STATE OWNERSHIP IN TERMS OF TRANSITION: CURSE OR BLESSING. THE CASES OF KAZAKHSTAN AND CHINA

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Roza Nurgozhayeva

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STATE OWNERSHIP IN TERMS OF TRANSITION: CURSE OR BLESSING. THE CASES OF KAZAKHSTAN AND CHINA

Roza Nurgozhayeva, J.S.D
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This dissertation argues that the institutional framework within transition economies, including the lack of a liquid capital market and a competitive product market, in addition to the focus on public benefits and socio-economic development, favors state-owned companies in terms of a non-market based system notwithstanding the popular concept of transaction costs and corporate efficiency. Despite the apparent costs of state ownership, including political considerations, soft budget constraints and weak profit motivations, there is a rational choice for state ownership in cases when private firms are not able to deliver the same quality of goods at a lower cost.

Within the standard framing, successful application of the best practices of corporate governance requires an efficient financial market, where stocks are liquid and corporate conduct is transparent. In this situation, the market for corporate control is a check on the firm's behavior. However, in transition economies, where just a small portion of the entire market's shares is publicly traded, the stock price bears little relationship to a company's underlying value, performance, or governance. Weak contract enforcement, poor protection of property rights, and underdeveloped capital markets have brought about a different set of governance mechanisms and policy agendas including the creation of competitive production capabilities, industrialization, economic diversification and social security. Thus, any discussion of corporate governance in these countries must consider the implications of state ownership structures.

Prior studies largely fail to properly identify and distinguish different forms of state ownership. While all forms of state corporate vehicles are ultimately owned by the state, they differ in many aspects. In contrast to the traditional governance model of state-owned entities generally characterized by overemployment, strong government control, weak incentives and political considerations, state companies today have different corporate structures and governance models. In particular, many state-owned enterprises have been corporatized and listed on domestic and international stock exchanges. In other words, they have been transformed into share-based, profit-oriented corporations (typically in the form of a limited liability company or a joint stock company), where the government has formally withdrawn from management and keeps the position of a shareholder. As opposed to the traditional governance structure, the corporate structure of state-owned entities today looks similar to their private counterparts including such corporate bodies as a general meeting of shareholders, a board of directors, and an audit committee. Many state companies have minority shareholders and independent directors in their corporate structures. They have become subject to the same governance and accounting standards and regulations as their private counterparts. These changes in state governance structures have produced a new composition of incentives and objectives as opposed to traditional state entities. Consequently, gathering all the types of state enterprises into one group (that has been typically done in prior studies) creates a misleading notion about the real effect of state shareholding.

This paper offers another insight into questions of corporate efficiency and alternative governance models of state ownership in transitional economies based on the examples of China and Kazakhstan. My study attempts to determine whether the models of state ownership, existing in transition economies, diminish institutional shortcomings and have important implications for capital costs and the investment policies of the market actors.

BIOGRAPHICAL SKETCH

Roza Nurgozhayeva serves as the Head of the Office for coordination of international contracts at Nazarbayev University, Kazakhstan. She completed her bachelor degrees in law (cum laude) and economics in Kazakstan and LL.M. at Cornell Law School. In 2016, she obtained a J.S.D from Cornell University. Roza's research interests include corporate governance, corporate efficiency, state ownership, and transition economies with a focus on the institutional framework and state ownership models within transition economies from the perspective of corporate governance theories, the concepts of transaction costs and corporate efficiency.

This dissertation is dedicated to my parents.

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INTRODUCTION

Government-owned organizations exist throughout the world including the United States. Typically, these are larger companies that tend to produce a "strategically important product"[1] or provide public services such as telecommunication, transportation, and water or electricity supply. They have a variety of corporate forms and agendas. Some of them compete in the open market with private companies, putting profit motivation in the first place. Other entities are non-commercial social service organizations. Finally, the third group represents the mix of these two approaches. Regardless of the corporate forms and goals of state entities, the issues of their accountability, legitimacy, corporate governance, and incentive structures have all been subject to academic discussion. These debates typically focus on the justification of state intervention in the economy, the correlation between state ownership and sound financial institutions, and the role of state-owned entities in a country's economic development.[2] The majority of studies touch upon concerns regarding the productive efficiency of state-

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[1] Cull, R., & Xu, L. C. (2003). Who gets credit? The behavior of bureaucrats and state banks in allocating credit to Chinese state-owned enterprises. Journal of Development Economics, 71, 533-559.

[2] Kahan, M., & Rock, E. B. (2011). When the government is the controlling shareholder. Texas Law Review, 89, 1293-1363. Available at SSRN: http://ssrn.com/abstract=1616266; Roper, J., & Schoenberger-Orgad, M. (2011). State-owned enterprises: issues of accountability and legitimacy. Management Communication Quarterly, 25(4), 693-709; Levine, R. (1997). Financial development and economic growth: views and agenda. Journal of Economic Literature, 35(2), 688-726; Millon-Cornett, M., Guo, L., Khaksari, S., & Tehranian, H. (2010). The impact of state ownership on performance differences in privately-owned versus state-owned banks: An international comparison. Journal of Financial Intermediation, 19, 74-94; Haggarty, L., & Shirley, M. M. (1997). A new data base on state-owned enterprises. The World Bank Economic Review, 11(3), 491-513; Barth, J. R., Caprio, Jr. G., & Levine, R. (2001). Banking system around the Globe. Do regulation and ownership affect performance and stability? In F. S. Mishkin (Eds.), Prudential supervision: want works and what does not (pp. 31-96). University of Chicago Press; Dewenter, K. L., & Malatesta, P. H. (2001). State-owned and privately owned firms: An empirical analysis of profitability, leverage and labor intensity. The American Economic Review, 91(1), 320-334; Cull, R., & Xu, L. C. (2003). Who gets credit? The behavior of bureaucrats and state banks in allocating credit to Chinese state-owned enterprises. Journal of Development Economics, 71, 533-559; Levy-Yeyati, E., Micco, A., & Panizza, U. (2004). Should the Government be in the Banking Business? The Role of State-Owned and Development Banks. Research Working Paper 517. Inter-American Development Bank, November; Perotti, E. (2007). State ownership: A residual role? World Bank policy research paper 3407, September; Dinç, I. S. (2005). Politicians and banks: Political influence on government-owned banks in emerging markets. Journal of Financial Economics, 77, 453-479.

owned enterprises, their political and agency costs, and the entire effect of state ownership on firm performance.[3] This literature often distinguishes state-owned companies from privately-owned firms, and vice versa, largely based on a percentage of shares held either by private or state actors. Accordingly, all the deficiencies of state-owned companies are explained from an ownership perspective or the distinction between state (public) and private. The latter has been considered a key element of the market economy and, consequently, transitional reforms have focused on the increase of the private sector's share and its autonomy from the state. This notion has significantly shaped the analysis of transition economies, where state ownership has been traditionally associated with poor economic performance.[4] Precisely, questioning the efficiency of state-owned enterprises, the literature often emphasizes their lower profit compared to their private counterparts.

However, although scholars agree that the central process in terms of transition is the building of complete markets and liberal institutions,[5] which have a strong positive impact on firm performance, there is often a legitimate reason why particular companies are state-owned rather than owned and operated in the private sector. In reality, weak contract enforcement, poor protection of property rights, and underdeveloped capital markets have brought about a different set of governance mechanisms and policy agendas including the creation of competitive production capabilities, industrialization, economic diversification and social security. Hence, state-owned enterprises often function in strategic and socially-important industries where there is little or no competition. Privately-owned companies operating in such

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[3] For example, La Porta et. al. (2002), Barth et. al. (1999), Beck and Levine (2002), and Caprio and Peria (2000) point out that government ownership is associated with lower economic growth and a lower level of financial development, as well as a higher likelihood of financial crises.

[4] Analyzing the role of governments in China, Latin America, and Eastern Europe scholars almost always find its unfavorable effect. See Berger, A. N., Clarke, R.G., Cull, R., Klapper, L., & Udell, G. F. (2005). Corporate governance and bank performance: A joint analysis of static, selection and dynamic effects of domestic, foreign and state ownership. Journal of Banking and Finance, 29, 2179-2221.

[5] "Broadly defined, market liberalization includes all forms of government initiatives to break the state monopoly in the market, free price controls, reduce entry barriers, and privatize state-owned enterprises (SOEs). Many emerging and low-income countries commonly use market liberalization as a strategy to promote economic development…" From Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147.

industries would require significant regulatory intervention since their profit-maximizing rationale would be in conflict with state policy objectives and, therefore, would potentially lead to higher costs and product quality distortions. Thus, a controlling position of the state in many large and often strategic firms remains a significant factor in determining accountability structures, investment policies, as well as the strengths and weaknesses of state-owned companies.

In order to address institutional and market frictions, the state bears distinct roles (regulator, shareholder, investor and creditor) and becomes capable of impacting the activities and decision-making of not only state-owned companies but also private firms. As a consequence, we may observe interdependence and interrelation of the state and private sectors and the emergence of different incentives and hybrid models of corporate governance in transition economies. However, there has been a lack of attention to the transformation of the state and state corporate structures in transition economies, as well as the effect of this transformation on corporate governance dynamics.[6]

This study attempts to fill this gap and provide an alternative approach to understanding good governance and corporate efficiency by studying the examples of China and Kazakhstan. Although both countries have many historical, cultural, and market differences, they share certain similarities. In particular, their experience demonstrates that corporate governance is largely affected by institutional environment and economic development existing in these countries. In the context of the lack of sufficient capital markets and formal governance mechanisms, state-owned companies in China and Kazakhstan

[6] By examining the actual market dynamics and the resulting state-building processes of the tobacco sector, Wang (2006) develops the theoretical agenda of ‘‘market-building as state-building’’ in transitional economies. Wang (2006) refers to Fligstein (1996), who argued that “market construction and transformation is a political project in which the state, large-scale organizations, and the pre-existing institutions of the economic system all play important roles. Particularly for post-communist countries like China, Fligstein’s theme represents a significant economic sociological perspective for understanding the state/market relationship in general. Going beyond a new institutional-economic view of markets that concentrates on exploring whether or not the state can efficiently function to stimulate economic growth during institutional change (e.g., Williamson 1975, 1981; North 1981, 1990), the economic-sociological perspective stresses how the state as an economic and political actor has actively constructed the markets and simultaneously been reconstructed by market processes.” From Wang, J. (2006). State-building as market-building in China. European Journal of Sociology, 47(2), 209- 240.

perform an active role in capitalizing national economies and sustaining economic growth.[7] These policy agendas, in turn, shape and expand a set of benchmarks for assessing corporate efficiency of state-owned companies by including tax revenues, employment and other socio-economic goods granted to the private sector and the population.

At the same time, the description of state-controlled enterprises in China and Kazakhstan supports the traditional theory that state-owned companies have multiple objectives, which together with political considerations are the major source of high transaction costs of state ownership.[8] Therefore, by examining government policies in China and Kazakhstan, we may highlight the institutional failures and costs that state-owned companies have to deal with in terms of economic transition as well as the benefits that these enterprises can contribute for sustained economic growth. Such benefits seem to counterbalance the transaction costs of state ownership in China and Kazakhstan.[9] The question then is not whether the state

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[7] Lin and Milhaupt (2011) raise the following question: [H]ow is a system without a plethora of formal institutions deemed important to Western firms producing a rapidly expanding list of Fortune 500 companies and supporting high and sustained levels of economic development in China?" And then, as one of the hypotheses they suggest: "[I]t is quite possible that China's formal legal institutions may "improve" in ways that reinforce the current system of industrial organization rather than prompt a transition to different forms of corporate organization. State capitalism may prove to be a durable institutional arrangement as a result of interest group politics, public policy, and path dependence." See Lin, L-W., & Milhaupt, C. J. (2011). Where are the (national) champions: Understanding the mechanisms of state capitalism in China. Stanford Law Review, 65(4), 697-759. Available at: http://ssrn.com/abtsract=1952623.

[8] For instance, it has been estimated that slightly over half of state-owned enterprises in China may have experienced conflict between their state- and shareholder-centered regimes coexisting. See Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[9] The analysis of Kazakhstan's context is grounded on primary data. As a native speaker I enjoy an access to state regulations, official financial reports and statements located on corporate websites. In addition, I largely used secondary resources including academic publications, the international organizations' statements and independent analytical reports. Nevertheless, the relatively limited amount of public information on the activities of Kazakhstani sovereign wealth funds, especially the National Fund of Kazakhstan, hampered my research.

With respect to China, there exists a vast body of literature on the reform of state-owned enterprises both in Chinese and other languages. As a non-Chinese who does not know the language, I do not have access to a large number of these publications or the primary data. Nevertheless, it seems to me possible to grasp some important features of this discussion on the basis of articles by Chinese scholars translated into English as well as by other academics writing on China.

sector is more or less efficient than the private sector, but how state-owned companies support economic development within the institutional environment inherent in transition economies.[10]

Thus, this study asks the following research questions: What are the characteristics, both the advantages and disadvantages, of the corporate governance approach applied in terms of economic transition? What is the tradeoff between the costs and benefits of this approach? What are the incentive structures operating within the system and how might they be improved? How might this corporate governance approach evolve in the future?

The cases of Kazakhstan and China are not unique. Most transition countries suffer from similar institutional deficiencies such as relatively weak legal and financial systems. My research is an attempt to conduct an in-depth academic analysis of the course of corporate governance carried out by two states that contributes to sustained economic growth without a formal institutional infrastructure including a sound contract system, well-protected property rights, and liquid capital markets. Therefore, this paper will be valuable in shedding light on corporate governance processes in other economies with similar growth potential and institutional challenges.

This paper does not have the goal of demonstrating a comparative advantage of state ownership as generally more important or efficient for economic governance in transitional countries. Moreover, it neither intends to disregard the positive effect of international governance standards nor claim that these standards are fundamentally and always ineffective. However, at the initial stages of transition, steady economic development often calls for state ownership and state capital to support national industries and fill institutional gaps (the market failure rationale). Thus, the meaning of what is "efficient" may vary depending on a particular institutional context and a socio-economic agenda existing in a country. The

[10] As Lin and Milhaupt (2011) put it: "The interesting question for us is not whether the state sector is more efficient than the private sector, but how the state sector has supported economic growth and produced globally important firms in the absence of formal infrastructure deemed essential in the standard theories on the relationship between institutions and development." See Lin, L-W., & Milhaupt, C. J. (2011). Where are the (national) champions: Understanding the mechanisms of state capitalism in China. Stanford Law Review, 65(4), 697-759. Available at: http://ssrn.com/abtsract=1952623.

government may choose different corporate governance approaches or even mix them.[11] Likewise, one may assess the performance of state-owned enterprises not only from the perspective of their revenue but also from the amount of social benefits produced by these companies.

The reminder of the paper proceeds as follows. The first chapter provides the reader with a conceptual framework of the research and the existing academic thinking of corporate governance, corporate efficiency, and the role of institutions in economic development. It describes a summary of my theoretical claims. The second chapter proceeds with the study of institutional and market conditions in Kazakhstan. It examines the country's state asset management system with an emphasis on its strengths and weaknesses and the government approach to measuring the value of a state owned enterprise. The third chapter considers the case of China. It begins with tracing the differences between China and Kazakhstan, and then briefly describes China's institutional context and studies costs and benefits of state companies in China. The fourth chapter proceeds with the analysis of the tradeoff of state ownership in both countries. Finally, the paper concludes with policy measures that would improve state-owned companies' performance.

[11] Different theoretical approaches to corporate governance, including the product market approach or the public good approach, will be discussed in the following parts.

CHAPTER 1

THEORIES OF CORPORATE GOVERNANCE AND CORPORATE EFFICIENCY IN STATE-OWNED ENTERPRISES

The choice between public and private ownership has been subject to heated academic debate.[12] Broadly speaking, these debates are grounded on a conceptual dispute between two economic systems: state-based versus market-based. In the former, governments play the leading (often crucial) role in the allocation and control of economic resources and production (so-called "state capitalism"). The latter system, or "market capitalism," is driven by private business and investments, where the state fulfills the role of a regulator.

In state-based systems, governments possess strategic economic resources and distribute them in accordance with their socio-economic and political agendas. To fulfill their goals, governments engage state-owned vehicles including sovereign wealth funds, state shareholding companies, state banks, and development institutions (hereinafter "SOEs"). Although there are substantial discussions on transition economies that include many worthy insights for explaining corporate governance in SOEs, the analysis is usually based on a static and unilateral approach. The literature generally omits the modern dynamics

[12] For instance, see Megginson, W. L., & Netter J. M. (2001). From state to market: A survey of empirical studies on privatization. Journal of Economic Literature, 39(2), 321-389; Shirley, M. M., & Walsh, P. (2000). Public versus private ownership: the current state of the debate. World Bank Policy Research Paper, August. doi.org/10.1596/1813-9450-2420; Dewenter, K. L., & Malatesta, P. H. (2001). State-owned and privately owned firms: An empirical analysis of profitability, leverage and labor intensity. The American Economic Review, 91(1), 320-334; Cull, R., & Xu, L. C. (2000). Bureaucrats, state banks, and the efficiency of credit allocation: The experience of Chinese state-owned enterprises. Journal of Comparative Economics, 28, 1-31; Shleifer, A. (1998). State versus private ownership. Journal of Economic Perspectives, 12(4), 133-150; Millon-Cornett, M., Guo, L., Khaksari, S., & Tehranian, H. (2010). The impact of state ownership on performance differences in privately-owned versus state-owned banks: An international comparison. Journal of Financial Intermediation, 19, 74-94; Roper, J., & Schoenberger-Orgad, M. (2011). State-owned enterprises: issues of accountability and legitimacy. Management Communication Quarterly, 25(4), 693-709.

of state ownership structures and governance in terms of acting and changing institutional conditions existing in transitional countries.[13] Therefore, the question is what is missing in the traditional theory?

What Is Missing in the Traditional Theory?

My argument is that the institutional framework within transition economies favors state-owned companies in terms of a non-market based system notwithstanding the popular concept of transaction costs and corporate efficiency.[14] Despite the apparent costs of state ownership, including political considerations, soft budget constraints and weak profit motivation,[15] there still might be a rational choice for state ownership in cases when private firms are not able to deliver the same, or even superior, quality of goods at a lower cost.[16]

Successful application of the best practice of corporate governance requires an efficient financial market, where stocks are liquid and corporate conduct is transparent. In this situation, the market for corporate control is a check on the firm's behavior. However, in transition economies where just a small portion of the entire market's shares is publicly traded, the stock price bears little relationship to a company's underlying value, performance or governance. Any discussion of corporate governance in

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[13] See Palazuelos, E., & Fernández R. (2012). Kazakhstan: Oil endowment and oil empowerment. Communist and Post-Communist Studies, 45, 27–37. This paper focuses on the role of large foreign companies as key players in influencing the initial conditions. However, even though foreign transnational companies led the reforms in 1990th, today the situation have changed and governments and SOEs have become exceptionally influential not only domestically, but also internationally.

