectively, in all decisions.

$$PI_{Ai} = \frac{\sum_{j=1}^{n} S_{ij}}{n} \qquad GI_{Ai} = \frac{\sum_{j=1}^{n} S_{ij}}{n} \tag{1,2}$$

S_{ij} is the level of intervention of state actors of firm i in decision j, in all 63 decisions ($n = 63$). Nearly all major firm decisions are included, providing us with a comprehensive measure of state intervention.[7]

Our average measure, however, may conflate varying economic effects of different state interventions in the firm. Thus, to additionally investigate specific domains of such interventions, we grouped corporate decisions into three broad clusters – personnel, financial and strategic – all affecting mechanisms of corporate governance: the market for managers, the financial market and the product markets, respectively. These domains are also consistent with those areas of government intervention described for China's township and village enterprises (Che and Qian, 1998; Oi, 1992; Walder, 1995).

Interventions in personnel decisions establish close networks between state and economic actors that allow other timely and direct interventions, whenever state involvement is deemed necessary, in order to realize industrial policy objectives or other types of development strategies. Our dataset confirms that China's local party committees actually exert the most control in personnel decisions, especially: (i) the selection of functional department managers; (ii) the selection of business department managers; (iii) the selection of branch managers; (iv) the selection of subsidiary managers; and (v) the selection and dismissal of vice-CEOs (see column 6 of Appendix III). In essence, party involvement concentrates on human capital issues, which have been a central focus of the nomenklatura system for decades of socialist planning (Shirk, 1992, p. 61). The fact that local party units tend to have a high level

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of involvement in decisions assigned de jure to the enterprise manager suggests that they may use the manager's office as their venue for interventionist activities. Personnel dependencies reinforce informal network ties with decision-makers within the firm, which can then easily be activated for further state intervention.

Similarly, intervention in financial decisions can be used to manipulate resource allocation in line with the state's industrial policy priorities and development objectives. Studies of the other Asian developmental states suggest that state interventions were particularly common in financial decisions, including those regarding loans, mergers and acquisitions, the issuing of new shares and so on (Kang, 2002; Whitley, 1999). For China it is well documented that local governments were particularly active in providing financial resources and pooling resources to promote the development of China's TVEs (Che and Qian, 1998). Similarly, our dataset confirms that with an overall mean of 1.41 (see column 7 of Appendix III) government officials actually exert more influence on financial decisions than on any other area of firm governance. Four out of the top five decisions (column 8) are related to financial issues, including (rank 1) decisions on being merged, (rank 3) merging with other firms, (rank 4) changes in shareholding structure and (rank 5) decisions on share placements and new issues.

Finally, a firm's strategic decisions, such as the entry into new markets and industries or the creation or abolition of new departments, branches and subsidiaries, critically affect market development and may therefore be closely screened by any state seeking to promote structural change. Although neither party nor bureaucracy has a particularly strong influence on strategic decisions, the party's mean value of involvement (1.77, column 5) is still above the overall average of 1.15 (last row). In contrast, government influence in strategic decisions is 1.24, about the same as the mean value of all 63 decisions (1.25, last row).

To investigate the performance effects of state intervention in these policy domains, we construct three measures to capture the level of state intervention in personnel decisions (PI_P and GI_P), averaging 20 decision-types overall; in financial decisions (PI_F and GI_F), averaging 18 decision-types; and in strategic decisions (PI_S and GI_S), averaging nine decision-types, respectively (see Appendix I).

$$PI_{Pi} = \frac{\sum_{j=1}^{n} S_{ij}}{n} \qquad PI_{Fi} = \frac{\sum_{j=1}^{n} S_{ij}}{n} \qquad PI_{Si} = \frac{\sum_{j=1}^{n} S_{ij}}{n} \tag{3,4,5}$$

$$GI_{Pi} = \frac{\sum_{j=1}^{n} S_{ij}}{n} \qquad GI_{Fi} = \frac{\sum_{j=1}^{n} S_{ij}}{n} \qquad GI_{Si} = \frac{\sum_{j=1}^{n} S_{ij}}{n} \tag{6,7,8}$$

Economic performance. We evaluate the effects of state interventions through two indicators of a firm's profitability. Return on Asset (ROA) measures a company's net profit divided by its total assets in luding foreign capital and Return on Equity

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(ROE) measures how much profit a company earned in comparison with the total amount of shareholder equity found on the balance sheet. Briefly, both measures indicate how well the company's management has performed with the total assets and with the resources provided by stockholders, respectively. Sceptics may have reservations about these measures owing to China's still-immature accounting standards. However, empirical work suggests that China has devoted serious efforts to making national accounting standards consistent with international standards (Lin et al., 2001).[8]

Control variables. We introduce the following control variables to isolate the performance effects of state intervention as exerted by party and government.

Lag performance. A high level of state intervention may affect firm performance and conversely firm performance may affect the level of state intervention. To partially deal with this reverse-causality problem, we include lag performance variables (PL) as control variables. This allows us to capture potential interactions between state intervention and performance in the previous year. Furthermore, our inclusion of lag performance as control variables captures the tendency of respondents to blame state actors for a firm's poor performance in the previous year, thus partially alleviating the problem of blame shifting.

Industry. The firms in our sample belong to various industries and therefore enjoy different profit-making opportunities. They may also be associated with different levels of state intervention because some industries are regarded as politically more important than others. We included industrial dummies ($INDUSTRY_i$) for energy, transportation, wholesale and retail, real estate, social services and manufacturing, with conglomerate as the reference group.

Firm size. Large firms may benefit from economies of scale and may have better access to financial resources, which could improve their performance (Fama and French, 1995). They may be associated with a higher level of state intervention because they can deliver more benefits to politicians and bureaucrats (Lioukas et al., 1993). To capture the possible confounding effect of firm size, we control the natural logarithm of a firm's sales (SALES).

Capital structure. Qi et al. (2000) and Xu and Wang (1999) both find that financial leverage in China's listed firms is related to firm performance. In contrast, financial leverage may be related to state intervention because state actors still provide an important network for obtaining bank loans in China (McGregor, 2001). We therefore introduce the debt to asset ratio (DAR) as a control variable.

State ownership. The proportion of state ownership affects the state's chances for direct interference and is positively correlated to the intensity and quality of state intervention exerted by the local state asset operating companies that manage public shares. We use the percentage of state shares (PSTATE) as a control variable.