[14] According to Rodrik (1999), "[t]he institutional basis for a market economy is not uniquely determined. Formally, there is no single mapping between the market and the set of non market institutions required to sustain it." Rodrik, D. (2000). Institutions for high-quality growth: What they are and how to acquire them. Studies in Comparative International Development, 35(3), 3-31.

[15] These costs will be discussed in the following parts.

[16] See Shleifer, A. (1998). State versus private ownership. Journal of Economic Perspectives, 12(4), 133-150.

these countries must consider the implications of state ownership structures. Foreign investments[17] and the evolution of corporate governance structures and alternative accountability methods have also affected economic governance in terms of economic transition.[18]

Furthermore, a very complex process of institutional reforms has contributed to the atmosphere of mistrust and general uncertainty in many transition countries. The development of Western-style institutions has been slow and has failed to establish a credible institutional framework, such as the rule of law and an independent judicial system.[19] As a consequence, the path toward a market-oriented economy has brought about institutional uncertainty and social challenges.[20] Seeking to solve socio-economic agendas while urging economic reforms, governments prefer to mix governance models by making them neither purely shareholder- nor purely state-oriented.

On a particular stage of development, the choice might not necessarily be between fully privatized or fully state-owned enterprises.[21] Instead, the question would be what are the ways to make the existent structure of resource allocation less costly and more efficient rather than whether SOEs perform well enough or whether state ownership itself has to be replaced by private interests.

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[17] The scarcity of domestic capital forces market actors to seek foreign investments.

[18] We may distinguish the following typical features of many transition economies. First is the strong insider control of large and medium-size enterprises. The desire of control is caused by the poor enforcement of property rights. At the same time, the strong control over assets impedes investors to contribute capital. Second feature is outside financing dominated by state and commercial banks. In the absence of alternative external sources of finance, the central bank channeling considerable funds to state enterprises through the largest banks. With respect to private actors, the absence of the market for corporate assets prevents them from rising outside funds. As a result, enterprises in the transition economies are establishing links among themselves through trade credits and crossholding of equity. See Aoki, M., & Kim H-K. (Eds.). (1995). Corporate governance in transitional economies: Insider control and the role of banks. World Bank Institute (WBI) development study. Washington, DC: World Bank.

[19] Sušjan, A., & Redek, T. (2008). Uncertainty and growth in transition economies. Review of Social Economy, 66(2), 209-234.

[20] In this regard, scholars mention the problems of unemployment, income uncertainty and inequality in transition economies. Keynes (1937) defined uncertainty as a concept referring to matters about which no calculable probability is possible. Keynes, J. M. (1937). The general theory of employment. Quarterly Journal of Economics, 51, 209-223.

[21] Chang, H-J. (2007). State-owned enterprise reform. Policy Notes, Department for Economic and Social Affairs (UNDESA).

While all of the forms of state corporate vehicles are ultimately owned by the state, they differ in many aspects. Prior studies largely fail to properly identify and distinguish different forms of state ownership.[22] Nonetheless, SOEs have a variety of corporate structures and governance models. In particular, there are some SOEs with a corporate form of a state entity per se. These entities are usually created for a particular socio-economic agenda. In this regard, in order to operate, the government grants these entities a portion of state assets. As a consequence, state entities are subject to direct state management and control. They are strictly limited in their investment and commercial activities. Also, they are exclusively funded from the state budget and have to transfer their profit back to the state.[23]

Another type of state-owned companies is share-based, profit-oriented corporations (typically with the form of a limited liability company or a joint stock company), where the government has formally withdrawn from management and keeps the position of a shareholder. These SOEs have been corporatized and listed on domestic and international stock exchanges. As a result, the formal governance structure of many SOEs looks similar to their private counterparts including such corporate bodies as a general meeting of shareholders, a board of directors, and an audit committee. Many SOEs have minority shareholders and independent directors in their corporate structures.[24] SOEs and private companies have become subject to the same governance and accounting standards and regulations. These changes in the

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[22] For example Haggarty and Shirley (1997), following Jones (1975), provide common definition of SOEs as "government-owned or -controlled economic entities that generate the bulk of their revenue for selling goods or services." This definition has limited commercial activities for SOEs.

[23] In Kazakhstan, state entities usually operate in such industries as energy or water supply, health care, national parks, professional education or academic research. As the result of their social-economic nature, the government controls pricing policies of its state entities making state funding the only source of their financing, In turn, state entities have to transfer the main portion of their net profit to the state budget. If a state entity accomplishes its socio-economic goals, it can be reorganized or liquidated.

It is worth to mention that state entities become a quite obsolete corporate form remaining from the Soviet times. In Kazakhstan today, many state entities have been reorganized in the form of JSCs.

[24] By and large, the SOEs reform has targeted the application of the principles of private management to SOEs with the only difference - the nature of the owner: a state institutional investor instead of a private actor. As a result, boundaries between public and private as well as between state and market become quite vague. Many SOEs demonstrate quasi-public, quasi-private features. See Ralston, D.A., Terpstra-Tong, J., Terpstra, R. H., Wang, X., & Egr, C. (2006). Today's state-owned enterprises of China: Are they dying dinosaurs or dynamic dynamos? Strategic Management Journal, 27, 825-843 and Francis, C-B. (2001). Quasi-public, Quasi-private trends in emerging market economies: The case of China. Comparative Politics, 33(3), 275-294.

SOEs' formal governance structures have modified the substance of corporate governance in state companies by producing a new composition of incentives and objectives as opposed to traditional state entities.[25] Therefore, gathering all the types of state enterprises into one group, as has typically been done in prior studies, creates a misleading notion about the real effect of state shareholding.

The study of the market in some transition economies demonstrates that their main players are speculative investors seeking to invest in seriously undervalued assets with a high potential for short-term growth.[26] For example, Schuch et al. (1996) showed that potential foreign investors in transition economies, when they face various transition-specific factors, tend to avoid long-term commitments. Instead, they often prefer short-term investments in industries with short vertical business chains, rather than in sectors with long business chains, such as manufacturing.[27] Thus, this type of investor is less concerned with the quality of corporate governance and institutional development of the country or the company they invest in. In these circumstances, the state bears the central role in the constitution, construction, and operation of the economy including monitoring labor and capital markets, suppression of monopolies, regulation of financial markets, and promotion of industrialization and high technologies.[28]

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[25] For instance, Chen, Firth, and Xu (2009) classify state owners in China's listed companies into three major types based on their political and economic interests: SAMBs (state asset management bureaus), SOEs affiliated with the central government, and SOEs affiliated with the local government. They argue that these three types of state owners have very different objectives when it comes to the listed firms they control. See Chen, G., Firth, M., & Xu, L. (2009). Does the type of ownership control matter? Evidence from China's listed companies. Journal of Banking & Finance, 33, 171–181.

[26] In 2003, the Russian Institute of Directors (RID) conducted a survey that showed an overall positive correlation between "good" corporate governance and stock prices of large Russian companies. These investors look for a high return through significant growth in stock prices in a very short period of time and, consequently, are willing to take big risks. See Belikov, I. (2004). Corporate governance in Russia: Who will pay for it and how much? Online Resources of Center for International Private Enterprise, April. Available at http://www.cipe.org/publications/detail/corporate-governance-russia-who-will-pay-it-and-how-much.

[27] Schuch, A. A., Anderson, J. C. & Houston, M. J. (1996). Marketing strategies for East Central Europe: a balancing act between globalization and local market responsiveness. In P. Chadraba and R. Springer (Eds.), 4th Annual Proceedings of the Conference on Marketing Strategies for Central & Eastern Europe.

[28] Gerschenkron (1962) argued that the state's role in nurturing capitalist development becomes even more significant in the context of late industrialization due to relative economic backwardness, a thesis supported by East

SOEs as state agents and investors have enough power to collect information and induce managers of the firms they invest in to commit through contract covenants and close monitoring and, in this sense, to solve problems with incentives.[29] In this context, some empirical studies provide evidence on the SOEs' higher financial discipline compared to their private counterparts with respect to state investment programs.[30] Hence, minority shareholders tend to rely on a large state equityholder as a disciplining force for corporate management.

Institutional arrangements existing in transition economies have also determined the concept of efficiency applied to SOEs in transition economies.[31] To be precise, these entities are the key operators of state socio-economic, pension and social security programs. Hence, their failure can undermine government planning and spending and, as a consequence, harm the investment climate and political course of a country. Thus, through equityholding, the state authorities tend to achieve certain socio-

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Asian paths to development. See Gerschenkron, A. (1962). Economic backwardness in historical perspective. Cambridge, Mass: Harvard University Press; The Political Economy of the New Asian industrialism. Ithaca: Cornell University Press, 1987; Gereffi, G., & Wyman, D. (Eds.) (1990). Manufacturing miracles: paths of industrialization in Latin America and East Asia, Princeton: Princeton University Press.

[29] Shleifer, A., & Vishny, R. (1986). Large shareholders and corporate control. Journal of Political Economy, 94, 461–488.

[30] To address inefficiencies of domestic institutions, governments employ vertically-structured groups of SOEs, which allow creating internal markets for capital, managers and information that provide a certain degree of efficiency in resource allocation across the groups and the economy as a whole since the groups represent different industries. See Samphantharak, K. (2007). Internal capital markets in business groups. SSRN Working Paper Series, March. Available at: http://ssrn.com/abstract=975562; Khanna, T., & Yafeh, Y. (2005). Business groups and risk sharing around the World. The Journal of Business, 78(1), 301-340; Khanna, T., & Yafeh, Y. (2007). Business groups in emerging markets: paragons or parasites? Journal of Economic Literature, 45(2), 331-372; Khanna, T., & Palepu K. (2000). Is group affiliation profitable in emerging markets? An analysis of diversified Indian business groups. The Journal of Finance, 55(2), 867-891.

[31] "In order to be efficient any corporate structure should provide its constituencies with right incentives to run the firm from the perspectives of long-term interests of all groups with a stake in the firm. For example, to improve its corporate governance a company may hire high quality auditors or have independent directors. Such steps help corporate insiders to demonstrate their intention to commit and hence make it possible to raise more capital externally. However, despite the effort to improve governance in a company, it still heavily depends on the country of its residence. Such factors as weak contract enforcement and insufficient protection of property rights can sharply increase transaction and agency costs. Thus, a country image, the overall level of its financial development as well as the existing system of political and legal institutions might considerably impact corporate governance practice and the costs of capital." From Stulz, R. M. (2006). Financial globalization, corporate governance and Eastern Europe. Financial Development, Integration and Stability: Evidence from Central, Eastern and South-Eastern Europe, 16-40.

economic imperatives that are critical for economic growth. This implies state control for purposes other than the maximization of the SOE's income. Based on this rationale, some governments treat SOE efficiency relative to whether the SOEs' objectives outlined by their shareholders have been achieved. While one of these objectives is an increase in profit, governments take a rather broader track and evaluate SOE performance from the perspective of social welfare and long-term socio-economic benefits provided to the population and business community including net profits, taxes, social programs, sponsorship and programs of development. Accordingly, the purposes of SOEs is not only making money but also accomplishing national industrial development and fair redistribution of resources in the absence of an adequate "marketplace."

Thus, corporate governance in SOEs is likely to be more complex than in private firms.[32] Multiple objectives of SOEs have produced a system in which corporate efficiency is measured relative to the SOEs' actual agenda, including the maximization of shareholder wealth. This, in turn, creates several obstacles. While private firms typically have a common goal of profit maximization that is a relatively straightforward index to measure the performance of managers, SOEs often have several goals that might conflict with each other. Many SOEs' goals are not easily assessed since there is no clear understanding of what the benchmarks are.[33] Moreover, non-listed SOEs do not have a market-valued share price. The ambiguity of measurement standards brings about monitoring difficulties, when the monitoring agency hardly knows how to evaluate the costs and benefits of SOEs' operations and how the achieved results trade off and fit into the country's socio-economic goals.[34]

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[32] See Su, D., & He, X. (2012). Ownership structure, corporate governance and productive efficiency in China. Journal of Productivity Analysis, 38, 303–318; Su, D. (2005). Corporate finance and state enterprise reform in China. China Economic Review, 16, 118-148; Chen, G., Firth, M., & Xu, L. (2009). Does the type of ownership control matter? Evidence from China's listed companies. Journal of Banking & Finance, 33, 171–181; Fan, J., Wong, T., & Zhang T. (2007). Politically connected COEs, corporate governance, and post-IPO performance of China's newly partially privatized firms. Journal of Financial Economics, 84, 330–357.

[33] Su, D., & He, X. (2012). Ownership structure, corporate governance and productive efficiency in China. Journal of Productivity Analysis, 38, 303–318.

[34] The status of monitoring agencies can be different. For example, the Sovereign Wealth Fund Samruk-Kazyna, a state-owned JSC, fulfills the function of monitoring and control in Kazakhstan. In China, the management of SOEs

Therefore, we may assume that the costs of SOE management and control are still quite high because of the multiple objectives of SOEs and the presence of political considerations. Without careful analysis and reform of corporate governance in SOEs, their transaction costs will continue to grow as long as markets evolve and the economy develops. On balance, the state is ready to assume short-term losses in profit of their SOEs and offset them by generating socio-economic benefits because governments are motivated to commit to financially sustainable SOEs and further corporate governance reforms. Then, the question arises of how to commit to better corporate governance and achieve better SOE performance.

There can be applicable ways to diminish the costs of SOE management through governance mechanisms, many of which have been adopted from the private sector. First, SOEs should be managed within a stable and sustainable macroeconomic system with clear rules on the use of the state budget and the SOEs' assets. State policies need to establish long-run comprehensible outputs and outcomes for SOEs and their industries. To achieve this goal, the government should define the coherent criteria of success for SOEs that corresponds with the long-run outcomes of the entire industry. Also, it should establish concrete quantitative and quality indicators to assess the SOE performance in order to improve the quality of further monitoring. Second, SOEs must be run in accordance with the principles of integrity, full disclosure and internal risk management. To effectively analyze state industrial policies and budget spending, information on the actual total amount of state financing across different industries should be complete and available. In this regard, the data on SOEs' investment strategies, portfolio allocation, risk management and management reward systems needs to be transparent. And finally, competent professionals must run SOEs on a competitive basis with full compliance with law and regulations. Professional managers should be appointed in accordance with their skills and work

affiliated with the central government has been placed in the hands of the State Asset Supervision and Administration Commission established in March 2003. The new commission is in charge of China's largest SOEs on behalf of the State Council. The SOEs affiliated with local governments are directly controlled and managed by state assessment management bureaus.

experience rather than their political affiliation and personal connections. The number of independent directors should be increased.

With respect to Kazakhstan and China, although these countries have implemented substantial reforms of their state sectors, abovementioned policy measures are still relevant. Corporate governance of SOEs continues to evolve in these countries. For instance, clear and concrete indicators of SOEs' operations are still work in progress in order to improve monitoring and assessment of SOEs' performance. Many SOEs demonstrate poor disclosure in terms of their investment strategies, portfolio allocation, risk management, and management reward system. Finally, political considerations and bureaucratic affiliation continue to be an issue for SOE management in Kazakhstan and China. Therefore, the ways to diminish the shortcomings of SOE management remain a priority for Kazakhstan and China.

Summing up, there might be legitimate reasons why SOEs exist and operate in a particular industry or in a particular market. Unless these reasons, as well as the SOEs' objectives, are understood, trying to draw a simple analogy between the private and public sectors likely leads to poor results. The response on what constitutes SOE efficiency can be found in the institutional environment of transition economies.[35]

Institutions in Transition Economies

The question of whether particular sets of rules and institutions promote economic efficiency more than others has remained one of the central themes in economic theory over the past decades.[36]

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[35] Dewenter, K. L., & Malatesta, P. H. (2001). State-owned and privately owned firms: An empirical analysis of profitability, leverage and labor intensity. The American Economic Review, 91(1), 320-334: "…whether government firms are more or less efficient than private firms is primarily an empirical issue. To date the body of empirical evidence is mixed. Douglas W. Caves and Laurits R. Christensen (1980), Stephen Martin and David Parker (1995), Stacey R.Kole and J. Harold Mulherin (1997), and others, however, present a body of evidence supporting the view that government firms are intrinsically no less efficient than private firms."

[36] The literature provides many examples of the role of institutions in economic development. In particular, many scholars, starting from La Porta et al.'s papers, have studied the experience of different countries in order to reveal

The traditional line of argumentation places private firms in a better position to deal with transaction costs and incentives, and it offers a variety of alternative mechanisms to discipline managerial behavior.[37] In the orthodox shareholder model, the problems of management carelessness, incompetence, and moral hazard are corrected by outside stockholders through efficient capital markets for corporate control and competitive labor markets for managers. An existing "marketplace" has been assumed to provide the owners of private firms with stronger incentives to manage their companies efficiently as opposed to state-owned enterprises.[38] However, this theoretical approach studies corporate governance systems mainly in their ideal conditions. Meanwhile, as the cases of Kazakhstan and China indicate, the market and the regulatory contexts of many transition economies are highly imperfect.[39] In this regard,

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the causal relationship between institutions and economic growth. More specifically, they have focused on reforms in the developing world where there has been an economic boom even in the absence of best practice institutions, effective property rights and contract enforcement, sufficient investor protection, and macroeconomic stability. See Thomas, C. (2011). LAW AND NEOCLASSICAL ECONOMIC DEVELOPMENT IN THEORY AND PRACTICE: TOWARD AN INSTITUTIONALIST CRITIQUE OF INSTITUTIONALISM. Cornell Law School Research Paper No. 11-16. Available at: http://ssrn.com/abstract=1844715; PISTOR, K., & WELLONS, P. A. (1999). THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN ECONOMIC DEVELOPMENT: 1960–1995. HONG KONG: OXFORD UNIVERSITY PRESS AND THE ASIAN DEVELOPMENT BANK. See also Steier, L. P. (2009). Familial capitalism in global institutional contexts: Implications for corporate governance and entrepreneurship in East Asia. Asia Pacific Journal of Management, 26, 513–535; Carney, M. (2005). Corporate governance and competitive advantage in family-controlled firms. Entrepreneurship Theory and Practice, 29(3), 249-265. doi: 10.1111/j.1540-6520.2005.00081.x.

[37] The choice of public versus private provision depends on how different ownership patterns affect the incentives to reduce costs and to improve quality or innovate. Precisely,"[w]hen assets are publicly owned, the public manager has relatively weak incentives to make either of these investments, because this manager is not the owner and hence gets only a fraction of the return. In contrast, private regulated contractors have much stronger incentives because, as owners, they get more of the returns on the investment. Which ownership structure is more efficient depends on whether having high-powered incentives to invest and innovate is a good idea. The weak incentives of government employees with respect to both cost reduction and quality innovation underlie the basic case for the superiority of private ownership, a case that has been confirmed by the variety of empirical studies and general observation." From Shleifer, A. (1998). State versus private ownership. Journal of Economic Perspectives, 12(4), 133-150.

[38] From bureaucracy to business enterprise: Legal and policy issues in the transformation of government services (2003). Edited by Michael J. Whincop, Ashgate Publishing Limited.

[39] "If the securities market is thin and the workers and managers have strong attachments to their employing firms, market signals of corporate valuation would be garbled and full of noise. Further, exercising corporate control through the market (the takeover mechanism) would simply not be feasible unless insiders gave up their shares." From Aoki, M., & Kim H-K. (Eds.). (1995). Corporate governance in transitional economies: Insider control and the role of banks. World Bank Institute (WBI) development study. Washington, DC: World Bank.

Lin and Milhaupt (2011) suggest that the traditional point of view focuses on what transition system lack, as opposed to how the actually function."[40]

Legal systems. The idea that law and regulation clearly matter for market development is supported by the law and economics literature.[41] Solid protection of property rights and an independent and professional judicial system are considered as prerequisites for liquid capital markets.[42] However, countries are different in terms of their institutional context and market maturity. The experience of Kazakhstan and China demonstrates that economic development rather precedes, than follows legal change. The failure of the "shock therapy" approach in Kazakhstan reveals that fundamental legal reforms can be successfully adopted if the market reaches a certain development stage. In this regard, gradualism inherent to Chinese transitional reforms is largely consistent with the Coffee's (2001) "crash-then-law" thesis.[43] Market development and international market integration of Kazakhstan and China push economic reforms together with the attempt to modernize the legal infrastructure. In particular, China's membership in the World Trade Organization (WTO)[44] has compelled Chinese policymakers to revise a wide range of issues including trade, intellectual property, investment, and dispute resolution. In order to meet the requirements of the international market and successfully compete in the market of transnational trade and investments, China has to implement substantive reforms in the legal system, judicial

[40] Lin, L-W., & Milhaupt, C. J. (2011). Where are the (national) champions: Understanding the mechanisms of state capitalism in China. Stanford Law Review, 65(4), 697-759. Available at: http://ssrn.com/abtsract=1952623.

[41] La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R. (2002). Investor protection and corporate valuation. Journal of Finance, 57, 1147–1170.

[42] See Clarke (2003), Shleifer and Vishny (1997) for a comprehensive survey, Black (2001), and Coffee (2001). The correlation between law and market development has been discussed in the literature, especially after LLSV's research. In generally, these debates have the similar "law matters" focus. LLSV demonstrate that law is the key precondition for market development. In other words, deep markets cannot be in place unless fundamental legal reforms are implemented. Therefore, common law countries perform better because their legal system protect contract and property rights more effectively.

[43] A group of scholars, including Coffee (2001) offers the opposite hypothesis that market development precedes legal reforms (a so-called "crash-then-law" thesis).

[44] Kazakhstan is currently in the process of applying for the WTO membership.

infrastructure and law enforcement.[45]

Kazakhstan and China are civil law countries. Their legal systems include branches of statutory law in accordance with specific areas of regulations and principles, for example, constitutional, civil, criminal, labor laws or litigation. Each branch of law consists of the basic law (often, the code) and special laws regulating particular fields of relations. For instance, the basic civil law in Kazakhstan is the Civil Code, including its two parts, adopted in 1994 and 1999 respectively. In China, the primary source of civil law is the General Principles of the Civil Law and special civil laws including the Contract Law, the Company Law, the Marriage Law, etc.[46]

Kazakhstan and China are unitary states. Therefore, each country has only one legislative system of multiple levels, which has a hierarchical structure. Constitutions of two countries stipulate that the legislative power is exercised by the Parliament (Kazakhstan) and the National People's Congress (China). The government of Kazakhstan and the State Council of China formulate administrative regulations according to the Constitutions and laws. Regional authorities are entitled to formulate local regulations, which should not contradict to the Constitution, laws or administrative regulations of the government.

There are other similar features of the legal systems of Kazakhstan and China. One of them is that the legal systems of both countries are not actually separated from the administrative systems. Despite the fact that a substantial legal framework has been put in place, still law has been treated as an instrument for the state autocratic system to enforce its control in order to maintain social order.[47] In this regard, the

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[45] Lam Y. T., & Chen Z. (2004). The development of the construction legal system in China. Construction Management and Economics, 22(4), 347-356. DOI: 10.1080/0144619032000122177.

[46] To optimize civil legislation, China is in a process of drafting its own Civil Code. Information from the website of the Ministry of Justice of the People's Republic of China as of 19 October, 2015. See http://english.moj.gov.cn/Legal-Knowledge/node_7642.htm.

[47] It worth mentioning that this can be deemed as a consequence of Soviet legal traditions. However, Clarke (2003) notices that that approach can be traced in China's history. In particular, "…as the central part of the Qing Dynasty's legal system, for example, the Qing Code was a collection of rules that were predominantly concerned with the official activities and functions of the bureaucrats within the government apparatus, not with disputes and relationships between and among private citizens. The imperial law touched upon private matters only as the matters

judicial systems have become a part of the state bureaucracy and, therefore, have not obtained an actual independent status.[48]

Other common features are the abundant number of legal acts and the ambiguity of legal norms that create a basis for various loopholes and weak law enforcement. This could be explained by the pace of economic transition that itself generates the ground for uncertainty and rapid institutional changes. Market transformations call for the urgent introduction of corresponding regulations. Often, those regulations do not correspond with the existing set of legal norms. As a consequence, urgent need for some regulations has led to inconsistencies and contradictions in legislation with some details left out.[49]

The study of such transition economies as Kazakhstan and China demonstrates that relatively underdeveloped markets, weak legal institutions and state financing have become powerful elements that determine the corporate governance practices. First, general scarcity of available financial resources and limited access to bank loans make the government and state-owned institutions the largest investors capable of providing both economies with long-term investments.[50] These long-time horizons help

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were thought to affect imperial policies. Thus, the code was primarily of an administrative nature, and it tended to rely only on administrative and criminal penalties. This is in sharp contrast with the Roman law tradition, from which western laws are derived. At the heart of Roman law is civil law, rather than administrative law. Roman law arose during a time when Rome was a small agricultural society. As a result, the law developed mostly in response to the occurrence of disputes between private citizens and/or social groups."

[48] Although, Kazakhstan's Constitution officially adopted the doctrine of the separation of power, judicial independence has been largely undermined. However, Kazakhstani judges are professionally trained lawyers. In contrast, many judges in China "…are not trained lawyers, and even a large number of them, especially in less developed provinces, are former military officers who had no formal legal training prior to being a judge." There is a Communist Party political-legal committee that is superimposed on the legal system, controlling the assignment, promotion, demotion and replacement of judges. See Chen, Z. (2003). Capital markets and legal development: The China case. China Economic Review, 14(4), 451-472.

[49] Lam Y. T., & Chen Z. (2004). The development of the construction legal system in China. Construction Management and Economics, 22(4), 347-356. DOI: 10.1080/0144619032000122177.

[50] One of the major obstacles for a company to obtain bank financing is collateral. An extensive theoretical literature shows that collateral can mitigate moral hazard and adverse selection problems in loan. See Mishkin, Frederic S. (2007). Is financial globalization beneficial? Journal of Money, Credit and Banking, 39(2-3), 259-294.

However, in the atmosphere of general uncertainty inherent in transition economies the role of collateral becomes a core-stone. Insufficient property rights protection and week legal enforcement urge private entrepreneurs not to domestic companies overcome institutional and market uncertainties and focus on the quality of goods and services they deliver.[51]

Second, both insufficient protection of property rights and poor legal enforcement explain why shareholders favor ownership concentration and their motivation to bear the costs arising from having a controlling shareholder.[52] Since the majority of transitional countries, including Kazakhstan and China, lack the markets that can discipline managers and provide investors with the opportunity of diversification, many SOEs and large private companies have a controlling shareholder and a vertically integrated group structure.[53] SOEs enjoy vertical integration with the administrative advantage of maintaining control over state assets. This arrangement prompts the effective transmission of capital and information from the government to SOEs, and vice versa, through the hierarchical system of state ownership.[54] In the absence of formal institutions, a hierarchical group structure helps the governments to

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legalize their property. This, in turn, makes the collateral requirement hard to follow and as a consequence, limit bank financing. See De Soto, H. (2001.) The mystery of capital: Why capitalism triumphs in the west and fails everywhere else. London: Black Swan. He observed a vast informal sector in many Latin American countries not captured by adopted formal regulations and consequently argued that for economic growth the existing property law systems should comply with actual extralegal property rights.

[51] The concept of uncertainty is relevant for transition economies. These economies have been undergoing a very complex process of institutional transformation. Those changes have resulted in substantial economic losses and have increased the uncertainty of their socio-economic environment. See Sušjan, A., & Redek, T. (2008). Uncertainty and growth in transition economies. Review of Social Economy, 66(2), 209-234.

[52] The presence of a controlling shareholder reduces the managerial agency problem, but at the cost of the private benefits agency problem. Non-controlling shareholders will prefer the presence of a controlling shareholder so long as the benefits from reduction in managerial agency costs are greater than the costs of private benefits of control. Gilson, R. J., & Gordon, J. N. (2003). Controlling Controlling Shareholders, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 152, 785- 843.

[53] Kahan, M., & Rock, E. B. (2011). When the government is the controlling shareholder. Texas Law Review, 89, 1293-1363. Available at SSRN: http://ssrn.com/abstract=1616266; Fama, E. F. (1980). Agency problems and the theory of the firm. Journal of Political Economy, 88(2), 288-307.

[54] In essence, state ownership offer close oversight and vertical integration as an alternative method to reduce transaction costs. This method provides state shareholders with such governance tools as electing board members, deciding on major corporate transactions, allocating corporate assets, etc. The state-controlling shareholder can be a powerful monitoring force. The centralized group structures, within which SOEs operate, make it easier for the government as a large shareholder to monitor SOE management using reporting procedures and political connections. These groups include different actors such as central and local authorities, parent SOEs, state-owned banks and SWFs that often have distinct incentives. Multiple parties involved in SOE decision-making deliver an opportunity to debate major policy issues and SOE spending. Furthermore, within a pyramidal holding company

diversify risks by spreading state investments among different industries and enterprises.[55] On the other hand, the affiliation with the group allows SOEs to receive a variety of state-provided benefits and obtain additional capital, technologies and information at lower costs.[56] Group networks facilitate information and capital sharing and diversification of risks.[57]

Some transition economies, including China and Kazakhstan, have incorporated sovereign wealth funds (hereinafter "SWFs") as a part of the SOE group structures in order to capitalize and monitor SOEs'

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structure its members enjoy access to internal capital and information markets as well as the advantage of risk sharing and stability regarding market fluctuations. At the same time, the governments utilize the opportunity to diversify and more effectively allocate resources. This means that the governments have a chance to allocate and channel assets across industries. See Klein, B., Crawford, R. G., & Alchian, A. A. (1978). Vertical integration, appropriable rents, and the competitive contracting process. Journal of Law and Economics, 21(2), 297-326.

[55] According to Khanna and Yafeh (2007), "[i]mperfections in labor markets (both for skilled employees and executives), limited enforcement of contracts, inadequate rule of law and other institutional deficiencies may give rise to business groups that generate these public goods for the benefit of group members. Diversified groups may be efficient if they make up for missing institutions related to the process of entrepreneurship: new ventures initiated by business groups relay not only on capital infusion form the group, but often also on the group brand name and implicitly on its reputation, providing a guarantee that is scarce in emerging markets (Noel Maurer and Tridib Sharma 2001). There is also an internal (within-group) market for talent." Khanna, T., & Yafeh, Y. (2007). Business groups in emerging markets: paragons or parasites? Journal of Economic Literature, 45(2), 331-372.

[56] In particular, Morck and Yeung (2006) found that membership in a group reduces bankruptcy probability and secure easier access to capital markets. "The reason is that external capital providers will be more willing to provide financing if they expect solvent business groups to provide support to their member firms. An implicit guarantee of support by firm's group is likely to be especially valuable in emerging economies with poor protection for creditor rights. Hence, our evidence on the support role of intragroup loans agrees well with the observation that groups constitute a large fraction of the corporate sector in many emerging economies, unlike in economies with more efficient and developed financial markets." From Morck, R., & Yeung, B. (2004). Special issues relating to corporate governance and family control. World Bank Policy Research Working Paper 3406.

[57] "… an enterprise may be most profitably pursued as part of a large diversified business group that can act as an intermediary between individual entrepreneurs and imperfect markets. For example, groups can use their track record and reputation in their established lines of business to gain credibility for new ventures among suppliers and customers. More generally, the scale and scope of groups could allow business groups to internally replicate the functions provided by stand-alone intermediary institutions in advanced economies. Firms affiliated with business groups, therefore, can benefit from access to these internal institutions to mitigate external market failures. Group structures also have the capacity to reduce the costs of diversification. Though groups themselves are often highly diversified, individual firms in each group are typically focused." From Khanna, T., & Palepu K. (2000). Is group affiliation profitable in emerging markets? An analysis of diversified Indian business groups. The Journal of Finance, 55(2), 867-891. See also Khanna, T., & Yafeh, Y. (2007). Business groups in emerging markets: paragons or parasites? Journal of Economic Literature, 45(2), 331-372; Kshetri, N., & Dholakia, N. (2011). Regulative institutions supporting entrepreneurship in emerging economies: A comparison of China and India. Journal of International Entrepreneurship, 9, 110–132.

operations. This type of fund is quite different from the traditional understanding of SWFs provided by the literature.[58] Typically, SWFs have been defined as government investment vehicles funded by foreign exchange inflows, which in turn are derived from commodity exports, trade surpluses or privatization of state assets, but managed separately from official reserves.[59] The majority of SWFs have been positioned as passive investors that seek diversification through investing in liquid and safe foreign instruments.[60] SWFs in resource-dependent countries tend to invest in more permanent non-commodity sectors in order to avoid the so-called "Dutch Disease."[61]

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[58] The concept of SWFs was originally introduced in oil exporting countries several decades ago as commodity-based funds creating a buffer against commodity price fluctuations. Since then, the number of SWFs has doubled during the last decade. Among the largest SWFs, more than half were established after 2000. However, the term a "sovereign wealth fund" was itself invented only in 2005. SWFs have mostly been established in emerging and developing countries with a large share of state ownership. These countries have accumulated excessive exchange reserves. SWFs as a form of state-owned corporations, being more flexible than national banks or government agencies, represent an alternative investment mechanism that could diversify sovereign portfolio allocations and maximize social and political benefits on a country-level. Ronald Gilson and Curtis Milhaupt named this phenomenon as "the new mercantilism."

See Truman, E. M. (2007). A scoreboard for sovereign wealth funds. Washington: Peterson Institute for International Economics; Jen, S. (2007). Sovereign wealth funds. What they are and what's happening. World Economics, 8; GILSON, R. J., & MILHAUPT, C. J. (2008). SOVEREIGN WEALTH FUNDS AND CORPORATE GOVERNANCE: A MINIMALIST RESPONSE TO THE NEW MERCANTILISM. STANFORD LAW REVIEW, 60(5), 1345-1370; Rozanov, A. (2005). Who holds the wealth of nations. Central Banking, 15(4), 52-7. See also Kimmitt, Robert. 2008. "Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy." Foreign Affairs 87 (1); Markheim, D. (2008). Sovereign wealth funds and U.S. National Security. Heritage Lectures, 1063.

[59] See Epstein, R. A., & Rose A. M. (2009). The regulation of sovereign wealth funds: The virtues of going slow. The University of Chicago Law Review, 76, 111-134. For alternative definitions see Allen, M., & Caruana, J. (Eds). (2008). Sovereign wealth funds - A work agenda. IMF Paper, February; Chow, C. K. W., Fung, M. K. Y., Lam K. C. K., & Sami, H. (2012). Investment opportunity set, political connection and business policies of private enterprises in China. Review of Quantitative Finance and Accounting, 38(3), 367-389. doi: 10.1007/s11156-011.

[60] Kern, S. (2007). Sovereign wealth funds - State investment on the rise. Deutsche Bank research. Retrieved from http://www.dbresearch.dc/PROD/DBRJNTERNET_DEPROD/ PROD0000000000215270.pdf; Allen, M., & Caruana, J. (Eds). (2008). Sovereign wealth funds - A work agenda. IMF Paper, February; Balding, C. (2008). A Portfolio Analysis of Sovereign Wealth Funds. Working Paper, University of California, Irvine, Department of Economics, June.

[61] Traditionally, the literature defines "Dutch disease" as a situation "where the harvesting oil resources appreciates the exchange rate and, hence, reduces the competitiveness of the non-oil sector and prevents the development of the non-oil manufacturing sector." See El-Kharouf, F., Al-Qudsi, S., & Obeid, S. (2010). The Gulf corporation council sovereign wealth funds: Are they instruments for economic diversification or political tools? Asian Economic Papers, 91,124-151.

However, despite an internationally accepted concept of SWFs, there is a particular group of SWFs that has been outside the generally accepted scope because they invest primarily or exclusively in domestic markets.[62] While there is a substantial literature on SWFs, they have been predominantly examined from the point of their impact on international financial markets and geopolitics. This focus leaves the domestic perspectives of SWFs' creation and socio-economic implications largely unexamined.[63] The reality is that these funds lend to domestic enterprises, inject capital into national infrastructures, and monitor SOE operations. In their capacity, they are able to influence investment policies and corporate governance of the firms they invest in through shareholding and the corporate governance of debt.[64] The lack of capital market liquidity and low transparency are supposed to compel this group of SWFs to hedge their risks through tight covenants and close monitoring. Therefore, SWFs are able to serve as a commitment device for corporate insiders[65] to increase their accountability and mitigate rent-seeking behavior.[66]

[62] "Many such entities have been set up in developing countries around the world: Khazanah Nasional Berhad in Malaysia, State Capital Investment Corporation in Vietnam, Samruk-Kazyna National Wealth Fund in Kazakhstan, Mumtalakat Holding Company in Bahrain, Mubadala Development Company in Abu Dhabi, Oman Investment Fund, to name just a few." See Rozanov, A. (2011). Definitional challenges of dealing with sovereign wealth funds. Asian Journal of International Law, 1(2), 249 - 265.