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Administrative levels. Following Walder (1995), the administrative level of a firm's responsible government superiors (AS) may affect firm performance due to differing budget constraints and competitive pressure. At the same time, the quality and intensity of state intervention may differ due to differing access to local information, monitoring capabilities and political priorities. In order to capture possible effects stemming from decentralized administration and the proximity between firm and administrator, we include three dummy variables indicating the existence of a central or provincial government, city or county government and other authorities as administrative superiors.

Decision-making power of shareholders, boards of directors and managers. A high level of shareholder, manager and board of directors (BoD) involvement in firm decision-making suggests the existence of active corporate monitoring and governance, which could in turn reduce agency problems and lead to improved firm performance. At the same time it implies a lower relative level of state intervention. We therefore construct a set of three indices to measure the corporate governance involvement of shareholders (SI), board of directors (BI) and managers (MI) in decision-making. These indices are constructed in the same manner as the PI and GI index.

Analyses

Our model seeks to measure the overall performance effect of party and government intervention. Each is estimated separately because of a risk of multicollinearity. We construct the following regression model, where P denotes the performance measure of ROA and ROE and PI_K and GI_K denote the four measures of decision-making power of party committees and government administration (namely PI_A, PI_P, PI_F and PI_S and GI_A, GI_P, GI_F and GI_S):

Party Involvement

$$P = \alpha + \sum_{i=1}^{12} \lambda_{K_i} INDUSTRY_i + \beta_{K1} SALES + \beta_{K2} DAR + \beta_{K3} PSTATE + \beta_{K4} AS_i + \beta_{K5} PL + \beta_{K6} MI + \beta_{K7} BI + \beta_{K8} SI + \beta_{K9} PI_K + \varepsilon \quad (9)$$

Government Involvement

$$P = \alpha + \sum_{i=1}^{12} \lambda_{K_i} INDUSTRY_i + \beta_{K1} SALES + \beta_{K2} DAR + \beta_{K3} PSTATE + \beta_{K4} AS_i + \beta_{K5} PL + \beta_{K6} MI + \beta_{K7} BI + \beta_{K8} SI + \beta_{K9} GI_K + \varepsilon \quad (10)$$

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RESULTS

The descriptive statistics (mean, standard deviation and Pearson correlation) are in Table 1.[9]

Table 2 presents the ordinary least square (OLS) estimates on the overall performance implications of government and party involvement. For the government these estimates are insignificant, though the estimated coefficients have negative signs. In contrast, the slope coefficient on party involvement (PI_A) is actually negative and significant for both estimations on ROA and ROE. These results, consistent with those of Wong et al. (2004) and Chang and Wong (2004) , suggest negative performance effects of party intervention in decision-making processes at the firm level.

With regard to the control variables, it seems worth mentioning that none of the new formal organs of corporate governance established with China's new Company Law seems to have a decisively positive influence on company performance. Particularly the negative contribution of a BoD is remarkable. Ongoing efforts of Chinese authorities to improve internal corporate governance mechanisms therefore seem to be much in line with the current realities in its listed firms.

We performed OLS estimates on the economic impact of state intervention in the domains of personnel, financial and strategic firm decisions. As to personnel decisions, estimates on performance implications of government interventions yield negative and significant coefficients, suggesting a detrimental impact. For party involvement, our estimates suggest that interference is not detrimental to firm performance (Table 3a). Although the estimated slope coefficient has a negative sign, the effect of party intervention on firm performance remains insignificant at conventional levels. This finding is consistent with the widespread assumption in the literature that party committees have a comparative advantage in personnel matters (in comparison with other fields of intervention) due to the CCP's effective vertical command structure and long tradition of supervisory activities within the nomenclature system. Qian (1995) suggests that party control may limit excessive managerial discretion and abuse of insider control, when effective corporate governance mechanisms are not yet in place. However, our estimates do not indicate any positive performance effects.

Our estimates on the economic effect of government interventions into financial decisions deserve specific attention, as such interventionism undoubtedly serves as a central instrument to promote and steer specific corporations in China as in other East Asian economies (Table 3b). The high degree of regulation of China's financial and capital market actually provides convenient chances for state bureaucrats to remain involved and to manipulate financial decision-making. First, the stock market is a pseudo-market due to over-regulation and heavy state intervention. Market entry and market exit are seriously politicized as both procedures are

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Table 1. Descriptive statistics of key variables and Pearson correlation matrix (N = 66)

	Variables	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*	*15*	*16*	*17*	*18*	*19*	*20*
1	Return on asset (ROA)																				
2	Return on equity (ROE)	0.85**																			
3	Percentage of state shares (PSTATE)	−0.01	−0.05																		
4	Debt to asset ratio (DAR)	−0.25*	0.08	0.05																	
5	Logarithm of sales (SALES)	0.16	0.22	0.18	0.10																
6	Central and province administration	0.09	0.14	0.13	0.18	0.27*															
7	City and county administration	−0.00	−0.06	0.15	−0.03	−0.09	−0.33**														
8	Other authority	−0.03	−0.00	−0.19	0.07	−0.08	−0.12	−0.09													
9	Party intervention (PI_A)	−0.21	−0.17	0.16	0.08	0.18	0.23	0.02	−0.09												
10	Party intervention in personnel decision (PI_P)	−0.18	−0.14	0.18	0.11	0.14	0.23	0.01	−0.09	0.95**											
11	Party intervention in financial decision (PI_F)	−0.21	−0.20	0.09	0.04	0.23	0.19	−0.00	−0.10	0.94**	0.81**										
12	Party intervention in strategic decision (PI_S)	−0.18	−0.16	0.15	0.01	0.17	0.19	0.04	−0.05	0.95***	0.88**	0.88*									
13	Government intervention (GI_A)	−0.20	−0.15	0.28	0.20	0.04	0.13	0.18	−0.12	0.63**	0.63**	0.54**	0.55**								
14	Government intervention in personnel decision (GI_P)	−0.26	−0.20	0.31	0.25	−0.00	0.15	0.20	−0.11	0.64**	0.65**	0.52**	0.57**	0.96**							
15	Government intervention in financial decision (GI_F)	−0.17	−0.15	0.29	0.16	0.05	0.11	0.12	−0.11	0.57**	0.57**	0.49**	0.49**	0.97**	0.87**						
16	Government intervention in strategic decision (GI_S)	−0.24	−0.22	0.30	0.15	0.14	0.18	0.17	−0.11	0.67**	0.67**	0.60**	0.56**	0.91**	0.90**	0.83**					
17	Decision-making power of board of directors (BI)	−0.00	−0.08	0.23	−0.17	0.03	0.06	0.13	−0.10	0.26	0.19	0.31*	0.26	0.09	0.05	0.09	0.07				
18	Decision-making power of shareholders (SI)	−0.11	−0.06	0.25*	020	0.01	0.04	0.06	−0.05	0.37**	0.30*	0.39**	0.37**	0.24	0.24	0.21	0.21	0.50**			
19	Decision-making power of managers (MI)	0.13	0.08	−0.10	−0.05	0.15	0.13	−0.02	−0.03	0.51**	0.49**	0.54**	0.47**	0.33**	0.25*	0.29*	0.38**	0.32**	0.09		
20	Lag performance (LROA)	0.65**	0.43**	0.04	−0.29*	0.04	−0.02	0.12	0.01	−0.15	−0.16	−0.13	−0.10	−0.15	−0.16	−0.14	−0.16	0.26*	−0.10	0.18	
21	Lag performance (LROE)	0.63**	0.51**	0.10	−0.06	0.08	0.03	0.11	0.05	−0.10	−0.09	−0.09	−0.08	−0.06	−0.06	−0.06	−0.08	0.27*	0.02	0.18	0.92**