[63] Some recent studies have argued that SWFs are primarily established to achieve specific medium- and long-term domestic goals. These studies observe SWFs through the prism of a domestic political context and a tension of interests that tend to respond to certain expectations of actors and mitigate the uncertainty of future financial policy and socioeconomic stability. See Shih, V. (2009). Sovereign wealth funds in Singapore and China. Geopolitics, 14, 328–344; Fini, M. (2011). Financial ideas, political constraints: sovereign wealth funds and domestic governance. Competition and Change, 15(1), 71–93. doi: http://dx.doi.org/10.1179/102452911X12905309381897; Pekkanen, S. M., & Tsai, K. S. (2011). The politics of ambiguity in Asia's sovereign wealth funds. Business and Politics, 13(2). ISSN (Online) 1469-3569, DOI: 10.2202/1469-3569.1344.

[64] See Whitehead, C. K. (2012). Creditors and debt governance. Cornell Law School Research Paper No. 011-04. Available at http://ssrn.com/abstract=1760488. The author observes "the traditional role of debt, focusing on the impact of debt on corporate governance and, in particular, the effect of an illiquid credit market on creditors' reliance on covenants and monitoring – a reliance that has continued even as the credit market has evolved."

[65] Scholars argue that outside financing can improve corporate governance in the firm by solving a commitment problem and monitoring the management effectively. In particular, Grinstein (2006) shows that debt claims motivate the investors in control to disciplinary actions serving as a credible commitment device. His study demonstrates that investors prefer to commit to the least costly disciplinary action as more efficient. And to commit to such an action, control rights should be allocated to investors who find it optimal to discipline. Therefore, in many cases financial institutions comply with their disciplinary role in a less expensive way than private equity. See Grinstein, Y. (2006).

The experience of Kazakhstan and China demonstrate that informal institutions are another tool to deal with imperfections in markets and regulation.[67] Due to the lack of formal financing, informal arrangements can assist private entrepreneurs in raising capital. Also, to obtain access to state funds and assets, private business has to build solid connections and networks with SOE management and government officials. One of the examples of such networks is a so-called "*guanxi*" in China that will be discussed in the next chapters. In this regard, Li et al. (2006) observe that, due to excessive government regulation and a weak legal system, Chinese private entrepreneurs seek to participate in politics in order to acquire certain privileges or resources brought about by their political connections. This is backed up by the argument in Chow (1997) that China has the appearance of a semi-legal system with the other half being supplied by informal networks.[68] Alternatively, by building relations with state officials as well as

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The disciplinary role of debt and equity contracts: Theory and tests. Journal of Financial Intermediation, 15, 419-443. Another positive effect of debt is that it may force the firm to pay out cash and, therefore, affect the firm's future spending. In this sense, Stulz (1990) suggests that such a financial "diet" requires the firm to invest only in profitable projects.

[66] However, as noticed by Mehlum, Moene, and Torvik (2006) the presence of abundant financial resources does not necessarily lead to accountability. Some countries establish institutions that facilitate the distribution of a resource rent, while the others favor an unproductive seizure of resource revenues by particular interest groups. Some observers suggest that SWFs may have a positive effect on governance and profitability of the firms in which they invest. In terms of limited capital markets, state assets originated from commodity revenue or trade can be channeled into national private sector to support innovations, new technologies, infrastructure, social services and other sectors, which traditionally are considered as less attractive for private financing. From this viewpoint, SWFs enhance capital liquidity, rescue distressed firms from bankruptcy, and preserve jobs especially at the time of financial distress. See SANTISO, J. (2008). SOVEREIGN DEVELOPMENT FUNDS: KEY FINANCIAL ACTORS OF THE SHIFTING WEALTH OF NATIONS. OECD EMERGING MARKETS NETWORK WORKING PAPER, OCTOBER; Mehlum, H., Moene, K., & Torvik, R. (2006) Institutions and the resource curse. Economic Journal, 116(508), 1-20.

[67] From the point of view of the **consistency** of formal and informal institutions, the government-business relations models can be described in terms similar to the concept *institutional complementarity*… This means the formal and informal rules mutually reinforce each other in terms of incentives set for agents and informal institutions increase the strength of formal rules as well as divide the domain of their application… It is easily possible to imagine a trade-off between a stable combination of inefficient institutions and institutional reform, creating better institutions but causing additional costs through inconsistency. The concept of "second-best" institutions (Rodrik, 2008) targets exactly this trade-off; the problem is of course that the trade-off may easily imply corner solutions. See Rodrik, D. (2008). Second-best institutions. NBER Working Paper 14050, June. doi: 10.3386/w14050.

[68] Hou, W., & Moore, G. (2010). Player and referee roles held jointly: the effect of state ownership on China's regulatory enforcement against fraud. Journal of Business Ethics, 95, 317–335.

joining business groups, the SOEs' managers and the management of private companies utilize an opportunity to acquire political and administrative protection and to obtain access to information, technologies and financing.[69] As an example, a vertically integrated group structure of SOEs in Kazakhstan is one of the arrangements that can decrease the costs of capital and information for the group members. Within the group, its members can deal with unexpected contingencies through their internal governance and capital structures, risk sharing and investment diversification.

Therefore, the case studies of Kazakhstan and China illustrate that global standards of corporate governance may fail to deal with distinctive institutional systems existing in transition economies.[70] Although, these standards have proved to be the basis for a workable governance system that might be worthwhile for transition countries to follow,[71] this does not exclude an option to favor other approaches or to develop hybrid or alternative governance forms. In this context, Grandori (1997) suggests that more effective combinations of mechanisms can exploit greater discretion in combining elements selectively taken from different contexts and models.[72]

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[69] In particular, Khanna and Palepu (2000) argue that "[t]he absence of intermediary institutions makes it costly for emerging market firms to acquire necessary inputs such as finance, technology, and management talent. Market imperfections also make it costly to establish a quality brand image in product markets, and to establish contractual relationships with international joint venture partners." From Khanna, T., & Palepu K. (2000). Is group affiliation profitable in emerging markets? An analysis of diversified Indian business groups. The Journal of Finance, 55(2), 867-891. See also Engelberg, J., Gao, P., & Parsons, C. A. (2012). Friends with money. Journal of Financial Economics, 103, 169–188; Fracassi, C. (2014). Corporate finance policies and social networks. Journal of Financial and Quantitative Analysis, Revise and Resubmit. Available at: http://ssrn.com/abstract=1121503; Khanna, T., & Rivkin, J. W. (2001). Estimating the performance effects of business groups in emerging markets. Strategic Management Journal, 22, 45-74.

[70] René M. Stulz points out that corporate governance in a firm "…still heavily depends on the country of its residence. Such factors as weak contract enforcement and insufficient protection of property rights can sharply increase transaction and agency costs. Thus, a country image, the overall level of its financial development as well as the existing system of political and legal institutions might considerably impact corporate governance practice and the costs of capital." From Stulz, R. M. (2006). Financial globalization, corporate governance and Eastern Europe. Financial Development, Integration and Stability: Evidence from Central, Eastern and South-Eastern Europe, 16-40.

[71] Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[72] Grandori, A.: 1997, ''Governance structures, coordination mechanisms and cognitive models'', Journal of Management and Governance 1: 27–49.

Thus, the content and the set of "appropriate" institutions prevailing in transition and developed countries can vary.[73] This means that, first, different countries may benefit from different institutional arrangements and, second, institutional context matters and state ownership is an important element of many economic systems.[74] Accordingly, scholars and policymakers have been induced to revise the roles of state (public) and private sectors in the economy. Theories define particular situations when state ownership is superior. In particular, state ownership is a workable mechanism to deal with market failures.[75] Also, SOEs are instruments of government policy seeking (1) to develop new industries (the so-called infant industry rationale); (2) to ensure that economic policy complies with socially beneficial investment opportunities; (3) to subsidize underserved groups or sectors; and (4) to respond to a financial downturn.[76]

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[73] In particular, Acemoglu et al. (2006) argue that in certain circumstances countries that are distant from the global technology frontier may benefit from institutional arrangements that privilege incumbent firms over entrants. Qian (2003) describes Chinese transitional institutions that managed to provide efficient incentives while maintaining the rents of politically powerful individuals. Djankov et al. (2003) argue that the appropriate choice of institutions depends on a society's initial conditions. Finally, Dixit (2004) claims that self-enforcing governance arrangements can be more efficient than formal institutions in early stages of economic development in light of the large fixed costs of setting up the latter.

[74] Fligstein and Choo (2005) raise two problems for efficiency analysis within global corporate governance standards: "First, systems of corporate governance result from political and historical processes rather than from efficient solutions to the functional needs of the owners of capital who seek to maximize profits for themselves. Second, the fact that many societies appear to have experienced comparable economic growth without converging on a single form of corporate governance (i.e., that of the United States) suggests that there is no set of best practices of corporate governance but rather many sets of best practices, and that the relationship linking these institutions to good societal outcomes like economic growth is more complex than agency theory would allow." See Fligstein, N., & Choo, J. (2005). Law and corporate governance. Annual Review of Law and Social Science, 1, 61–84.

[75] Roper, J., & Schoenberger-Orgad, M. (2011). State-owned enterprises: issues of accountability and legitimacy. Management Communication Quarterly, 25(4), 693-709; Shirley, M. M., & Walsh, P. (2000). Public versus private ownership: the current state of the debate. World Bank Policy Research Paper, August. doi.org/10.1596/1813-9450-2420; Dewenter, K. L., & Malatesta, P. H. (2001). State-owned and privately owned firms: An empirical analysis of profitability, leverage and labor intensity. The American Economic Review, 91(1), 320-334; Caprio, G., Fiechter, J. L., Litan, R. E., & Pomerleano, M. (2004). The future of state-owned financial institutions. Washington DC: The Brooking Institution Press.

[76] Andrei Shleifer (1998) distinguish the following situations, in which state ownership can be legitimate: 1) opportunities for cost reductions that lead to non-contractible deterioration of quality are significant; 2) innovation is relatively unimportant; 3) competition is weak and consumer choice is ineffective; and 4) reputational mechanisms are also weak. See Shleifer, A. (1998). State versus private ownership. Journal of Economic Perspectives, 12(4), 133-150.

In this light, one may conclude that state ownership can be justified when explicit regulation is difficult to implement and private commitments are hindered by poor legal enforcement.[77]Moreover, Shleifer and Vishny (1997) suggest that monopoly powers, externalities or distributional issues can raise concerns that private ownership may not be in the best interests of all parties served. In this regard, Laffont and Tirole (1993) and Sappington and Stiglitz (1987) argue that private firms with large investors might underprovide quality or otherwise short-change the firms' stakeholders or ignore environmental risks because of their single-minded short-term focus on profits.[78] Bichsel (2006) points out that state ownership can be welfare improving, firstly, through adopting a relatively consumer-friendly pricing policy and, secondly, through a disciplinary effect on the prices exerted by the presence of SOEs in the market.

As Easterbook and Fischel (1989) argue, "[T]here are high costs of operating capital and managerial markets, just as there are high costs of other methods of dealing with the divergence of interests." [79] Putting it differently, any institutional arrangement along with certain benefits entails inevitable costs caused by establishing and running the institution. The improvement of private law institutions can be one of the alternatives to increase corporate efficiency in transition economies. However, this alternative does not necessarily lead to better corporate performance since the transaction costs of market and regulatory inefficiencies remain high. The lack of liquid capital markets creates the shortage of financing for domestic companies as well as limits opportunities for the diversification of risks and investments. Consequently, conservative investors are largely reluctant to invest in transition economies meaning that the main players in these markets are speculative investors with very narrow and

[77] Perotti, E. (2004). State ownership: A residual role? World Bank Policy Research Working Paper No. 3407, September. Available at SSRN: http://ssrn.com/abstract=625284.

[78] In this regard, Andrei Shleifer (1998) suggests that "the government sometimes becomes the efficient producer precisely because its employees are not motivated to find ways of holding costs down." In other words the government, not private entities, becomes responsible for the long-run environmental policy. See Shleifer, A. (1998). State versus private ownership. Journal of Economic Perspectives, 12(4), 133-150. Also see Lynn A. Stout, The Mythical Benefits of Shareholder Control, 93 VA. L. REV. 789, 801–02 (2007).

[79] Easterbrook, F. H., & Fischel, D. R. (1989). The corporate contract. Columbia Law Review, 89(7), 1416-1448.

short-term interests. These investors are not able to address the agenda of sustained economic development, industrial diversification and solid social welfare.[80] Therefore, the government becomes one of the major sources of funding and monitoring. In this capacity, the government prefers to set up a group of SOEs and deal with unexpected contingencies through their internal governance and capital structures than to set up a contract-based regime–regulations or taxes–to address such concerns.[81] The reason for the contract-based regime's failure is its high costs in terms of existing institutional deficiencies. Thus, SOEs may be a rational choice for countries in economic transition. In this regard, I believe that the popular concepts of corporate governance and transaction costs can be misleading since the institutional context of many transition economies, including China and Kazakhstan, is imperfect.[82]

Three Traditional Academic Approaches to Corporate Governance

Theoretical discussions on corporate governance in SOEs can be roughly gathered into three groups. The first set of theories argues that private firms are more successful than SOEs in terms of financial performance and corporate governance (the economic approach). The second line of argumentation points out that product-market competition, not ownership, primarily determines enterprise

[80] In particular, the standard "public good" rationale, that will be touched upon in the following part, is based on the assumption that privately-owned firms pursue short-term limited profit interests and treat social responsibility as a financial burden. Therefore, they can demonstrate poor social responsibility comparing to their state-owned counterparts. SOEs can serve broader public needs and social objectives. In many transitional countries, SOEs have been founded to boost national economies by delivering subsidized goods and services, maintaining guaranteed markets, supporting domestic suppliers, providing investments, and delivering technologies. Granting access to these benefits, SOEs can stimulate private companies to be more socially responsible.

[81] Chang, H-J. (2007). State-owned enterprise reform. Policy Notes, Department for Economic and Social Affairs (UNDESA).

[82] See Chang, H-J. (2011). Institutions and economic development: Theory, policy and history. Journal of Institutional Economics, 7(4), 473–498, where the author argues that "[d]espite their usual emphasis on scarce resource and opportunity costs, mainstream institutional economists almost entirely ignore the issue of the costs of establishing and running institutions, thus making their proposals for institutional reforms appear more attractive than what they really are…"

performance (the market-based approach). The third theoretical view focuses on a "public good" hypothesis, suggesting that governments employ SOEs to facilitate industrial development and to maximize social welfare since private firms fail to carry out these functions (the "public goods" approach).

The Economic Approach. One of the frequently cited definitions of corporate governance is given by Shleifer and Vishny (1997). They define corporate governance as a tool by which suppliers of finance to corporations assure themselves of getting a return on their investments. In other words, they observe corporate governance from the perspective of resource allocation and conflicts of interest in a firm. This *economic approach* to corporate governance is grounded in transaction costs and principal-agent theories and treats the firm as a corporate contract.[83] In theory, information and contract imperfections that often cannot be solved through *ex-ante* contracting bring about the issues of unforeseen contingences, informational asymmetry, and opportunistic behavior.[84] These factors raise the costs of contracting in a firm and result in the problems of free riding, adverse selection and moral hazard.[85] From the perspective of the economic approach, private owners are considered to deal with these problems in a more effective

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[83] Marcel Kahan and Michael Klausner "Path dependence in corporate contracting: increasing returns, herd behavior and cognitive biases" (1996, Washington university law quarterly, vol. 74:347): "The standing point for the modern analysis of the firm is the metaphor of a firm as a "nexus of contracts". From these perspectives, the rights and obligations of various stakeholders in a corporate enterprise – shareholders, creditors, employees, and managers – are determined by a set of "corporate contracts". Some of these "contracts" are explicit, such as credit agreements, bond indentures, employment contracts, and charter provisions. Others are implicit, such as the rule of corporate law and creditors protection law, which consist largely of default rules that can be overridden by contract. In the absence of information imperfections, corporate contracts are expected to maximize the joint wealth of the contracting parties."

[84] Tirole, J. (1999). Incomplete contracts: Where do we stand? Econometrica, 67(4), 741-781.

[85] Tirole (1999): "The important feature of complete contracting is that the only impediments to perfectly contingent contracting are that the agents may have private information at the date of contracting (adverse selection), receive future information that cannot be directly verified by contract enforcement authorities, that this information may be private information (hidden knowledge) and that agents may take actions that cannot be verified (moral hazard)." See also Coase, R. H. (1937). The nature of the firm. Economica, New Series, 4(16), 386-405; Williamson, O. (1975). Markets and hierarchies, analysis and antitrust implications: A study in the economics of internal organization. New York: Free Press; Zingales, L. (2000). In search of new foundations. The Journal of Finance, 55(4), 1623-1653. doi 10.1111/0022-1082.00262.

way through monitoring, corporate boards, independent directors, minority shareholders and sufficient investor protection.[86] In contrast, SOEs are supposed to be inherently less efficient in mitigating agency and transaction costs. In this regard, scholars typically mention the role of political considerations that cause the SOEs' poor performance. In particular, Boycko et. al. (1996) argue that politicians cause government-owned firms to employ excess labor inputs.[87] Krueger (1990) suggests that such firms may be pressured to hire politically connected people rather than those best qualified to perform a desired task.[88] Finally, politicians can merely channel the SOEs' funds, either to their families and cronies, or to business interests in order to support their political campaigns.[89] As a result, SOEs are expected to generate less revenue.[90]

There are several factors that might explain the higher transaction costs of SOEs. First is the negative effect of politics on SOE management. This means that politicians are often driven by their own incentives or particular political agendas that often contradict the SOEs' profit interest.[91] Second, the

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[86] In their frequently cited article "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) Jensen and Meckling discuss different theoretical and empirical aspects of agency costs. They claim that the incentive of equityholders to induce managers to take excessive risks will likely cause considerable agency costs arising from the divergence of the interests of shareholders and creditors. See Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. Journal of Financial Economics, 3(4). Available at SSRN: http://ssrn.com/abstract=94043.

[87] Boycko, M., Shleifer, A., & Vishny, R. (1996). A theory of privatization. Economic Journal, 106(435).

[88] Krueger, Anne O. (1990). Government failures in development. Journal of Economic Perspectives, 4(3), 9-23.

[89] Mishkin, Frederic S. (2007). Is financial globalization beneficial? Journal of Money, Credit and Banking, 39(2-3), 259-294.