Notes: * $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$.

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Table 2. Overall effect of state involvement on firm's economic performance

Independent variables	*ROA*	*ROE*	*ROA*	*ROE*
	Coeff. (SE)	*Coeff. (SE)*	*Coeff. (SE)*	*Coeff. (SE)*
(Constant)	0.04	0.03	−0.01	−0.12
	(0.09)	*(0.20)*	*(0.09)*	*(0.20)*
Control Variables				
Industry dummy	NO	NO	NO	NO
Debt to asset ratio (DAR)	−0.02	0.09	−0.04	0.04
	(0.03)	*(0.07)*	*(0.03)*	*(0.06)*
Logarithm of sales (SALES)	0.00	0.01	0.01	0.01
	(0.00)	*(0.01)*	*(0.00)*	*(0.01)*
Lag performance	0.63***	0.57***	0.59***	0.55***
	(0.11)	*(0.12)*	*(0.10)*	*(0.12)*
Decision-making power of Board of directors (BI)	−0.03**	−0.06	−0.03**	−0.05
	(0.02)	*(0.03)*	*(0.02)*	*(0.03)*
Decision-making power of shareholders (SI)	0.01	0.01	0.01	0.02
	(0.01)	*(0.02)*	*(0.01)*	*(0.02)*
Decision-making power of managers (MI)	0.01	0.02	0.02	0.02
	(0.01)	*(0.02)*	*(0.01)*	*(0.02)*
Shareholding				
Percentage of state shares (PSTATE)	−0.00	−0.03	−0.01	−0.04
	(0.02)	*(0.04)*	*(0.02)*	*(0.04)*
Administrative level				
Central and provincial	0.01	0.03	0.01	0.02
	(0.01)	*(0.02)*	*(0.01)*	*(0.02)*
City and county	0.00	−0.00	0.00	−0.01
	(0.01)	*(0.03)*	*(0.01)*	*(0.03)*
Other authority	−0.01	−0.03	−0.00	−0.02
	(0.03)	*(0.06)*	*(0.03)*	*(0.06)*
Effect of state involvement				
Government intervention (GI)	−0.02	−0.04		
	(0.01)	(0.03)		
Party Intervention (PI)			−0.02**	−0.03*
			(0.01)	*(0.02)*
Adj R Square	0.38	0.26	0.42	0.26
Standard Error	0.03	0.08	0.03	0.08
Observations	64	64	66	66

Notes: * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

regulated by complex and opaque approval procedures, which usually involve political bargaining processes of the responsible government bureaus (OECD, 2002). Similarly, new share issuance depends on government approval. Casual observation confirms that firms without reliable political networks have little chance of being listed on one of China's stock exchanges. Indeed only a small

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Table 3. Performance effect of state involvement

Independent variables	*ROA*	*ROE*	*ROA*	*ROE*
	Coeff. (SE)	*Coeff. (SE)*	*Coeff. (SE)*	*Coeff. (SE)*
Table 3a. **Involvement in personnel decisions**				
(Constant)	0.05	0.09	−0.01	−0.11
	(0.09)	*(0.20)*	*(0.09)*	*(0.20)*
Control Variables				
Industry dummy	NO	NO	NO	NO
Debt to asset ratio (DAR)	−0.01	0.12*	−0.02	0.06
	(0.03)	*(0.06)*	*(0.03)*	*(0.06)*
Logarithm of sales (SALES)	0.00	0.00	0.00	0.01
	(0.00)	*(0.01)*	*(0.00)*	*(0.01)*
Lag performance	0.65***	0.60***	0.64***	0.60***
	(0.11)	*(0.12)*	*(0.11)*	*(0.12)*
Decision-making power of board of directors (BI)	−0.02*	−0.04	−0.02*	−0.03
	(0.01)	*(0.02)*	*(0.01)*	*(0.02)*
Decision-making power of shareholders (SI)	0.00	−0.01	0.00	−0.00
	(0.01)	*(0.02)*	*(0.01)*	*(0.02)*
Decision-making power of managers (MI)	0.01	0.02	0.01	0.03
	(0.01)	*(0.02)*	*(0.01)*	*(0.03)*
Percentage of state shares (PSTATE)	0.00	−0.02	−0.01	−0.04
	(0.02)	*(0.04)*	*(0.02)*	*(0.04)*
Administrative level				
Central and provincial	0.01	0.03	0.01	0.02
	(0.01)	*(0.02)*	*(0.01)*	*(0.02)*
City and county	0.01	0.01	0.00	−0.01
	(0.01)	*(0.03)*	*(0.01)*	*(0.03)*
Other authority	−0.00	−0.02	−0.00	−0.01
	(0.03)	*(0.06)*	*(0.03)*	*(0.06)*
Effect of state involvement				
Government intervention (GI)	−0.03*	−0.07**		
	(0.02)	*(0.03)*		
Party intervention (PI)			−0.01	−0.02
			(0.01)	*(0.02)*
Adj R Square	0.39	0.30	0.38	0.25
Standard error	0.03	0.07	0.03	0.08
Observations	64	64	66	66
Table 3b. **Involvement in financial decisions**				
(Constant)	−0.04	−0.11	−0.10	−0.29
	(0.09)	*(0.20)*	*(0.09)*	*(0.19)*
Control variables				
Industry dummy	NO	NO	NO	NO
Debt to asset ratio (DAR)	−0.03	0.09	−0.03	0.05
	(0.03)	*(0.07)*	*(0.03)*	*(0.06)*

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Table 3. (cont.)