[90] Boardman, A. E., & Vining, A. R. (1989). Ownership and performance in competitive environments: A comparison of the performance of private, mixed, and state-owned enterprises. Journal of Law and Economics, 32(1); Megginson, W. L., & Netter J. M. (2001). From state to market: A survey of empirical studies on privatization. Journal of Economic Literature, 39(2), 321-389; Dewenter, K. L., & Malatesta, P. H. (2001). State-owned and privately owned firms: An empirical analysis of profitability, leverage and labor intensity. The American Economic Review, 91(1), 320-334; Grossman, G., & Krueger, A. (1993). Environmental impact of a North-American free trade agreement. In: P. Garber (Eds.), The U.S. – Mexico Free Trade Agreement. Cambridge, MA: M.I.T. Press.

[91] As Stiglitz argues, this sort of vagueness created serious agency problems in the public sector: "[T]he ambiguity of objectives provides the managers further discretion to pursue their own interests. In the private sector, there is one over-riding concern: profits. In the public sector, there may be a multiplicity of objectives – economic (such as employment) as well as non-economic (national security). Managers can always claim that the reason they are losing

officials of state shareholders may fail to monitor the SOEs' managers because they invest not their own money, but state assets. In addition, even if the general public can monitor the officials, the population may not have the ability to oversight politicians and influence their decisions if the state is too powerful.[92] Third, since SOE managers do not personally benefit from the SOEs' successful performance and do not have a stake in the SOEs, they might be indifferent to the SOEs' financial results. Free riding of the SOEs' management and soft budget constraints are also potential sources of high costs.[93] The structure of

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money is not that they are inefficient or incompetent, but that they have been pursuing other goals. And it is virtually impossible for an outsider to judge the validity of those claims." Stiglitz, J., et al.: 1989, The Economic Role of the State (Basil Blackwell, Oxford).

[92] According to the principal-agent theory, politicians and the government (the agents) are supposed to work on behalf of the public (the principals). However, there is a tension between those interests since politicians have an incentive to act in their own interests, which do not necessarily comply with the public ones, resulting in a standard agency conflict. The problem of informational asymmetry can be also great in terms of SOEs. In particular, Alchain (1965) argues that state ownership is more dispersed since the general public can be considered the owner. Widely dispersed ownership of SOEs leads to citizens' inability to ensure whether the politicians are acting in their interest, because the government's power is harder to control. In this sense, agency conflicts in SOEs can be compared to the similar concerns in private firms with a diffuse ownership structure. However, Perotti (2007) points out that the free-riding problem applies to taxpayers more than to dispersed shareholders and limited disclosure is probably a greater drawback in state companies than in private companies in the absence of institutions empowered to audit state decisions. Moreover, Vickers, and Yarrow (1991) and Lin, Cai, and Li (1998) recognize that, even though both state and private ownership suffer from collective-action problems in monitoring, private ownership has a crucial advantage – the ability of the market to generate information to address problems of informational asymmetry. Nevertheless, when there are no efficient market mechanisms that provide companies and their managers with the right incentives, the advantage of private companies disappears.

In contrast, some scholars consider SOEs to be companies with highly concentrated ownership, where the government is a controlling owner (Yarrow 1986). In that case, the government faces all the costs associated with concentrated ownership, such as the lack of diversification.

Furthermore, having the government as a counterpart in a corporate contract may cause ambiguity: on the one hand, the government's participation can guarantee better access to government financing, but on the other hand, there might be difficulty in enforcing the contract if the government fails to comply with its contractual obligations. Investigating both industrialized and developing nations, Nellis (1989) shows that the effectiveness of such agreements is low, and that effectiveness is often reduced by unforeseen events, political pressure, and the failure of the government to fulfill its obligations. See also Mishkin, Frederic S. (2007). Is financial globalization beneficial? Journal of Money, Credit and Banking, 39(2-3), 259-294. Also see Kahan, M., & Rock, E. B. (2011). When the government is the controlling shareholder. Texas Law Review, 89, 1293-1363. Available at SSRN: http://ssrn.com/abstract=1616266.

[93] "If the managers of a privately-owned firm cannot keep it in the black, shareholders will eventually withdraw their investment, regardless of the social consequences. Because of this, private owners are able to issue much more credible threats to their managers. Politicians, on the other hand, would never allow a major public corporation to go bankrupt, and the managers know it. Thus public-sector managers have much less fear of losing money. They some-

state ownership, when it is sometimes hard to define an ultimate owner, makes it difficult to exercise effective discipline over SOE managers or provide them with the right incentives to improve SOE performance.[94] Moreover, it might be a challenge for non-commercial SOEs to hire or retain highly skilled managers since the balance between the level of income and the number of responsibilities offered by these entities looks less attractive for highly experienced managers than the one offered in private companies.

Another argument for the SOEs' higher transaction costs is based on a dual role of the government: along with being just a shareholder or a creditor, it also acts as a regulator of these SOEs. This dual position complicates the SOEs' operations and creates a basis for conflict in incentives. A potential conflict may arise as a result of the divergence of interests between the government as a controlling shareholder and minority shareholders.[95] Also, there is the possibility of conflict between the SOE managers and the government as a creditor.[96] According to the principal-agent theory, politicians and the government (the agents) are supposed to work on behalf of the public (the principals). However, there is a tension between those interests since politicians have an incentive to act in their own interests, which do not necessarily comply with the public ones.[97] All of these situations potentially magnify transaction costs of SOEs.[98] Ironically, privately-owned firms suffer from similar conflicts in incentives

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times intentionally run deficits in order to secure budget increases." From Heath, J., & Norman, W. (2004). From stakeholder theory, corporate governance and public management: What can the history of state-run enterprises teach us in the Post-Enron era? Journal of Business Ethics, 53, 247–265.

[94] The possibility of moral hazard "arises when the agent's action, or the outcome of that action, is only imperfectly observable to the principal. A manager, for example, may exercise a low level of effort, waste corporate resources, or take inappropriate risks." Heath, J., & Norman, W. (2004). From stakeholder theory, corporate governance and public management: What can the history of state-run enterprises teach us in the Post-Enron era? Journal of Business Ethics, 53, 247–265.

[95] Gilson, R. J., & Gordon, J. N. (2003). Controlling Controlling Shareholders, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 152, 785- 843.

[96] Whitehead, C. K. (2012). Creditors and debt governance. Cornell Law School Research Paper No. 011-04. Available at http://ssrn.com/abstract=1760488.

[97] Mishkin, Frederic S. (2007). Is financial globalization beneficial? Journal of Money, Credit and Banking, 39(2-3), 259-294.

[98] Allen, F., Qian, J. "QJ," Qian, M., & Zhao, M. (2009). A review of China's financial system and initiatives for the

and agency problems. The incentive of equityholders to induce managers to take excessive risks will likely cause considerable agency costs arising from the divergence of the interests of shareholders and creditors.[99] Corporate insiders, seeking higher return, can expropriate wealth from minority shareholders in different ways from the actual looting of corporate assets to investing in highly risky projects.[100]

However, notwithstanding the apparent costs of state ownership mentioned above, its structure can mitigate or avoid particular conflicts inherent in private firms. For instance, on the surface there might be less managerial agency costs triggered by self-interested management and weak, dispersed shareholders since the government usually enjoys a dominant shareholding position.[101] In many SOEs, the government is typically the single shareholder or holds a big corporate share and exercise tight control over the SOEs' operational decisions. Concentrated ownership can mitigate a collective action problem and provide an effective mechanism for monitoring in terms of SOEs. In fact, to protect their interests, state dominant shareholders enjoy the opportunity to closely monitor SOE managers and to put more pressure on them in terms of SOE performance and good governance.[102]

The Product Market Approach. The *market-based approach* to corporate governance focuses on product market competition as a corporate governance tool. From this perspective, corporate governance can be

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future. China's Emerging Financial Markets, Edited by James A. Barth, John A. Tatom and Glenn Yago, The Milken Institute Series on Financial Innovation and Economic Growth, 2009. Available at: http://fic.wharton.upenn.edu/fic/papers/08/0828.pdf.

[99] Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. Journal of Financial Economics, 3(4). Available at SSRN: http://ssrn.com/abstract=94043.

[100] Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. Journal of Financial Economics, 3(4). Available at SSRN: http://ssrn.com/abstract=94043.

[101] Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. Journal of Financial Economics, 3(4). Available at SSRN: http://ssrn.com/abstract=94043.

[102] The pressure is more intense for SOEs that produce consumer goods since the quality and price of their products are subject to close oversight of the government and the population. Also see Yves Bozec, Richard Bozec, Ownership Concentration and Corporate Governance Practices: Substitution or Expropriation Effects? Canadian Journal of Administrative Sciences, Vol. 24, Issue 3 (September, 2007), pp. 182-195.

defined as a set of mechanisms that transforms product market signals into corporate decisions.[103] This approach is broader than the traditional economic approach because it equally considers other groups of actors, not only managers and shareholders. Furthermore, it does not refer to the type of ownership (public or private) as a key element affecting corporate governance. Instead, it generally takes the premise that ownership is largely irrelevant in many cases. In other words, it suggests looking at the issue of corporate governance in the wider context of the product market, where different factors and primarily market competition "may be substitutes as well as complements in pushing the firm towards efficiency."[104] In fact, Caves and Christensen (1980) present a body of evidence supporting the view that the product is a more influential determinant of firm efficiency than ownership and, under truly competitive conditions, SOEs and private firms might be equally efficient.[105]

Nonetheless, property rights theory disagrees with this academic notion and claims that ownership makes a difference in how incentives are allocated and, therefore, has a direct relevance to corporate governance.[106] Accordingly, it matters who owns and controls the firm, especially when the possibility of opportunistic behavior is real and the costs of contracting are high.[107] Furthermore, the

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[103] Berglöf, E., & Von Thadden, E-L. (1999). The changing corporate governance paradigm: Implications for transition and developing countries. Conference Paper, Annual World Conference on Development Economics, Washington, D.C.

[104] Berglöf, E., & Von Thadden, E-L. (1999). The changing corporate governance paradigm: Implications for transition and developing countries. Conference Paper, Annual World Conference on Development Economics, Washington, D.C.

[105] Caves, Douglas W., & Christensen, Laurits R. (1980). The relative efficiency of public and private firms in a competitive environment: The case of Canadian railroads. Journal of Political Economy, 88(5).

[106] The starting point of the theory is that corporate contracts are incomplete and, as a result, there is a need to allocate decision rights in the event not specified by the initial contract. These decision rights are associated with the ownership of an asset. By changing the allocation of ownership, we change the incentives of corporate constituencies. See Grossman, Sanford J., & Hart, Oliver D. (1980). Takeover bids, the free-rider problem, and the theory of the corporation. Bell Journal of Economics, 11; Hart, O., & Moore, J. (1990). Property rights and the nature of the firm. Journal of Political Economy, 98(6).

[107] In this regard, Grossman and Hart (1986), Hart and Moore (1990), and Hart (1995) "focus generally (and not just to model government) on contractual incompleteness, and more specifically on the idea that ownership of assets gives the owner control and bargaining power in situations where contracts do not specify what has to be done. As a consequence, ownership strengthens the owner's incentives to make investments that improve the ways or reduce the

nature of transaction costs varies depending on different types of ownership. For instance, such sources of transaction costs as political considerations and multitasking are distinctive for state ownership structures. Thus, there should be specific mechanisms to mitigate these costs. Finally, in the absence of the competitive product market, its signals cannot be adequately transformed in corporate decisions. This is the case of many transition economies that make efforts to create strong and competitive state-owned enterprises ("national champions") and, as a result, their markets are largely dominated by state monopolies.

<u>The "Public Good" Approach</u>. The *public good approach* is also concerned with who controls the firm. Particularly, it interprets SOEs as an outcome of negotiation and compromise between different social actors. In this regard, scholars refer to another definition of corporate governance grounded in political and social rationales.[108] The standard "public good" rationale is based on the assumption that, while privately-owned firms pursue strictly private interests (mainly profitability), SOEs serve broader public needs. Thus, along with capital returns, managers of SOEs are usually instructed to fulfill various social objectives including: (1) macroeconomic sustainability; (2) national industrial development; (3) fair redistribution of services and resources; (4) model employer; (6) social stability; and (5) control of negative externalities, for instance gambling and nuclear energy generation.[109] In many transitional countries, SOEs have been founded to boost national economies by delivering subsidized goods and services, maintaining guaranteed markets and supporting domestic suppliers. They often provide strategic sectors and enterprises (including private firms) with essential investments in order to upgrade their

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costs of using the assets, because the owner has the power to reap more of the rewards on these innovations." From Shleifer, A. (1998). State versus private ownership. Journal of Economic Perspectives, 12(4), 133-150.

[108] Barker, Robert M. (2010). Corporate governance, competition, and political parties. Oxford: Oxford University Press.

[109] Heath, J., & Norman, W. (2004). From stakeholder theory, corporate governance and public management: What can the history of state-run enterprises teach us in the Post-Enron era? Journal of Business Ethics, 53, 247–265.

productive technologies and improve international competitiveness. They are also involved in regional development through direct subsidies or specific investment projects.[110]

However, notwithstanding different academic views, all the theories of corporate governance aim to achieve the same goal – higher efficiency. At the same time, each approach has its own interpretation of what constitutes *efficiency* in terms of a corporate vehicle.

The Matter of Efficiency

Despite multiple theoretical perspectives, scholars acknowledge that there may be several definitions of corporate efficiency.[111] To be specific, one set of assumptions defines efficiency through two factors: *ex-ante* efficiency and Pareto efficiency.[112] The second camp considers shareholder value to be equivalent to corporate efficiency.[113] The third group of scholars measures efficiency according to "net profit before interest and tax" or "return on assets."[114] Thus, although the issue of what defines corporate efficiency remains controversial among economists, all of the theories are grounded in the fundamental idea of value maximization. What are the factors that contribute to the value of SOEs?

In general, the majority of studies have treated corporate efficiency as tied to the allocation of resources by rational actors, who make their decisions based on market signals.[115] From this perspective, private companies are considered to perform better than SOEs and therefore to be more efficient.[116] Nevertheless, the notion that SOEs are less efficient than private companies remains largely unsolved in the literature.[117] For instance, along with SOEs, private firms also suffer from agency problems and the high costs of monitoring.[118] In fact, in the case of liberal, liquid and competitive markets, both private and state managers act in the same market conditions and have similar incentives; as a result, the gap in

[110] Heath, J., & Norman, W. (2004). From stakeholder theory, corporate governance and public management: What can the history of state-run enterprises teach us in the Post-Enron era? Journal of Business Ethics, 53, 247–265.

[111] One of the theories emphasizes the impact of initial conditions on a country's institutional arrangements. This means that the existing set of institutions is the subject of particular political, social, and economic conditions rather than just a matter of efficiency (Bebchuk and Roe 1999; Roe 1994; Gilson, 2001; Hansmann and Kraakman, 2001; Hall and Soskice 2001).

[112] "The first is ex-ante efficiency – a corporate charter is ex-ante efficient if it generates the highest possible joint payoff for all the parties involved … and other third parties that may be affected by the corporate actions. The second is Pareto efficiency – a corporate charter is Pareto efficient if no other charter exists that all parties prefer. A Pareto efficient charter is also a surplus maximizing charter when the parties can make unrestricted side transfers." From Becht, M., Bolton, P., & Roell, A. (2003). Corporate governance and control. In G.M. Constantinides, M. Harris and R. Stulz (Eds.), Handbook of the economics and finance. Elsevier B.V. Chapter 1.

[113] According to Jensen and Meckling (1976), if (a) the firm is viewed as a nexus of complete contracts with creditors, employees, clients, suppliers, third and other relevant parties, (b) only contracts with shareholders are open-ended, that is only shareholders have a claim on residual returns after all other contractual obligations have been met, and (c) there are no agency problems, then maximization of (residual) shareholder value is tantamount to economic efficiency.

[114] Khanna, T., & Rivkin, J. W. (2001). Estimating the performance effects of business groups in emerging markets. Strategic Management Journal, 22, 45-74.

[115] See Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. Journal of Financial Economics, 3(4). Available at SSRN: http://ssrn.com/abstract=94043; Easterbrook, F. H., & Fischel, D. R. (1989). The corporate contract. Columbia Law Review, 89(7), 1416-1448; Zingales, L. (2000). In search of new foundations. The Journal of Finance, 55(4), 1623-1653. doi 10.1111/0022-1082.00262.

[116] Shirley, M. M., & Walsh, P. (2000). Public versus private ownership: the current state of the debate. World Bank Policy Research Paper, August. doi.org/10.1596/1813-9450-2420; Dewenter, K. L., & Malatesta, P. H. (2001). State-owned and privately owned firms: An empirical analysis of profitability, leverage and labor intensity. The American Economic Review, 91(1), 320-334; Cull, R., & Xu, L. C. (2000). Bureaucrats, state banks, and the efficiency of credit allocation: The experience of Chinese state-owned enterprises. Journal of Comparative Economics, 28, 1-31; Shleifer, A. (1998). State versus private ownership. Journal of Economic Perspectives, 12(4), 133-150; Millon-Cornett, M., Guo, L., Khaksari, S., & Tehranian, H. (2010). The impact of state ownership on performance differences in privately-owned versus state-owned banks: An international comparison. Journal of Financial Intermediation, 19, 74-94; Roper, J., & Schoenberger-Orgad, M. (2011). State-owned enterprises: issues of accountability and legitimacy. Management Communication Quarterly, 25(4), 693-709; Caves, Douglas W., & Christensen, Laurits R. (1980). The relative efficiency of public and private firms in a competitive environment: The case of Canadian railroads. Journal of Political Economy, 88(5); Shleifer, A. (1998). State versus private ownership. Journal of Economic Perspectives, 12(4), 133-150; Perotti, E. (2004). State ownership: A residual role? World Bank Policy Research Working Paper No. 3407, September. Available at SSRN: http://ssrn.com/abstract=625284; Boycko, M., Shleifer, A., & Vishny, R. (1996). A theory of privatization. Economic Journal, 106(435); Mishkin, Frederic S. (2007). Is financial globalization beneficial? Journal of Money, Credit and Banking, 39(2-3), 259-294.

[117] Although many empirical studies have found that government ownership is negatively associated with firm performance, the other researchers have recently concluded that there might be solutions when government ownership increases corporate value. In particular, Tian and Estrin (2008) discover that the relationship between corporate value and government ownership becomes positive as long as the size of government shareholdings reaches 25 percent. See Wei, Z. B., Xie, F. X., & Zhang, S. R. (2005). Ownership structure and firm valuation in China's privatized firms: 1991–2001. Journal of Financial and Quantitative Analysis, 40, 87–108; Tian, L. H., & Estrin, S. (2008). Retained state shareholding in Chinese PLCs: Does government ownership always reduce

performance should be less obvious. However, what if there is no capital, labor or product markets to discipline managers and provide sufficient capital?

From the viewpoint of the traditional shareholder-oriented model,[119] SOEs may actually conform to the idea of profit maximization. The government can be, and actually is, interested in avoiding the SOEs' financial losses. These losses will force the state authorities to shrink the financing of state social programs and policies of development.[120] In addition, the government has a strong motivation to pursue positive return from SOE operations because poor performance of large SOEs as monopolies in their industries can hurt the economy as a whole and decrease state revenues since these SOEs are usually major taxpayers. This, in turn, will reduce the rate of economic growth, and the government's credibility among the population and international investors will decline. Recent empirical studies point out that poor economic institutions shorten the expected tenures of autocrats and weaken their hold on power.[121] In other words, well-run and financially sustainable SOEs comply with the state interest of economic development. The case studies of Kazakhstan and China confirm this idea. In fact, SOEs have become the key instruments for policymakers in two countries to achieve economic diversification, provide socio-economic stability, boost technological potential, and retain political control. The governments in Kazakhstan and China benefit from SOEs' operations through expanded tax revenues, dividends, sponsorship and socio-economic projects carried out by SOEs.

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corporate value? Journal of Comparative Economics, 36, 74–89.

[118] Vickers, J., & Yarrow, G. (1991). Economic perspectives on privatization. Journal of Economic Perspectives, 5(2), 111-32.

[119] Considering the firm as the set of explicit contracts, this model focuses primarily on the equity interest as the only residual claim, which bears most of the costs and risks of corporate decisions. Based on that, equityholders are entitled to the right of decision-making. Therefore, the firm should be governed from the perspective of shareholders' supremacy (Zingales 2000).

[120] Qian and Roland (1998) argue that loss-making SOEs in China create an enormous drain on government budgets and state-owned banks, and this eventually forced the government to adopt the privatization program. See Qian, Y., & Roland, G. (1998). Federalism and the soft budget constraint. American Economic Review, 88(5), 1143–1162.

[121] Holcombe, Randall G., & Boudreaux, Christopher J. (2013). Institutional quality and the tenure of autocrats. Public Choice, 156, 409–421.

This means the hypothesis that politicians tend to maintain poor institutions to gain personal benefit seems quite unconvincing today. International integration and foreign investments unavoidably compel governments to proceed with further institutional reforms.[122] Since many SOEs are listed on international stock exchanges in order to attract investors from abroad, it is a matter of state interest to ensure that these firms are profitable, transparent and operate in compliance with the listing standards.[123] In particular, the case studies of Kazakhstan and China illustrate that capital and new technologies are crucial for further economic growth of these two economies. Due to the lack of domestic capital and information capacities, access to international capital and technological resources becomes important for the governments and SOEs in both countries. To obtain the access, they have to commit themselves to international listing and accounting standards. In particular, SOEs in Kazakhstan have undertaken significant reforms in order to improve their corporate governance practice and increase their credibility.[124]

At the same time, some academics doubt the legitimacy of using the private sector's benchmarks and specifically the amount of net profit generated by SOEs to assess their performance.[125] One of the peculiarities of the state sector is the presence of different priorities (for instance, social and public policy issues) rather than just the SOEs' financial performance and market value.[126] Furthermore, it is often

[122] Gilson, R. J., & Milhaupt, C. J. (2010). Economically benevolent dictators: Lessons for developing democracies. Columbia Law and Economics Working Paper No. 371. Available at SSRN: http://ssrn.com/abstract=1564925.

[123] Pistor, K., & Xu, C. (2005). Governing stock markets in transition economies: Lessons from China. American Law and Economic Review, 7(1), 184–210; Coffee, John C. (2002). Racing toward the top?: The impact of cross-listings and stock market competition on international corporate governance. Columbia Law Review, 102(7), 1757-1831. doi: 10.2307/1123661/abstract_id=315840.

[124] Please, see subchapter 2.2 "Development Institutions in Kazakhstan."

[125] From bureaucracy to business enterprise: Legal and policy issues in the transformation of government services (2003). Edited by Michael J. Whincop, Ashgate Publishing Limited.

[126] Accordingly, multiple objectives result in incentive structures quite different from those in the private sector. "In order to be efficient any corporate structure should provide its constituencies with right incentives to run the firm from the perspectives of long-term interests of all groups with a stake in the firm. For example, to improve its corporate governance a company may hire high quality auditors or have independent directors. Such steps help corporate insiders to demonstrate their intention to commit and hence make it possible to raise more capital

difficult to calculate SOE market value, especially in the case of unlisted SOEs, which have no market-valued share prices that (at least approximately) indicate their performance. Even if the SOEs' shares are traded on a domestic stock exchange, an illiquid stock market and weak infrastructure, as well as little or no competition in the industry, may eliminate the chance to measure SOE performance in accordance with market value criteria. In this context, the private sector's standards provide little assistance in assessing SOE performance.[127]

However, if we expand the conventional meaning of corporate value beyond just net income, and include tax revenues and socio-economic benefits gained by the government and the population from the SOEs' activities, the meaning of what is efficient in terms of a state corporate vehicle can change as well.[128] In this context, tax revenues, employment, social programs and other goods generated by SOEs can be included in SOE value.

Thus, let me take a closer look at what is behind state ownership structures in Kazakhstan and China and how different socio-economic pressures have been translated into corporate governance of SOEs in each country. Although the literature on state ownership is quite extensive, there is no in-depth analysis of Kazakhstani SOEs. In the case of academic research, Kazakhstani SOEs have usually been mentioned in the context of a general overview of state property around the world. These studies have been quite fragmentary and incomplete and are narrowed by state entities running substantial commodity reserves on behalf of the government.[129] In terms of SOEs in China, the literature is largely focused on the

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externally..." From Stulz, R. M. (2006). Financial globalization, corporate governance and Eastern Europe. Financial Development, Integration and Stability: Evidence from Central, Eastern and South-Eastern Europe, 16-40.

[127] Khanna, T., & Rivkin, J. W. (2001). Estimating the performance effects of business groups in emerging markets. Strategic Management Journal, 22, 45-74.

[128] Another issue noticed by Heath and Norman (2004) is that the single directive of profit-maximization hampers comparisons across firms "because all managers are trying to do roughly the same thing, in a similar economic environment. But if managers have the freedom to balance objectives as they see fit, then the basis for comparison disappears…" This leads to the case, when "[a] firm that puts more emphasis upon regional equality, or employment security, would simply not be comparable to a firm that put more emphasis on profitability." See Heath, J., & Norman, W. (2004). From stakeholder theory, corporate governance and public management: What can the history of state-run enterprises teach us in the Post-Enron era? Journal of Business Ethics, 53, 247–265.

[129] Olcott, M. B. (2007). KazMunaiGaz: Kazakhstan's national oil and gas company. James Baker Institute of Public

costs and deficiencies of state ownership structures compared to the best corporate governance practices. It lacks attention to the benefits that SOEs can and, in fact, do provide to the Chinese economy and population. In general, the literature analyzes the management of state assets in Kazakhstan and China in light of its compliance with the prevalent and influential international standards of corporate governance. However, the next chapters study SOEs in Kazakhstan and China by combining multiple theoretical perspectives, within the context of existing institutional and market conditions in both countries, in order to offer new insight into the evolution of state corporate management and its role in terms of transition.

Policy, Rice University; Olcott, M. B. (2010). Central Asia's oil and gas reserves: To whom do they matter? Global Journal of Emerging Market Economies, 2(3), 257–300; Kaiser, M. J., & Pulsipher, A. G. (2007). A review of the oil and gas sector in Kazakhstan. Energy Policy 35, 1300–1314; Palazuelos, E., & Fernández R. (2012). Kazakhstan: Oil endowment and oil empowerment. Communist and Post-Communist Studies, 45, 27–37; Peck, Anne E. (2002). Industrial privatization in Kazakhstan: The results of government sales of the principal enterprises to foreign investors. Russian and East European Finance and Trade, 38(1), 31- 58; Libman, A., & and Ushkalova, D. (2009). Post-Soviet countries in global and regional institutional competition: The case of Kazakhstan. MPRA Paper, University Library of Munich, Germany; Libman, A. (2008). Government-business relations in Post-Soviet space: The case of Central Asia. MPRA Paper, University Library of Munich, Germany; Bhuiyan, Shahjahan H., & Amagoh, F. (2011). Public sector reform in Kazakhstan: Issues and perspectives. International Journal of Public Sector Management, 24(3), 227 – 249; Wandel, J., & Kozbagarova, B. (2009). Kazakhstan: Economic transformation and autocratic power. Mercatus Policy Series, Country Brief No. 4; Ellis, E. (2008). Samruk: The outsider's inside story. Euromoney, 39(465), 74-80; Kemme, D. (2012). Sovereign wealth fund issues and the National fund(s) of Kazakhstan. The William Davidson Institute at the University of Michigan. Working Paper No 1036, August; Kalyuzhnova, Y. (2006). Overcoming the curse of hydrocarbon: Goals and governance in the oil funds of Kazakhstan and Azerbaijan. Comparative Economic Studies, 48, 583-613; Kalyuzhnova, Y. (2011). The national fund of the Republic of Kazakhstan (NFRK): From accumulation to stress-test to global future. Energy Policy, 39, 6650–6657.

"The gratification of wealth is not found in mere possession or
in lavish expenditure, but in its wise application."
Miguel de Cervantes

CHAPTER 2

KAZAKHSTAN: REFRAMING THE PATH OF ECONOMIC TRANSITION

Kazakhstan is a large, sparsely populated, transition economy. It is abundant with mineral resources, especially oil and gas. Hence, due to commodity exports, Kazakhstan's per capita income has increased significantly. Nonetheless, Kazakhstani policymakers acknowledge that the country faces a number of challenges arising from its resource dependence. Therefore, economic diversification has become the key objective of state policy. Many state industrial programs have been approved in the last ten years. The system of state development institutions and two sovereign wealth funds have been created in order to reduce commodity dependence.[130]

In Kazakhstan today, the state carries out the central role in the country's economic development. This idea has been affirmed in Strategy 2050 introduced by President Nazarbayev. According to it, an economically steady state is particularly important to ensure the country's accelerated economic growth and effective economic planning in terms of existing macroeconomic and institutional conditions. In his interview to the Russian news channel "Russia 24," President Nazarbayev mentioned that he has become disappointed in the idea of a liberal economy and believes in the greater advantage of a planned economic system.[131]

However, at the dawn of independence, Kazakhstan followed an opposite path of development.

[130] Felipe, J., & Rhee, C. (2013). Report to the Government of Kazakhstan. Policies for industrial and service diversification in Asia in the 21st Century, Asian Development Bank, October.

[131] Pereverzev, I. (2012). Nash otvet Chemberlenu. Expert Kazakhstan, 21(362).

The old concepts of a planned economy, a powerful state and government market intervention were discredited. The idea of a free market economy captivated the minds of the political leadership. The "invisible hand of the market" as the supreme driving force of economic development replaced state regulation in the majority of industries. During those days, a new generation of young, ambitious businessmen emerged. They succeeded in high-margin sectors with the highest turnover rate such as trade, banking and financial services. Describing the beginning of the 1990s, some well-known domestic entrepreneurs appreciated the trust and support of the political leadership during that period. In particular, the founder and owner of the "Astana Group" holding company, Nurlan Smagulov, said to *Expert* magazine: "The President was the first leader who took us to USA to meet with the U.S. business community, was the first one who entrusted state positions to entrepreneurs."[132]

Privatization was the most important element of the Kazakhstani business community's growth during the first ten years of independence.[133] State property privatized at that time became the basis for many large private companies today. The state delegated the governance of privatized entities to a newly formed group of managers. Many of those enterprises survived and succeeded. On the other hand, the lack of professional knowledge and experience of corporate and risk management, and the absence of contract enforcement and proper commitment devices, brought about many failures.[134] At the beginning of the 2000s, many private companies founded in the 1990s expanded and eventually emerged as financial industrial groups that usually included a commercial bank in order to manage financial flows within the group.[135] As long as business expanded, private groups required additional external capital,

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132 See Amalbayev, A. (2012). Adam Smith v Astane. Expert Kazakhstan, 50(391). In Russian.

133 See Amalbayev, A. (2012). Adam Smith v Astane. Expert Kazakhstan, 50(391). In Russian.

134 In this regard, President Nazarbayev in his book "The Kazakhstan Way" recalled: "Having undertaken control under domestic air company "Air Kazakhstan", our guys brought it to the situation when our aircrafts were arrested at foreign airports for debts. Foreign companies banned their citizens to fly by planes of "Air Kazakhstan" because of the risk of such flights. If I did not make a decision to create a state company "Air Astana" jointly with the British, we would now have no aviation in the country."

135 See Amalbayev, A. (2012). Adam Smith v Astane. Expert Kazakhstan, 50(391). In Russian.

typically borrowed from abroad.[136] At the time of the global recession of 2008, many domestic corporations and especially commercial banks were heavily burdened by foreign credit obligations.[137] Therefore, when foreign capital left the country, domestic companies were severely hit by the scarcity of capital. In those circumstances, the government of Kazakhstan undertook the leading role in financing the economy.

This chapter starts with a review of the macroeconomic, legal and institutional context of Kazakhstan, including corporate reforms in the state sector. It points out that the traditional economic approach to corporate governance fails to work properly in Kazakhstan today since there are no well-developed markets for capital, labor and corporate control. In contrast, as we will see, the main challenge for private business in Kazakhstan continues to be raising capital because the banking system is unstable, foreign investments are volatile, alternative sources of capital are limited, and private investment interests are short-term and speculative. In this situation, government financing becomes a substitute for the private markets. The government, not private actors, becomes a driving force for monitoring national industrial projects and fulfilling the program of socio-economic development. In order to implement this agenda, the government of Kazakhstan has established the system of SOEs and SWFs. Therefore, this chapter studies the system of SOEs in Kazakhstan in the context of the "public good" approach to corporate governance.

Then, it analyzes the costs of state ownership in Kazakhstan versus its benefits. It emphasizes that the system of state ownership in Kazakhstan is quite costly. Although state programs have achieved some of their goals, partly due to rising energy prices, their efforts toward diversifying the economy and promoting new industries have fallen short of expectations. In fact, Kazakhstan's oil dependence has increased. Alternative capital arrangements have also failed to develop sufficiently. Even though state ownership structures in Kazakhstan provide many advantages in terms of the existing institutional environment, they suffer from many challenges including multiple tasks, political considerations, weak

[136] See Amalbayev, A. (2012). Adam Smith v Astane. Expert Kazakhstan, 50(391). In Russian.

[137] See Amalbayev, A. (2012). Adam Smith v Astane. Expert Kazakhstan, 50(391). In Russian.

economic planning and poor return. The fact that the board of directors and the managing office of SOEs are represented by the same composition of current or former state officials, who are well familiar with each other and have been rotated within the state bodies, increases the direct and indirect influence of the central government over SOE management.[138]

At the same time, this chapter highlights the benefits of SOEs in Kazakhstan. At the end of 2007, when the inflow of private investments and foreign lending dropped tremendously, these institutions undertook the leading role in the implementation of the programs of industrialization and economic diversification. Today, they are the key instruments of state investments. They are largest taxpayers in the country and major sponsors of different social, sport and charity programs. SOEs serve broad public interests in Kazakhstan. They provide the national economy with essential investments, facilitate regional development and support further economic growth. Also, they assist in maintaining social guarantees and the population's welfare.

Finally, this chapter concludes that, despite the costs of SOEs in Kazakhstan, the existing institutional environment makes the system of state ownership and its incentive structures less expensive and, thus, more efficient as opposed to the popular concept of corporate efficiency.

Resource Dependence and Institutional Deficiency

Kazakhstan as a resource-rich country generates its revenues from commodity exports.[139] Essentially, oil revenue accounts for one quarter of GDP, half of fiscal revenues, and two-thirds of export

[138] For instance, with respect to the Chinese CIC, Gordon Clark and Ashby Monk argue that the central government is able to maintain control of the fund because the Communist Party has a major say in the career prospects of senior officials and because of the overarching importance it attributes to economic growth. Clark, Gordon L., & Monk, Ashby H. B. (2010). Nation-state legitimacy, trade, and the China Investment Corporation. Working paper, University of Oxford.

[139] In 2011, Kazakhstan held 1.8 percent of the world's proved reserves, taking 12th position in the ranking at the end of 2011. Mineral resources represented 76.8 percent of total exports in 2012. Along with oil deposits, Kazakhstan possesses 20 percent of the world's gold reserves, 17 percent of uranium, 7.6 percent of zinc and 2 percent of copper. See Kazakhstan. Strategy Equity Research (2010). Renaissance Capital, November.

proceeds.[140] Hence, the fiscal budget of Kazakhstan has become highly sensitive to oil market volatility.[141] In the 1990s, the budget revenue of Kazakhstan was hit by low oil prices and the slow growth of oil exports. Moreover, oil was drilled from small fields using outdated technologies and transported by antiquated pipes. Between 1991 and 1995, oil production fell from 570 to 430 thousand barrels a day.[142] That resulted in a shrinking state budget and the rise of government expenditures.[143] The Kazakhstani economy experienced a deep recession. In that difficult situation, Kazakhstan invited foreign investors to exploit large oil fields (the Tengiz and Karachaganak fields) and explore new reserves (Kashagan).[144] With the expectation of future growth in oil production and exportation, the state authorities anticipated that foreign investors would bring best governance standards and higher accountability principles.[145]

Initially, foreign investors interested in the exploration of Kazakhstani natural reserves largely drove the development of Kazakhstan's economy.[146] Particularly, in the 1990s Kazakhstan achieved

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140 Republic of Kazakhstan. Staff Report for the 2012 article IV consultation (2012). IMF Country Report No. 12/164.

141 Republic of Kazakhstan. Staff Report for the 2012 article IV consultation (2012). IMF Country Report No. 12/164.

142 Olcott, M., 2002. Kazakhstan, Unfulfilled Promise Carnegie Endowment for International Peace. Washington; Van der Leeuw, C. (2000). Oil and gas in the Caucasus and Caspian: A history. London: Palgrave Macmillan.

143 Olcott, M., 2002. Kazakhstan, Unfulfilled Promise Carnegie Endowment for International Peace. Washington; Van der Leeuw, C. (2000). Oil and gas in the Caucasus and Caspian: A history. London: Palgrave Macmillan.