Independent variables	*ROA*	*ROE*	*ROA*	*ROE*
	Coeff. (SE)	*Coeff. (SE)*	*Coeff. (SE)*	*Coeff. (SE)*
Logarithm of sales (SALES)	0.01	0.01	0.01*	0.02*
	(0.00)	*(0.01)*	*(0.00)*	*(0.01)*
Lag performance	0.61***	0.55***	0.57***	0.52***
	(0.11)	*(0.12)*	*(0.10)*	*(0.12)*
Decision-making power of board of directors (BI)	−0.02	−0.02	−0.01	−0.01
	(0.01)	*(0.03)*	*(0.01)*	*(0.03)*
Decision-making power of shareholders (SI)	0.01	0.01	0.01*	0.02
	(0.01)	*(0.01)*	*(0.01)*	*(0.01)*
Decision-making power of managers (MI)	0.00	−0.00	0.01	0.01
	(0.01)	*(0.01)*	*(0.01)*	*(0.02)*
Percentage of state shares (PSTATE)	−0.01	−0.05	−0.02	−0.06
	(0.02)	*(0.04)*	*(0.02)*	*(0.04)*
Administrative level				
Central and provincial	0.01	0.03	0.01	0.02
	(0.01)	*(0.02)*	*(0.01)*	*(0.02)*
City and county	−0.00	−0.01	−0.00	−0.01
	(0.01)	*(0.03)*	*(0.01)*	*(−0.03)*
Other authority	−0.01	−0.04	−0.01	−0.03
	(0.03)	*(0.06)*	*(0.03)*	*(0.06)*
Effect of state involvement				
Government intervention (GI)	−0.01	−0.02		
	(0.01)	*(0.02)*		
Party intervention (PI)			−0.02**	−0.04*
			(0.01)	*(0.02)*
Adj R Square	0.35	0.22	0.40	0.26
Standard error	0.04	0.08	0.03	0.08
Observations	64	64	66	66
Table 3c. **Involvement in strategic decisions**				
(Constant)	0.02	0.02	−0.01	−0.12
	(0.09)	*(0.19)*	*(−0.09)*	*(0.20)*
Control variables				
Industry dummy	NO	NO	NO	NO
Debt to asset ratio (DAR)	−0.02	0.09	−0.02	0.04
	(0.03)	*(0.06)*	*(0.03)*	*(0.06)*
Logarithm of sales (SALES)	0.00	0.01	0.01	0.01
	(0.00)	*(0.01)*	*(0.00)*	*(0.01)*
Lag performance	0.64***	0.59***	0.64***	0.58***
	(0.10)	*(0.11)*	*(0.10)*	*(0.12)*
Decision-making power of board of directors (BI)	−0.02**	−0.05**	−0.02**	−0.04*
	(0.01)	*(0.02)*	*(0.01)*	*(0.02)*
Decision-making power of shareholders (SI)	0.01	0.01	0.01	0.01
	(0.01)	*(0.01)*	*(0.01)*	*(0.01)*

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Table 3. (cont.)

Independent variables	*ROA*	*ROE*	*ROA*	*ROE*
	Coeff. (SE)	*Coeff. (SE)*	*Coeff. (SE)*	*Coeff. (SE)*
Decision-making power of managers (MI)	0.01 *(0.01)*	0.02 *(0.02)*	0.01 *(0.01)*	0.03 *(0.02)*
Percentage of state shares (PSTATE)	−0.00 *(0.02)*	−0.02 *(0.04)*	−0.01 *(0.02)*	−0.04 *(0.04)*
Administrative level				
Central and provincial	0.02 *(0.01)*	0.04 *(0.02)*	0.01 *(0.01)*	0.02 *(0.02)*
City and county	0.00 *(0.01)*	−0.00 *(0.03)*	−0.00 *(0.01)*	−0.01 *(0.03)*
Other authority	−0.01 *(0.03)*	−0.03 *(0.05)*	−0.00 *(0.03)*	−0.02 *(0.06)*
Effect of state involvement				
Government intervention (GI)	−0.03** *(0.01)*	−0.07*** *(0.03)*		
Party intervention (PI)			−0.01 *(0.01)*	−0.02 *(0.01)*
Adj R Square	0.40	0.34	0.39	0.27
Standard Error	0.03	0.07	0.03	0.07
Observations	64	64	66	66

Notes: * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

minority of private firms are currently listed. Furthermore, the market for mergers and acquisitions is regulated with unclear criteria, offering a wide leeway for government involvement. Finally, the state banking system has only recently undergone very limited property right diversification and is still under intermittent pressure from the government to expand loans to rescue ailing state-owned firms (Woo, 2002). Though 'China's Law for Commercial Banking' stipulates that credit policy should be independent from state involvement (Leung and Mok, 2000; Zhu, 1999), a large number of loan decisions are influenced by political involvement, which banks can hardly escape, given the close networks between government, banks and enterprises (Park and Sehrt, 2001).

In spite of the strong predisposition of financial and capital markets to invite government intervention, our estimates do not suggest that government involvement in capital allocation promotes corporate performance. Consistent with our estimates on overall government intervention, state involvement is not associated with a significant positive effect on firm performance. Instead we estimate negative (though statistically insignificant) slope coefficients for both ROE and ROA. Our estimates once again suggest the absence of a 'helping hand' effect of government

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involvement in firms' financial decision-making. As for party intervention in financial decisions, our estimates yield a significant and negative effect for both performance measures.

For interventions in strategic decisions, our estimates are again mixed (Table 3c). We yield significant and negative performance effects for government involvement for both ROA and ROE, while the slope coefficients for party interference are negative but not significant at conventional levels (20 percent and 15 percent, respectively).

DISCUSSION

Summarizing our results, we find support for the political economy perspective emphasizing the state's inability to provide positive economic effects through direct intervention at the firm level (supporting H1). Negative significant effects are reported in the case of government involvement on personnel decisions as well as involvement in strategic firm decisions. Party intervention yields significant negative effects in the case of financial decisions as well as in an overall perspective averaging all firm decisions.

To the contrary, our tests do not indicate any positive economic effects of state involvement at firm level. In spite of an encompassing decentralization of state-share administration accompanied by strengthened fiscal incentives and improved monitoring and information capabilities of local government officials, we cannot identify any positive economic effects resulting from government intervention into firm decisions. Hypothesis 2 is clearly rejected. We therefore find no support for the state-centered approach, which predicts that a decentralization of public asset management reduces the risk of negative economic effects. Not only the lack of positive effects for state intervention is worth noting, but we also cannot establish a linkage between company performance and the level of administrative responsibility for the firm. Our findings are in line with Peng (2001), who also failed to produce evidence for the superior firm productivity of TVEs at the bottom levels of the hierarchy of government jurisdictions in China. Our confirmation of Peng's results for rural industry further undermines the general validity of the claim that as financial incentives increase in intensity and monitoring capacity improves, government can enhance the economic performance of firms through direct involvement in corporate governance (Walder, 1995).

It may be somewhat surprising that we do not find a qualitative difference between government interventions and party interventions. Both actors are characterized by clearly differing organizational features and incentive structures, which should in theory transform into different performance effects. In contrast to the reformed government bureaucracy, firm-level party committees lack sufficient insulation from societal claims because it is extensively enmeshed in interest-based networks of employees inside the firm. Second, since it lacks both financial interests

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in firm prosperity (via tax income or residual claims of state shares) and interest alignment by performance-based contracts, it does not have the same incentive as state bureaucrats to increase a firm's profitability. Instead, the party committee is structurally positioned to lobby on behalf of constituents for the redistribution of surplus, whether by fighting management's interest in laying off excess workers or by providing richer compensation packages for employees.

Skeptics may point to the fact that our empirical investigation is admittedly confined to a relatively small sample of firms. By standard statistical rule, however, a 14 percent sample from a population of 483 is more than adequate to make inferences about firms listed on the Shanghai Stock Exchange. Moreover, there is no reason to believe that a larger response rate might have reversed our results from negative to positive economic effects. This would imply that those firms that experience positive economic effects through government involvement systematically refused to participate in the survey thereby causing a critical non-response bias. Such a scenario seems indeed highly unlikely. Why would those firms that obviously enjoy beneficial state support in their daily decision-making reject participation in a survey conducted by a government institution? The logic should be just the reverse. Having good and supportive state-firm relations would – if it has any effect – rather increase the firm's willingness to participate.

The Role of State Involvement in Firms Revisited

We examined the involvement of state actors – government and party – in the corporate governance of firms listed on the Shanghai Stock Exchange to estimate their respective economic effect. Extending the underlying logic of Walder's local corporatist state approach to the urban decentralized industrial state sector, our results do not offer support for the hypothesis predicting entrepreneurial-style government behaviour through micro-interventions at firm level. Local state corporatists will of course rightly claim that their approach was designed to explain the local state's ability to act as an active entrepreneur promoting TVE development, while we extended the idea to the urban sector. This, however, does not weaken our argument, as the scope conditions for Walder's causal explanation do not rest on spatial prerequisites but distinct organizational features that are met in urban and rural areas alike.

Walder's (1995) local-corporatist state hypothesis hinges on two crucial factors, the incentive and also the capability assumption of local bureaucrats, which both deserve some closer examination. Kornai's soft-budget constraint theory builds the centerpiece of the local corporatist approach (Kornai, 1980, 1990). The claim is that fiscal decentralization as experienced in the early 1980s in China hardens local governments' budget constraints and thereby provides incentives to act in an entrepreneurial way. To begin with, it is worthwhile noting that the concept of soft

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budget constraints as developed by Kornai (1980, 1990, 1998, 2001) does not refer to government but to the firm level. It is the government that creates soft budget constraints at the firm level through the extension of preferential loans, tax exemptions and state subsidies. Walder is correct in his conclusion that fiscal federalism affects the pervasiveness of soft budget constraints, but not as he assumes in hardening budgets at the local government level. Governments themselves have by definition 'soft budget constraints' as there is always a bailout guarantee through higher level governments, extra-budgetary fees, tax increases and public debt. The budget effect of federalist systems rather lies in the fact that fiscal federalism creates incentives for interjurisdictional competition that will eventually bring about a hardening of budget constraints at the firm level. General macroeconomic models reveal the following mechanism: decentralized federalist governments compete with each other over mobile capital and labour resources by providing a competitive local infrastructure and business environment (Qian and Roland, 1998). As a consequence, opportunity costs of extending political favours in the form of soft credits and soft taxation to inefficient firms increase (subsequently causing soft budget constraints at the firm level) which thereby reduces incentives for bailouts. Eventually, fiscal federalism brings about a hardening of budget constraints at the firm level. To this extent, local state corporatists are right to claim that a more growth-oriented role for local government is likely to emerge in a federalist system; but this is essentially because unproductive bailout strategies of inefficient firms become relatively unattractive.

Walder's interpretation moves beyond this argument in claiming that government officials themselves will emerge as active entrepreneurs. There is, however, no inherent incentive for government officials, who are essentially acting as agents of the local population, to behave as profit-maximizing entrepreneurs. Although fiscal federalism can convincingly solve incentive problems at the firm level through the hardening of budget constraints, it does not address the individual incentives of salaried bureaucrats. If this were the case, hard budgets and corporate competition would be sufficient to solve incentive problems inherent in any principal agent problem; corporate governance problems stemming from a separation between ownership and control could simply not exist (Berle and Means, 1932).

The local state corporatist view of local governments as industrial firms cannot resolve the capability constraint of government involvement at the firm level. The political economy literature has rightly pointed to the fact that government officials are typically serving multiple objectives, which can in the short-run easily impede entrepreneurial decision-making (Sappington and Stiglitz, 1987). Neither fiscal federalism nor decentralization of government responsibilities provides an inherent argument for why the government's utility function should entirely change. Although one might follow the argument that the multiplexity of government goals should be less pronounced at the local than at the central government level

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(Walder, 1995), it is in the very nature of any government to be charged with multiple political, economic and social objectives. Potential conflicts of interest are illustrated by localist tendencies in China. Conflicts of interest, for instance, emerge in the cases of firm extensions across community boundaries, shifts of productions sites and the downsizing of firm employment. In each of these cases, the goals to maximize local revenues and wage labour naturally collide with a firm's objective of profit maximization. Also frequent extension of government help in case of labour unrest and local demonstrations, confirms that governments never act independently of non-economic goals, so long as they wish to secure broad social consensus.