144 Kashagan is Kazakhstan's largest offshore hydrocarbon field. Discovered in 2000, Kashagan has been described as the largest field found in the past 30 years with a potential of between 30 billion and 50 billion barrels with a common publicly quoted figure of 38 billion barrels (3 percent of the world's proven oil reserves). The field is located near the city of Atyrau, the northern part of the Caspian Sea. The field is operated by the North Caspian Operating Company (NCOC), the seven-firm consortium including Shell, Exxon Mobil, Total, ConocoPhillips, Kazakhstani state oil company KazMunaiGas, INPEX and Eni.

145 The government offered foreign investors such forms of cooperation as joint ventures and production sharing agreements. The role of foreign investments for the domestic economy will be discussed in the following subpart. See Palazuelos, E., & Fernández R. (2012). Kazakhstan: Oil endowment and oil empowerment. Communist and Post-Communist Studies, 45, 27–37.

146 In 2012 Ernst & Young published a multi-page survey "Investment attractiveness of Kazakhstan." It reveals that 85 percent of foreign investors consider Kazakhstan as the most attractive market in the CIS.[146] Unsurprisingly, among the most attractive industries investors name oil and gas (30 percent) and mining and metallurgy (23 percent). Kazakhstan attractiveness survey. Bridging the perception gap (2012.) Ernst & Young. Retrieved from www.ey.com/Publication/vwLUAssets/2012_Kazakhstan_Attractiveness_Survey/$FILE/Kz_attractiveness_E.pdf.

substantial success in terms of attracting foreign direct investments (hereinafter "FDI") and outperformed many other post-Soviet countries in FDI per capita and FDI as a percentage of GDP.[147] In the first years of independence, the inflow of FDI reached US$160 billion.[148] Liberal reforms and vast commodity deposits attracted new inflows of foreign investments, particularly in the oil and gas industry.[149] A great

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[147] Kazakhstan and Azerbaijan, for example, have been recording high growth rates (in 2004 Azerbaijan 10.6 percent and Kazakhstan 9.1 percent)… Kazakhstan cumulatively received US$1094 of foreign capital per capita, which is comparable to the levels of Croatia (the data from Transition Report, 2004)." From Sušjan, A., & Redek, T. (2008). Uncertainty and growth in transition economies. Review of Social Economy, 66(2), 209-234(29770463). Also see Libman, A., & and Ushkalova, D. (2009). Post-Soviet countries in global and regional institutional competition: The case of Kazakhstan. MPRA Paper, University Library of Munich, Germany.

[148] From the interview of the Minister of Trade of Kazakhstan to the Zona Kz internet newspaper, October 15, 2012 http://www.zonakz.net/articles/56467 Today, 70 percent of the total inflow of foreign investments in Central Asia goes to Kazakhstan. In 2011, multinationals invested in the country US$18 billion despite the global recession. Valentinova, L. (2012). Zhit' po sredstvam. Promyshlennost, 3(72). In Russian.

[149] In order to create comfortable conditions for investors the Investment Law of 2003 (the Investment Law) declares state support of investment activities through various preferences and establishes a dispute resolution mechanism. Since the date of its issuance, the primary purpose of the Investment Law has been the creation of a stable and transparent environment for all investors. Therefore, the Investment Law does not distinguish between foreign and domestic investors. However, it emphasizes that in cases of conflict between provisions of the Investment Law and bilateral investment treaties ratified by Kazakhstan, the treaties shall prevail. Some of the treaties provide foreign investors with effective protection tools in addition to those provided by Kazakhstani law. Before the Investment Law came into force, investments in general had been defined as foreign inflows of capital. Indeed, domestic companies possessed extremely limited funds to provide the economy with sufficient investments. Consequently, foreign investors enjoyed privileged treatment. Today, although the Investment Law applies equally to foreign and domestic investors, the interests of the former are still subject to special state attention. For instance, in 1998 President Nazarbayev created the Council of Foreign Investors. Principal state officials including the President of the country, the Prime Minister and his deputies, the Chair of the National Bank of Kazakhstan and key ministers represent Kazakhstan in the Council. Therefore, the Council is a useful platform for dialogue between foreign investors and state authorities.

The Investment Law brings investors standard guarantees. In particular, it protects investors against adverse changes in legislation. It assures the stability of investment contracts except for those based on considerations of national and ecological security, morality and healthcare or caused by treaties' amendments. Any statutes, acts of regulation and official statements affecting investor interests must be published. Furthermore, investors have open access to any information regarding the registration of legal entities and their charters, the registration of transactions with real estate, issued licenses, and other records affecting investment activities, which do not contain commercial secrets or another information protected by law. In the case of nationalization, the state ensures total reimbursement of investors' losses based on the fair market price. In order to provide investors with incentives to invest in the national economy, investors may be granted certain investment and tax preferences. In this regard, the government approves an annual list of priority sectors and strategic projects with available financial preferences. This list includes projects that tend to produce high-tech products with a high added value.

amount of FDI was directed to the most competitive extractive sector (75.25 percent in 2010),[150] with the oil industry taking the largest share. For instance, in 2008 the growth of investments in mining exceeded 9.5 percent compared to the previous year, whereas the growth of investments in manufacturing was only 2.7 percent. The overall share of investments in oil and gas extraction exceeded 40.0 percent of total investments in 2011, although that number dropped from almost 56.0 percent in 2007.[151]

Furthermore, Kazakhstan experienced an extremely rapid credit boom up to 2007. The annual growth rate of bank loans exceeded 60.0 percent in real terms.[152] That growth was boosted by an expanding deposit base and, most importantly, by relatively cheap foreign currency borrowing, which contributed to the rising share of bank foreign liabilities.[153]

Led by rising commodity prices, FDI inflows, and foreign borrowing, the Kazakhstani economy started recovering. At that time, the government undertook transition reforms to achieve market economy standards. Between 1994 and 1996, prices were liberalized, trade distortions reduced, and small and medium-sized enterprises (hereinafter "SMEs") privatized. Beginning from the late 1990s, the financial sector was strengthened, rural and urban infrastructure improved, and investments in the private sector encouraged. Oil production also jumped, reaching more than 1.8 million barrels a day in 2011 (15th position among producing countries).[154] The country's strong economic performance and financial reforms facilitated full repayment of its debt to the International Monetary Fund (hereinafter "the IMF") in 2000, when Kazakhstan paid back US$385 million - being the first among post-Soviet republics to do

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[150] IMF Country Report No. 11/151. (2011, June). Republic of Kazakhstan: Selected Issues.

[151] Those numbers are expected to increase when Kashagan's projected production expands. See Statistical report 2011 issued by the Committee on statistics of the Ministry of national economy of the Republic of Kazakhstan. Available at http://stat.gov.kz/.

[152] Barisitz, S., & Lahnsteiner, M. (2010). From stormy expansion to riding out the storm: Banking development in Kazakhstan. Finanzmarktstabilitätsbericht 19, 64-73. Available at www.oenb.at/de/img/fmsb_19_tcm14-195707.pdf.

[153] According to some analytics, in 2006 bank's external debt accounted almost a half of Kazakhstan's total foreign liabilities.

[154] BP Statistical Review of World Energy 2011 (http://www.bp.com/statisticalreview).

so.[155]

Driven by economic growth, the Kazakhstani legislation has also evolved in order to reflect and follow new market trends.[156] The focus of my research lies on Kazakhstani corporate and commercial laws.[157] Corporate law of Kazakhstan is grounded in the Civil Code of the Republic of Kazakhstan (hereinafter "the Code") that regulate civil and commercial relations in the country, including corporations, corporate governance, property rights, and contracts.[158] The Code is based on the fundamental market economy principals, such as: contract freedom, partite market relations, and the protection of private property. The Code distinguishes commercial and non-profit organizations. Commercial companies can be incorporated as state enterprises, partnerships, limited liability companies, joint-stock companies and production cooperatives.[159]

Corporate governance and capital arrangements of a company are carried out in accordance with its charter and by-laws depending on a particular corporate form, for instance, a joint stock company

[155] Over the last two years Kazakhstan, as a large oil exporter, benefited from higher commodity prices. As a result, its external trade and account balance improved significantly. In 2011, the account surplus was US$13.6 billion, equivalent to 7.3 percent of GDP, which was 4.5 times greater than in 2010. Also, the national foreign currency buffer has been restored. In particular, in September 2012 Kazakhstan's fiscal reserves exceeded US$55 billion, which is above the pre-crisis period. To appreciate positive changes in Kazakhstan's balance sheet, the rating agencies Standard & Poor's and Fitch upgraded the country's foreign currency sovereign credit rating to BBB+ (stable outlook) and BBB (positive outlook, with a country ceiling of BBB+), respectively. See Kazakhstan: prompt recovery, slower growth. (2012). Kazakhstan Economic Update, 1. The World Bank – Kazakhstan Report 68215; Kazakhstan: Microfinance and financial sector diagnostic study. Final report (2008-2009). International Finance Corporation and KfW Bankengruppe.

[156] The Constitution is the supreme law of the land. Another sources of statutory law are codes of statutes, normative acts including parliamentary acts, presidential decrees, and decisions of the Constitutional Council and the Supreme Court. These acts have different legal force in accordance with their prioritization. Additionally, the government, ministries and state agencies are entitled to issue secondary regulatory acts that govern specific relations or industries.

[157] Since the Kazakhstani law has been and continues to be constantly amended this and the following paragraphs observe provisions that were in effect in the last quarter of 2012.

[158] Other major pieces of legislation are: Law "On Joint-Stock Companies" (2003); Law "On Limited Liability Companies" (1998); Law "On Bankruptcy" (1997); Law "On State Property" (2011); Law "On State Registration of Legal Entities and Registration of Branches and Representative offices" (1995).

[159] Some of the corporate forms are regulated by specific legal acts. For example, there are the Law on Limited Liability Companies of 1998 and the Law on Joint Stock Companies of 2003.

(JSC) or a limited liability company (LLC).[160] These are the most common corporate forms of organization among large, medium and small-size entities in Kazakhstan.[161] The supreme governing body of these entities is the general meeting of shareholders, which has an ultimate power over the most important decisions affecting a company, such as amending the charter, electing or terminating the power of executive bodies, reorganization or liquidation. Another governing body is the board of directors for JSCs (compulsory) or a supervisory board for LLCs (discretionary), which is responsible for general policy issues. A company's executive body (collective or individual) runs day-to-day operations. To monitor financial and commercial activities a company can employ and an independent auditor and/or establish an internal audit division.[162]

At the same time, LLCs are principally designed to be privately-owned companies managed by a family or a small group of members, who appreciate the value of control. Typically, LLCs are represented by medium and small-size enterprises. Their legal capital is divided into ownership stakes, the size of which is specified in the charter. The size of a stake sets a limit on the stakeholder's liability. This means that stakeholders bear the risk associated with corporate activities only to the extent of their equity contributions to the legal capital.[163] But there can be some exceptions, for instance when a stakeholder has not fully paid for his or her stake.[164]

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160 The Russian abbreviation of LLC is TOO (Tovarishestvo s ogranichennoi otvetstvennostiyu), which translates as LLC but, in essence, is a type of a limited liability partnership (LLP).

161 Being the most common corporate form, these legal entities are primarily the subject of my research. Therefore, my statutory overview largely focuses just on these two.

162 In general, each corporate charter individually defines situations, when the external auditing of financial information is required. However, for certain LLCs their financial information is subject to a mandatory independent audit depending on the nature of their business, e.g.: construction and project companies, grain storage companies, insurance companies, pension funds, banks and financial companies, and developers of mineral resources.

163 The number of stakeholders is unlimited. However, there is a statutory prohibition for a LLC with a single member to become the sole stakeholder of another LLC. In addition, there is a preemptive right of LLC's members to buy the stakes offered for sale by other member. Although, as a general rule, the transfer of ownership stakes to a third party is permitted, this right can be restricted by the charter or statutory provisions.

164 There is another exception that can be applied on most of legal entities with limited liability. In particular, the Law on Bankruptcy indicates some cases leading to the erosion of the stakeholders' limited liability, e.g. false or deliberate bankruptcy.

In turn, JSCs are positioned as public companies that issue stocks in order to attract capital from an unlimited number of prospective investors.[165] The status of a "public company" generally refers to a fairly spread ownership structure.[166] It is granted by the National Bank of Kazakhstan as an authorized stock market regulator and entails a certain level of public disclosure.[167] Also, a public JSC should prohibit a "golden share" and introduce a corporate secretary position. Such company is obliged to adopt a corporate governance code and have a corporate website. The latter must provide an open access to

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[165] As a general rule, JSCs' shares can be transferred without any legal restrictions. Nevertheless, the Law assumes that there can be some statutory constraints on transfers of shares, the maximum number of shares in possession of each shareholder or the maximum of votes provided by one share.

The Kazakhstani corporate law allows JSCs to issue debt and equity instruments to achieve their objectives. JSCs may issue common and preferred stocks and golden shares. In addition, they may issue warrants, options, bonds, debentures, and convertible securities. The exception is non-profit JSCs are prohibited to issues preferred stocks. Moreover, at the time of issuance the total number of the preferred shares should not exceed 25 percent of the total number of outstanding shares. The issuance of a "golden share" is not available for JSCs with the status of a public company.

Each issuance must be registered with the authorities. Stocks can be offered privately or through public market using such instruments as preemptive rights of shareholders, subscription, and auction or subscription, and auction.

Dividends on common shares can be paid according to the decision of the general meeting of shareholders and in compliance with the timing defined in the charter or the prospectus of emission. Dividends on preferred stocks shall be paid regardless of any corporate decision. They are guaranteed in the charter affirming the amount and the timing of their payments. However, there are some restrictions on dividend payments, i.e., in case of negative equity capital and existing or possible insolvency.

[166] At the same time, the law permits the creation of a JSC with a single shareholder.

[167] The law identifies some additional reporting requirements for JSCs and their shareholders. However, the board of directors can constrain access to some corporate information that, according to the board's consideration, constitutes the company commercial, trade or professional secrets. In particular, if a person or a company intends to buy voting shares of a JSC and eventually will posses 30.0 percent or more of the JSC, this person has to inform the corporate body of this JSC and the authorized governmental body about such intention. In this case, the JSC cannot prevent shareholders from selling their stocks, but it can offer higher price for their shares. Moreover, this purchase triggers the obligation to offer the rest of shareholders to buy their stocks.

Also, annual financial reports approved by the general meeting of shareholders and examined by an auditor have to be published. Furthermore, every JSC should provide its shareholders and investors with the information about significant corporate events, e.g.: emissions of corporate securities, major transactions, mortgaging of 5.0 or more percent of corporate assets, getting a loan exceeding 25.0 percent of the company equity capital, involvement in corporate disputes, and other events that may affect the interests of shareholders and investors. JSCs with the status of public should allocate statements about corporate events on their corporate websites. Finally, these JSCs have to post their annual financial reports, audit reports and corporate events information on the depository's website. For JSCs listed on a stock exchange there is an additional requirement to file analogous quarterly reports to the web-sites of the depository and the stock exchange.

main corporate documents, such as: the charter, the corporate governance code, audited annual financial reports for the past two years, and other major corporate governance documents.

Largest Kazakhstani companies, including commercial banks, natural resources companies, development institutions and SOEs, have been incorporated as public JSCs.[168] Their shareholders enjoy a usual set of rights including the opportunity of class actions for minority shareholders, who jointly hold five and more percent of voting shares.[169] The board of directors performs its traditional supervisory function and defines the general strategy of a company's development.[170] Corporate officers (board members and executives) are bound by such principles as transparency, prudence, care and the supremacy of shareholding interests. They are forbidden from misusing corporate property and disclosing confidential corporate information.[171]

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[168] As in case of LLCs, the general rule is that shareholders of JSCs enjoy limited liability. However, the law distinguishes companies, which have decided to go public. In particular, a JSC with the status of a public company is an entity that has some key defining features including: (i) Public offering of the shares to an unlimited number of investors; (ii) 30 and more percent of outstanding common shares should be owned by minority shareholders each of them possessing 5 and less percent of the total number of outstanding common shares; (iii) Listing on a domestic stock exchange. Nonetheless, the subparagraphs (i) and (ii) are not applied to SOEs. Furthermore, there is a statutory limitation for state bodies to found JSCs or obtain their shares, except for the Government, municipal authorities, and the National Bank. SOEs can be shareholders of other companies only with the consent of an authorized state agency.

[169] Shareholders can bring a claim against corporate officers for damages and losses caused by limited, false or misleading information as well as management's fraudulent behavior and omissions. Along with common rights, a large shareholder (a shareholder or a group of shareholders who jointly own 10 or more percent of the company's voting shares) is entitled to call for an extraordinary meeting of shareholders or the board of directors, make suggestions on the board meetings' agenda or insist on auditing of the company at her own expense.

[170] The board obtains the following powers: calling for the meetings of shareholders; deciding on the issuance of authorized stocks; electing corporate executives and defining the amount of their indemnification; creating branches and representative offices; purchasing 10 and more percent of shares of other entities; fulfilling the role of the general meeting of shareholders in subsidiaries; and increasing corporate liabilities on 10 or more percent of equity capital.

To comply with its responsibilities the board creates different committees. The minimum number of the Board's members is three. Board members are elected by cumulative voting. Independent directors should represent one third of the corporate board.

[171] In case of their failure to comply with their responsibilities, they can be found liable in the amount of caused damages. Additionally, corporate executives are liable for representing false or misleading information about corporate finances to a third party resulting to material losses to this party. However, there are some exceptions, for instance, business judgment rule or voting against the appealed decision.

Regarding corporate governance in state-owned LLCs and JSCs[172], by large they are regulated by general norms. At the same time, the law highlights some specifics that can be explained from the perspective of state interests and the status of national companies for many state-owned JSCs.[173] For example, the board of directors of a state-owned JSC or the supervisory board of a state-owned LLC, where the government holds a share, should appoint two state representatives (typically state officials) as voting members.[174] Furthermore, there is a particular requirement to the transfer of corporate assets. For instance, the list of transactions that require a state shareholder's approval is broader than in private JSCs. This means that sate shareholders enjoy the greater extent of control over major corporate decisions regarding the allocation of corporate assets.

Nevertheless, LLCs or JSCs are not the only corporate forms available for SOEs. The law also permits to create a so-called state institution or state institutions (SE).[175] These entities are typically created based on particular socio-economic considerations, for instance: energy or water supply, health

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[172] According to the Law on State Property, LLCs and JSCs controlled by the state are companies with the state share of more that 50 percent in the equity capital or more than 50 percent of voting stocks, respectively. Therefore, our reference to state (government)-owned (controlled) companies implies the same definition.