Finally, the capability of government officials to act as entrepreneurs hinges on the solution of the asymmetric information problem between principal and agent. None of the recent changes in China's organizational structure could provide a solution in this case. Although today's staff-firm relations in public firm administration at the local level may be more appropriate than in the traditional system of state asset administration, this is of course at best solving capacity constraints. The staffing of organizations does not affect capability constraints stemming from vertical principal agent relations between government and firm (Hayek, 1945; Kornai, 1998).

We believe the weakness in the local state corporatism hypothesis lies in the fact that fiscal federalism and the resulting incentive effects do not substantially affect the government's ability to actively intervene in an entrepreneurial way. Our findings, however, should not suggest that the Chinese state did not play a strong and developmental role facilitating and shaping China's dynamic growth. In line with the theory of federalism, we instead suggest that China's success story is not built on a helping hand of entrepreneurial government involvement reaching directly into the firm, but suspect that it is the state's ability to create and maintain a supportive growth climate (Lin et al., 1996). Based on our extensive interviews with entrepreneurs in the Yangzi Delta, conducted over the years 2005 and 2006, interviewees frequently point to the government's ability to provide a pro-growth environment as a decisive development factor. Municipal governments compete by building supportive business environments to attract and retain private capital and facilitate the local entrepreneurs' competitive edge; by developing reputations for efficient and timely bureaucratic procedures; and through indirect incentives that do not interfere with the market mechanism (Yao, 2001). They invest in the construction of industrial parks with the infrastructure and services that optimize their chances for attracting private investors and entrepreneurs. Moreover, the competition is highly transparent, with annual rankings of provincial and urban competitiveness providing potential investors with the utmost transparency on institutional quality and government efficiency. Direct interference, in contrast, is often connected with localist tendencies inhibiting a firm's market oriented development and expansion. Close connections with

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government and party are therefore increasingly regarded as not being particularly helpful.

In other words, we suspect it is the state bureaucracy's capacity to set up and maintain an institutional environment that offers conditions favourable to private capital that explains the success of a developmental state in promoting transformative economic growth. In this sense, China's success is built on the gradual liberalization of product and labour markets, increasing openness to foreign trade, investment in infrastructure and institutional reforms such as property reforms and privatization which provide individual actors with sufficient security for planning, investing and economic risk taking. The beneficial effect of the state results from its capacity to construct and maintain institutional environments that provide positive incentives to entrepreneurs and managers at the firm level to invest in economic growth.

NOTES

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[1] Vgl. 'Gufenyouxian gongsi guoyou guquan guanli zanxing banfa' (3.11.1994), Art. 33f. in: Zhongguo Renmin Daxue Jinrong yu Zhengquan Yanjiusuo (ed.), 2000.

[2] The first industrial policy guideline was the '*Guowuyuan guanyu dangqian chanye zhengce yaodian de jueding*,' released by the State Council on March 15, 1989.

[3] Detailed analysis of the response rates across decision types indicates no obvious pattern. We are therefore unable to determine why some respondents left some decisions unrated. However, we suspect that this may happen when they have not encountered that decision. This is based on our observation that the response rates for the two questions relating to external donation – an uncommon activity among listed firms – are the lowest. We therefore do not see any reason to believe that any form of self-censorship has led to the provision of incomplete questionnaires. Experiments with a larger sample inclusive of firms with incomplete questionnaires confirmed our results.

[4] In the management structure of China's listed firms, the position of BoD secretary is similar to the position of managing director; such an individual is expected to be the most knowledgeable about a listed firm.

[5] In addition to data on the involvement of various power holders in listed firms, we obtained data on shareholding structure and market prices from the *Taiwan Economic Journal*. Other data were obtained from the Shanghai WIND information Co., Ltd. (WIND).

[6] As respondents' assessments are inherently subjective and may be plagued by inconsistency and biases, we test the internal consistency of the ratings of 63 decisions for each decision-maker including the board of directors, managers, shareholders' meetings and local party committees. Results indicate that our data are highly consistent, with Cronbach's alpha exceeding 0.92. We also tested the internal consistency of ratings for each type of decisions for each decision-maker. Results indicate that they are all consistent, with Cronbach's alpha exceeding 0.78 (the results are presented in Appendix III).

[7] We treat all decisions as equally important and thus assign them equal weightings. However, this may not be appropriate because some decisions (e.g., selection of CEO) are more important than others (e.g., selection of management consultant). But there is no reliable way to determine the

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relative importance of different decisions, because appropriate weightings depend on specific firm conditions. For example, the choice of a financial consultant may be of central importance for firms experiencing financial distress and undergoing strategic restructuring but may be unimportant for firms operating under normal conditions.

[8] Alternative performance measures would actually provide inferior approaches. For instance, market valuation, such as the market-to-book value or Tobin's q would presuppose the existence of an efficient stock market. This assumption is certainly not justified in China's casino-style stock markets, which are highly distorted by heavy speculation. Particularly, risk evaluation is not in line with market-based assessment. Black (1986, p. 533) suggests that Tobin's q of about 2 signals the existence of an efficient stock market. In China, Tobin's q reached values as high as 3.7 between 1996 and 1999 (Tenev and Zhang, 2002, p. 106). Productivity measures actually suffer from data limitations as stock-listed firms do not need to reveal the current number of employees.

[9] The Variance Inflation Factor has been calculated and signals problems due to multicollinearity for ROE and ROA.

APPENDIX I

Industrial Structure of Firms, 1999

	All firms listed at Shanghai Stock Exchange	*Sample firms*	*Respondents with incomplete questionnaires*
	Number (percentage)	*Number (percentage)*	*Number (percentage)*
Finance	3	0	1
	(0.64)	(0.00)	(0.55)
Public	40	5	16
	(8.49)	(7.58)	(8.79)
Real estate	12	0	4
	(2.55)	(0.00)	(2.20)
Conglomerate	81	16	22
	(17.20)	(24.24)	(12.09)
Manufacturing	280	39	119
	(59.45)	(59.09)	(65.38)
Wholesale and retail	55	6	20
	(11.67)	(9.09)	(10.99)
Total observations	471	66	182

Note: China Securities Regulatory Commission.

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APPENDIX II

Fundamental Data of Firms, 1999

	All firms listed at Shanghai Stock Exchange	*Sample firms*
	Mean (SD)	*Mean (SD)*
Return on assets	0.04	0.05
	(0.09)	(0.04)
Return on equity	0.07	0.09
	(0.46)	(0.09)
Debt to asset ratio	0.44	0.44
	(0.23)	(0.17)
Log of sales	19.92	19.97
	(1.19)	(1.21)
Percentage of state shares	0.32	0.33
	(0.28)	(0.27)
Total observations	471	66

Note: China Securities Regulatory Commission.

APPENDIX III

Decision-Making Power of Various Power Holders in China's Listed Firms

	Shareholders mean (SD)	*BoD mean (SD)*	*Manager mean (SD)*	*Party mean (SD)*	*Rank of party power*	*Government mean (SD)*	*Rank of gov. power*
1. Involvement in personnel decisions							
Selection of functional department manager	1.35 (0.59)	3.03 (1.21)	4.31 (0.71)	2.13 (1.18)	1	1.06 (0.23)	61
Performance appraisal of functional departments	1.39 (0.64)	2.72 (1.16)	4.32 (0.77)	1.99 (1.10)	6	1.07 (0.26)	60
Selection of business department managers	1.34 (0.61)	2.61 (1.18)	4.34 (0.74)	2.11 (1.17)	2	1.07 (0.26)	58
Performance appraisal of business department	1.32 (0.58)	2.55 (1.13)	4.31 (0.80)	1.99 (1.08)	7	1.07 (0.31)	58
Selection of branch manager	1.42 (0.65)	3.07 (1.28)	4.18 (0.87)	2.03 (1.18)	3	1.09 (0.28)	56
Performance appraisal of branch	1.39 (0.64)	2.94 (1.28)	4.18 (0.83)	1.83 (1.03)	15	1.09 (0.28)	56
Selection of subsidiary manager	1.49 (0.83)	3.41 (1.20)	3.92 (1.03)	2.00 (1.13)	4	1.10 (0.30)	50

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APPENDIX III (cont.)

	Shareholders mean (SD)	*BoD mean (SD)*	*Manager mean (SD)*	*Party mean (SD)*	*Rank of party power*	*Government mean (SD)*	*Rank of gov. power*
Performance appraisal of subsidiaries	1.44 (0.73)	3.06 (1.29)	4.01 (0.98)	1.89 (1.05)	12	1.10 (0.30)	50
Election and dismissal of chairman of BoD	3.35 (1.37)	4.04 (1.05)	1.47 (0.67)	1.62 (0.87)	36	1.68 (1.19)	1
Performance appraisal of and remuneration enjoyed by board chairman	3.10 (1.41)	3.69 (1.10)	1.49 (0.69)	1.62 (0.76)	35	1.06 (0.23)	61
Election and dismissal of board members	4.34 (1.04)	3.49 (0.88)	1.51 (0.73)	1.61 (0.82)	37	1.38 (0.81)	15
Performance appraisal of and remuneration enjoyed by board members	3.54 (1.43)	3.72 (0.94)	1.55 (0.79)	1.63 (0.82)	30	1.29 (0.74)	24
Election and dismissal of board secretary	2.56 (1.36)	4.44 (0.73)	1.87 (0.93)	1.65 (0.83)	29	1.14 (0.39)	43
Performance appraisal of and remuneration enjoyed by board secretary	2.27 (1.31)	4.35 (0.88)	2.07 (1.09)	1.63 (0.85)	31	1.13 (0.37)	45
Selection of supervisory committee members	4.28 (1.02)	2.24 (1.06)	1.63 (0.87)	1.75 (0.87)	22	1.25 (0.65)	28
Performance appraisal of and remuneration of supervisory committee	3.59 (1.50)	2.32 (1.17)	1.66 (0.93)	1.73 (0.91)	24	1.18 (0.51)	35
Selection and dismissal of CEO	2.27 (1.18)	4.65 (0.56)	1.94 (1.07)	1.90 (1.02)	11	1.44 (0.95)	8
Performance appraisal of and remuneration enjoyed by CEO	2.14 (1.14)	4.54 (0.65)	2.07 (1.07)	1.80 (0.94)	16	1.35 (0.75)	17
Selection and dismissal of vice-CEO	1.96 (1.10)	4.07 (1.05)	3.23 (1.29)	2.00 (1.06)	5	1.31 (0.71)	19
Performance appraisal of and remuneration enjoyed by vice-CEO	1.89 (1.09)	4.06 (1.07)	3.09 (1.31)	1.87 (1.03)	14	1.21 (0.53)	31
Mean	**2.32**	**3.45**	**2.86**	**1.84**		**1.21**	
Alpha	**0.92**	**0.83**	**0.85**	**0.98**		**0.92**	
2. Involvement in financial decisions							
Change in shareholding structure	4.04 (1.09)	3.72 (0.80)	2.27 (1.13)	1.39 (0.67)	60	1.56 (0.98)	4
Change in debt/equity ratio	3.59 (1.35)	3.93 (0.62)	2.58 (1.09)	1.37 (0.59)	62	1.43 (0.85)	10
Formulation of dividend plan	4.28 (1.10)	3.85 (0.62)	2.37 (1.02)	1.34 (0.58)	63	1.18 (0.59)	35

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APPENDIX III (cont.)

	Shareholders mean (SD)	*BoD mean (SD)*	*Manager mean (SD)*	*Party mean (SD)*	*Rank of party power*	*Government mean (SD)*	*Rank of gov. power*
Determining share placement and new issues	4.30 (1.09)	3.79 (0.75)	2.49 (1.05)	1.37 (0.62)	61	1.56 (1.01)	5
New investment in technology	3.24 (1.35)	4.01 (0.55)	3.27 (1.04)	1.44 (0.73)	47	1.49 (0.93)	7
New investment in infrastructure	3.24 (1.34)	4.00 (0.61)	3.17 (1.01)	1.44 (0.73)	48	1.53 (0.95)	6
Financial investment	3.14 (1.32)	4.04 (0.57)	3.04 (1.03)	1.39 (0.67)	58	1.38 (0.83)	15
Investment in other stock firms	3.55 (1.29)	3.96 (0.69)	2.94 (1.12)	1.42 (0.71)	52	1.31 (0.73)	19
Sale of assets	3.39 (1.37)	4.00 (0.70)	2.90 (1.10)	1.47 (0.84)	43	1.43 (0.85)	10
Determining loans for fixed asset investment	2.65 (1.43)	3.92 (0.73)	3.42 (1.05)	1.44 (0.75)	49	1.40 (0.82)	13
Determining loans for liquidity fund	2.30 (1.27)	3.56 (0.97)	3.68 (1.08)	1.39 (0.73)	59	1.29 (0.74)	24
Determining loans through mortgaging of assets	3.37 (1.41)	3.97 (0.72)	2.99 (1.04)	1.47 (0.81)	42	1.32 (0.78)	18
Serving as guarantee for other firms' large-scale loans	3.55 (1.32)	3.94 (0.77)	2.85 (1.06)	1.44 (0.75)	50	1.26 (0.65)	27
Determining amount of external donation	2.58 (1.46)	3.94 (0.79)	3.04 (1.22)	1.69 (0.95)	25	1.31 (0.76)	19
Determining external donation plan	2.35 (1.40)	3.52 (1.07)	3.20 (1.20)	1.76 (1.01)	19	1.31 (0.76)	19
Contracting of large-scale construction Project	2.37 (1.36)	3.72 (1.02)	3.42 (1.08)	1.54 (0.79)	41	1.31 (0.66)	19
Merging with other firms	4.04 (1.06)	3.89 (0.52)	2.94 (0.97)	1.55 (0.84)	40	1.60 (0.94)	3
Being merged by other firms	4.03 (1.23)	3.72 (0.85)	2.73 (1.07)	1.62 (0.96)	34	1.68 (1.03)	1
Mean	**3.33**	**3.86**	**2.96**	**1.47**		**1.417**	
Alpha	**0.93**	**0.87**	**0.95**	**0.98**		**0.97**	
3. Involvement in strategic decisions							
Organizational change	2.24 (1.25)	3.92 (0.84)	3.54 (0.94)	1.94 (1.01)	10	1.18 (0.51)	35
Creation and abolition of functional Departments	1.65 (0.86)	3.66 (1.08)	3.99 (0.80)	1.99 (1.02)	8	1.10 (0.34)	53
Creation and abolition of business Departments	1.44 (0.71)	2.93 (1.26)	4.31 (0.75)	1.89 (1.02)	13	1.10 (0.30)	50
Creation and abolition of branch	2.03 (1.22)	3.68 (1.03)	3.78 (0.90)	1.75 (0.98)	23	1.13 (0.34)	44

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APPENDIX III (cont.)

	Shareholders mean (SD)	*BoD mean (SD)*	*Manager mean (SD)*	*Party mean (SD)*	*Rank of party power*	*Government mean (SD)*	*Rank of gov. power*
Creation and abolition of subsidiaries	2.31 (1.37)	3.83 (0.93)	3.54 (1.01)	1.76 (1.01)	20	1.16 (0.36)	40
Formulation of long-term development plan	3.49 (1.30)	4.14 (0.64)	3.27 (1.00)	1.66 (0.93)	27	1.42 (0.73)	12
Formulation of strategic plan	3.11 (1.41)	4.20 (0.71)	3.30 (0.93)	1.63 (0.93)	32	1.44 (0.75)	8
Establishment of long-term relationship with other firms	2.42 (1.36)	3.78 (1.02)	3.59 (0.94)	1.63 (0.96)	33	1.22 (0.48)	30
Change of direction, entry into new industry and market	3.76 (1.21)	3.90 (0.76)	3.27 (0.97)	1.66 (0.99)	28	1.40 (0.69)	13
Mean	**2.50**	**3.78**	**3.62**	**1.77**		**1.24**	
Alpha	**0.82**	**0.78**	**0.79**	**0.96**		**0.89**	
4. Other decisions							
Call of shareholder meeting	3.23 (1.48)	4.07 (0.78)	2.14 (0.78)	1.44 (0.65)	46	1.21 (0.41)	31
Agenda setting in shareholder meeting	3.47 (1.37)	4.03 (0.81)	2.16 (0.86)	1.41 (0.60)	55	1.15 (0.36)	40
Call of board meeting	2.14 (1.07)	4.52 (0.73)	2.32 (0.91)	1.418 (0.60)	57	1.18 (0.42)	35
Agenda setting in board meeting	2.11 (1.05)	4.49 (0.84)	2.35 (0.91)	1.42 (0.60)	53	1.15 (0.40)	40
Call of supervisory committee meeting	1.96 (0.99)	1.89 (0.87)	1.73 (0.93)	1.56 (0.71)	39	1.13 (0.37)	45
Agenda setting in supervisory committee meeting	2.00 (1.03)	1.86 (0.87)	1.73 (0.94)	1.56 (0.73)	38	1.13 (0.37)	45
Call of manager's office meeting	1.63 (0.83)	2.68 (0.98)	4.54 (0.67)	1.79 (0.83)	17	1.17 (0.38)	39
Agenda setting in manager's office meeting	1.59 (0.75)	2.58 (0.98)	4.55 (0.67)	1.79 (0.83)	18	1.19 (0.40)	33
Selection of representatives attending manager's office meeting	1.42 (0.73)	2.32 (1.07)	4.51 (0.83)	1.66 (0.86)	26	1.08 (0.28)	57
Making amendments to firm's charter	4.11 (1.25)	3.62 (0.74)	2.21 (0.77)	1.45 (0.63)	44	1.29 (0.74)	24
Selection of accounting (auditing) firm	3.97 (1.30)	3.82 (0.87)	2.59 (1.15)	1.41 (0.75)	56	1.11 (0.32)	48
Selection of law firm	2.97 (1.58)	3.97 (0.96)	2.83 (1.24)	1.42 (0.77)	54	1.11 (0.36)	48
Selection of financial consultant	2.48 (1.48)	3.92 (1.04)	2.99 (1.26)	1.44 (0.81)	51	1.10 (0.34)	53

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APPENDIX III (cont.)

	Shareholders mean (SD)	*BoD mean (SD)*	*Manager mean (SD)*	*Party mean (SD)*	*Rank of party power*	*Government mean (SD)*	*Rank of gov. power*
Selection of management consultant	2.21 (1.38)	3.93 (1.06)	3.27 (1.21)	1.45 (0.84)	45	1.10 (0.34)	53
Training and education for board Members and higher management	1.78 (0.94)	4.17 (0.94)	2.99 (1.21)	1.75 (1.08)	21	1.24 (0.64)	29
Training and education for middle management	1.51 (0.75)	2.94 (1.32)	4.23 (0.81)	1.96 (1.19)	9	1.19 (0.60)	33
Mean of all decisions	**2.66**	**3.61**	**3.02**	**1.65**		**1.25**	
Alpha of all decisions	**0.97**	**0.92**	**0.97**	**0.99**		**0.98**	

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