[173] A national company is an entity created by the government or the municipal administrative authorities, where the state holds a controlling share. Traditionally, national companies are designed as JSCs and carryout their activities in key industries of the national economy. To accomplish the purchase or transfer of assets, which value is vary from 10.0 to 25 percent of the total assets of a national company, the latter must obtain the Board's approval or the general shareholder meeting's (the single shareholder's) approval if this value exceeds 25.0 percent. The Law on JSCs establishes the requirement of the Board's approval for major transactions with 25.0 percent and more of the book value of the total company's assets. In essence, there are some changes in the allocation of powers between the board and the general meeting of shareholders (the single shareholder) in state-owned JSCs. For instance, the value of transactions required the shareholders' approval is less than for private JSCs. This means that shareholders (literally the state) enjoy greater control under the major decisions with corporate assets. On the other hand, the traditional power of shareholders to select the company's auditor is delegated to the board in state JSCs.

[174] Regarding JSCs, as a general rule the law prohibits the elections of governmental officials in any corporate bodies if those officials supervised the company's activities as a part of their professional responsibilities during the past year. However, this provision does not apply on state-owned JSCs, in which the state share is 10.0 percent or more.

[175] Republican state enterprises and state institutions are subject of state management and control. In particular, state enterprises can obtain shares in other companies only with the government's permission. By large, they are created in the same way as other legal entities, although, there is a difference between these two. A state institution is a non-commercial organization, while a state enterprise is considered as a for-profit company. For this reason, since our research analyzes commercial entities, including LLCs and JSCs, in our statutory overview we will focus on state enterprises in particular.

care, national parks, professional education or academic research. Depending on the type of state property (republican or municipal), SEs can be formally owned by the government, regional authorities, or the National Bank of Kazakhstan.[176] The supreme governing body of each SE is a director appointed by an authorized state agency or the President of the country. The director arranges day-to-day decision-making and business processes based on his/her professional judgment within his/her competence strictly defined by the charter. The director is personally liable for the SE's financial and commercial activities as well as maintaining the quality of assets.

All goods, property rights and profit gained from business operational activities remain in the SE's possession. Also, SEs do not typically need outside financing since they are exclusively funded from the republican or municipal budgets.[177] Therefore, for certain types of transactions SEs must receive the state owner's written approval. For example, in case of transferring the SE's assets and property; establishing branches, representative offices or subsidiaries; or providing loans or guarantees, SEs are required to obtain the state owner's consent.

At the same time, it worth mentioning that SEs have become a quite obsolete form of state ownership. Many SEs have been already corporatized as JSCs. One of the rationales behind corporatization was the government's attempt to commercialize SEs, improve their performance and corporate governance practice.

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[176] Along with mentioned state bodies, the basic governance structure of the state property includes:

(1) The Ministry of Economic Development and Trade as a centralized body framing the general policy and development strategies of state property governance as well as analyzing and evaluating their implications;
(2) The Committee of State Property and Privatization of the Ministry of Finance responsible for supervising and allocating republican property, monitoring of strategic state assets, fulfilling the role of a stakeholder (shareholder) on the Government's behalf, and registration and recording of state property;
(3) Various profile ministries assessing the performance of state-owned (controlled) entities in their industries and in some cases accomplishing the function of an asset management company for these entities;

The National asset management companies governing state shares in national development institutions, national companies and other entities that have a corporate form of LLCs, JSCs or non-commercial organizations. The National asset management company, national holding companies or national companies are prohibited from holding shares in commercial companies with another corporate structure.

[177] In turn, SEs have to transfer a certain part of their net profit to the state budget. When a SE has accomplished its socio-economic goals, the owner can reorganize or liquidate the entity and withdraw its assets.

However, notwithstanding all the regulatory reforms, the financial crisis of 2008 revealed many institutional shortcomings in Kazakhstan, as well as the high volatility of foreign investments' inflow. In particular, as one of the outcomes, the credit obligations to non-residents rapidly declined in the balance sheets of domestic commercial banks from almost 55.0 percent to 13.8 percent as of January 1, 2013. Commercial banks had to repay their foreign borrowings and significantly reduced the amount of credit to the national economy. The growth rate of the banks' loan portfolios declined from 55.0 percent in 2007 to 0.3 percent in 2008.[178] That, in turn, affected the growth of GDP and created a deficit of funds for new and existing projects.

Today, the banking system in Kazakhstan remains unstable.[179] In this situation, most banks prefer to lend to large private companies and SOEs.[180] Accordingly, one of the surveys has demonstrated that the main challenge for Kazakhstani business is raising capital.[181] Notwithstanding the fact that a large portion of state funds are granted for lending to entrepreneurs (especially SMEs), SMEs are still a quite small share of the banks' loan portfolios, although the government has set a target to increase this share to 40.0 percent.

As a matter of fact, in order to obtain a loan entrepreneurs must comply with particular criteria: high productivity, export orientation, substantial investments in fixed assets, innovative activities, and

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[178] Kazakhstan: prompt recovery, slower growth. (2012). Kazakhstan Economic Update, 1. The World Bank – Kazakhstan Report 68215; Kazakhstan: Microfinance and financial sector diagnostic study. Final report (2008-2009). International Finance Corporation and KfW Bankengruppe.

[179] In particular, according to consolidated financial statements of large commercial banks for the first quarter of 2013, many of them decreased their net profits or suffered from losses. Each bank has specific reasons for the negative financial results, but it might be assumed that further depreciation of the loan portfolio and increased spending on the creation of provisions on non-performing loans (NPLs) may persist. See Gribanova, S. (2013). God nachalsya s ubutkov. Expert Kazakhstan, 21(413). In Russian. Available at http://expertonline.kz/a11015/.

[180] See Banki – eto gosudarstvo (2013). Editorial article. Expert Kazakhstan, 2*0*(412). In Russian. Available at http://expertonline.kz/a10939/.

[181] This research distinguishes male and female entrepreneurs. Despite all differences, 64.2 percent of women and 56.2 percent of men emphasize the problem of limited capital resources. The second challenge is implementation of labor law provisions (35.7 percent of female and 37.5 percent of male entrepreneurs). See Davis, P., & Abdiyeva F. (2012). Self-employment in a Post-Soviet economy: Entrepreneurship and gender differences in Kazakhstan. Central Asia: Regionalization vs. globalization, IX KIMEP International Research Conference (KIRC -2012), April, p. 91.

mandatory participation with their own funds. The share of own funds must be at least 20.0 percent of the total investments in a project. Moreover, commercial banks typically require liquid collateral to secure a loan. However, in the situation when property rights are not sufficiently protected and contract enforcement is weak, it is quite challenging for many entrepreneurs to fulfill the collateral requirement since they prefer not to disclose their property.[182] For start-ups the issue of liquid collateral becomes even more problematic. Even though any entrepreneur operating in the priority sectors of the economy can participate in state programs and get a portion of state financing, as a rule this financing is provided through one of the commercial banks. As a result, all the entrepreneurs have to comply with the bank requirements mentioned above. Many domestic companies have called for state support, which has become a substitute for a liquid capital market. Hence, in order to stay afloat, they have to nurture connections with SOE managers and state officials as well as rely on informal financial sources built on personal relationships.

Thus, private actors have possessed quite limited funds to invest in alternative and resource consuming industries in order to achieve economic diversification.[183] Rather, they often favor speculative and short-term interests. For instance, the Kazakhstani State Agency of Statistics has found that investors prefer to invest in the extraction and export of natural resources rather than support the development of alternative industries absorbing much higher capital costs with a more distant possibility of return.[184]

182 See De Soto, H. (2001.) The mystery of capital: Why capitalism triumphs in the west and fails everywhere else. London: Black Swan.

183 Russia can also illustrate this argument. In fact, one of the studies revealed that "… Russian businesses were reluctant to invest in new technologies. According to a survey by the Higher School of Economics, in 2010, the natural resource extraction remained the most active area of investment. Most disturbingly, the survey revealed the tendency to put new investments not into buying new technologies but in repairing and maintenance of the old obsolete equipment." See Busygina, I., & Filippov, M. (2011). Benefits and risks of political modernization in Russia. SSRN Electronic Journal, 01. doi: 10.2139/ssrn.1736483.

184 In accordance with the IMF survey, oil sector value added accounted for 111⁄2 percent of GDP in 2010, while oil exports represented nearly 57 percent of total exports of goods and services. The bulk of foreign direct investment (FDI) in recent years has flowed to the extractive industries sector (751⁄4 percent in 2010), with oil taking the largest share. See IMF Republic of Kazakhstan. Selected Issues Prepared by Ana Lucía Coronel, Dmitriy Rozhkov, Ali Al-Eyd (MCD), and Neil Saker (MCM) Approved by Middle East and Central Asia Department June 28, 2010.

Also, the official statistics uncover the low innovative activity of domestic entrepreneurs in Kazakhstan. The share of innovative products within the total volume of domestic production fluctuates just between 2.0 and 5.0 percent across the region.[185]

Alternative capital arrangements, such as the securities market, also fail to provide sufficient capital. Tremendous appreciation of the banking sector as one of the leading industries has resulted in very limited liquidity in this market.[186] There has been no ground to expect the issuance of new liquid financial instruments in the domestic securities market or to anticipate the general improvement of capital markets liquidity in the near future.[187] In this situation, state securities have obtained a dominant share in

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The Kazakhstani authorities tend to actively involve foreign investors, interested in Kazakhstani natural resources, in the process of industrialization. Speaking at the 25th meeting of the Foreign Investors Council, President Nazarbayev noticed that from now on granting the right on new fields and extension of existing contracts will be possible if investors agree to finance the development of alternative industries. The President added that the subsequent issuance of licenses for the extraction of natural resources would be linked to the construction of new facilities. See Valentinova, L. (2012). Zhit' po sredstvam. Promyshlennost, 3(72). In Russian.

185 Valentinova, L. (2012). Zhit' po sredstvam. Promyshlennost, 3(72). In Russian.

186 Briefly, although Kazakhstan's financial system embraces the securities market and nonbanking financial institutions, such as credit partnerships, mortgage companies and microcredit organizations, the Kazakhstani financial market is predominantly bank-based. The Law on Banks and Banking Activities of 1995 has introduced a two-tier banking system with the National Bank of the Republic of Kazakhstan on top. The National Bank is accountable to the President of the country. This institution is the principal regulator of the financial market and financial organizations. To comply with its control function, the National Bank has its representatives in banks, bank holding companies, pension funds, pension asset management companies, and insurance companies. These representatives enjoy the right of free access to information and to meetings of corporate bodies, including general meetings of shareholders, corporate boards, and internal committees, but with no right to vote.

The Law on State Regulation, Control, and Supervision of the Financial Market and Financial Organizations of 2003 has established a mandatory license requirement for any commercial bank, insurance company, pension fund, broker, or dealer. The Law defines commercial banks as financial institutions that carry out banking operations. The official status of a bank is determined by its state registration as a legal entity and the license issued by the National Bank. Every bank is incorporated in the form of a JSC. Its corporate name must contain the word "bank".

The degree of concentration in the banking sector has always been substantial, with the only difference that the largest commercial banks became state-owned after the 2008 financial crisis. These banks make up almost half of commercial bank assets, and the assets of each of the four largest banks exceed 20 percent of GDP.

187 The current picture of the Kazakhstani securities market is quite simple. 53 percent of the market is the currency trade (US$6 832.1 million), 42 percent - repo deals (US$5,364 million), 3.9 percent – government securities (US$503 million) and only 0.4 percent (US$56 million) - shares and 0.3 percent (US$39.2 million) - corporate bonds. See Batisheva, T. (2013). Investor zhazhdet svobody. Expert Kazakhstan, 9(401). In Russian. Available at http://expertonline.kz/a10365/.

corporate investments. In fact, as of January 1, 2013, government securities amounted to 50.5 percent of the investment portfolio of pension funds – the largest institutional investors in the country.[188]

Nevertheless, it is worth mentioning that continuing weakness in the banking sector has compelled the government to push forward the development of other markets. In particular, the government has introduced the state program "People's IPO," which aims to distribute the shares of large state monopolies to the population through the stock exchange.[189] There are the following objectives of the "People's IPO" that have been announced: (1) to attract people's savings in the economy; (2) to develop the stock market; and (3) to allocate the national wealth among citizens. This means that through buying shares of the largest national companies citizens are supposed to generate additional revenue and actively participate in SOE management. However, a small percentage of equity offered to the public is unlikely to provide minority shareholders with a real chance to impact the corporate governance and decisions of the national companies.[190] The government will retain control of the issuing companies (the majority of which are strategic for the national economy).[191] Furthermore, the development of the domestic stock market by engaging more actors seems to fail because the declared amount of shares will

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The majority of operations on the Kazakhstani stock exchange (KASE) include debt securities - 43.3 percent and government securities - 37.1 percent (from the Annual report 2012 of the Committee on supervision of the financial market and financial organizations of the National Bank of the Republic of Kazakhstan). As of January 1, 2013 the total market capitalization of non-government securities included in the official list of the KASE, was 10,114.5 billion tenge or only one third of the country's GDP. Therefore, the domestic securities market suffers from limited liquidity. The dominance of commercial banking in the capital market has largely determined such a generic feature of the Kazakhstani stock market as a small number of reliable issuers and investors.

[188] From the official website www.enpf.kz/9902

[189] In 2011, President Nazarbayev introduced the program at the 13th congress of the ruling party "Nur Otan." The program applies to the citizens of Kazakhstan and domestic pension funds exclusively. According to experts, the "People's IPO" might involve 160,000 of the population. Quoting the program: "The new financial instrument should increase the welfare of the population, and hence the welfare of the state." See the official website: http://halyk-ipo.kz. Also see Vopros raboty s investirami teper klyuchevoi, December 25, 2012. Available at http://halyk-ipo.kz/ru/news/intervyu/id=777.

[190] During the first three years, the government plans to offer about 5–15 percent of shares in 10 national companies.

[191] IPO kak volya i imitatsiya (2012). Editorial article. Expert Kazakhstan, 22(363). In Russian. Available at http://expertonline.kz/a1031/, p.11.

hardly affect the magnitude of trading and market capitalization.[192]

The reality of Kazakhstan's market is that so far private business has primarily concentrated on industries guaranteeing a quick return on investment (such as the export of raw materials, real estate, trade, and construction). Kazakhstani companies have largely lost an opportunity to attract foreign capital. Capital continues to be available solely for large companies the majority of which are SOEs. Investors have treated state shareholdings, the very large size of state companies, and their dominant position in the domestic market (and often their leading position in the world markets for natural resources) as the fundamental guarantees of their returns. In other words, in most cases it has been "the size of the company and its market share that are the main or, perhaps, even the exclusive factors that investors rely on when deciding whether to buy the stock."[193]

As a result, the time when profitability remained high just because of growing export revenues and foreign loans has passed.[194] Commercial banks have scrutinized commercial financing, making it less risky, more secured and thus more expensive for borrowers. Hence, entrepreneurs have become largely deprived of bank financing as a source of capital. Therefore, after more than twenty years of independence, the majority of domestic entrepreneurs are financially unable to perform a leading role in the process of industrialization and to compete in the global market.[195]

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[192] In addition, such a small volume of investments is quite insignificant for the budget of the national companies compared with other capital inflows. In particular, if we compare the amount of funds gained within the program with the amount of capital raised through public offerings in foreign financial markets, we see that in the latter case the amount is much higher. For instance, "KazTransOil" (a monopolist responsible for transportation of about 58 percent of the total volume of crude oil in the country based on the data of 2011) the first national company participating in the "People's IPO", offered 38,463,559 of its common shares (or 10 percent minus one share) and eventually obtained about US$150 million within the program. In contrast, in 2004 the company obtained US$300 million from the placement of its Eurobonds. See Gribanova, S. (2012). Natsionalnyie issobensti privatizatsii. Expert Kazakhstan, 22(363). In Russian. Available at http://expertonline.kz/a1022/.

[193] Belikov, I. (2004). Corporate governance in Russia: Who will pay for it and how much? Online Resources of Center for International Private Enterprise, April. Available at http://www.cipe.org/publications/detail/corporate-governance-russia-who-will-pay-it-and-how-much.

[194] See Amalbayev, A. (2012). Adam Smith v Astane. Expert Kazakhstan, 50(391). In Russian.

[195] From the Strategy of Industrialization and Innovation Development of Kazakhstan approved by the President Decree from May 17, 2003.

Despite the country's economic progress, the experience of the last ten years has demonstrated that the political leadership of Kazakhstan has revised its economic approach grounded on a liberal market toward the growing role of the state. To efficiently channel and allocate the inflows of foreign exchange to the economy, the government has created a system of state development institutions including two domestic sovereign wealth funds: the National Fund of Kazakhstan and the Sovereign Wealth Fund Samruk-Kazyna.[196] These institutions have become the primary vehicles for Kazakhstani policymakers to achieve economic diversification, provide socio-economic stability, and retain political control. They serve to accumulate and preserve wealth, diminish resource dependence and accomplish the industrialization of Kazakhstan's economy.[197] Put differently, the government has made an attempt to bring forward benefits from the country's rich resources in order to overcome commodity dependence.[198] As a result, the share of state ownership has increased. One of the studies estimates the consolidated revenue of the Sovereign Wealth Fund Samruk-Kazyna as 20-30 percent of the country's GDP; the assets - from 50.0 to 80.0 percent of GDP.[199] Using accumulated financial reserves, the state authorities seek to

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[196] These funds are among the largest SWFs in the world by assets under management with 17th and 13th positions respectively. See www.sovereignwealthfundsnews.com/ranking.php and www.swfinstitute.org/fund-rankings/.

[197] It is claimed that the Kazakhstani structure of state asset management was created in the image of Singaporean and Malaysian funds. In 2003, President Nazarbayev visited Singapore and Malaysia and was inspired by their SWF systems, which were tightly linked to the ruling families and the government. After that trip, management consultant McKinsey was hired to advise on the possible structure of Kazakhstani SOEs based on comparative studies of state companies around the world, from oil funds of the Gulf States, Temasek and Khazanah to the Scandinavian funds. However, as long as Kazakhstani financial and political systems have been evolving, Kazakhstani funds have obtained certain features of other SWFs, for instance the Chinese CIC.

[198] Two factors may explain why mineral wealth limits industrialization. First, a mineral-rich country experiences an appreciation of the real exchange rate that prevents it from reducing its net imports and moving up the industrial ladder (a Dutch disease argument). Second, because mineral extraction is a capital-intensive process, a country without a deep industrial base will find its (initially) scarce physical capital diverted to mining, and hence will lack the necessary resources to deepen capital levels in the industrial sector. IMF Republic of Kazakhstan. Selected Issues Prepared by Ana Lucía Coronel, Dmitriy Rozhkov, Ali Al-Eyd (MCD), and Neil Saker (MCM) Approved by Middle East and Central Asia Department June 28, 2010.

[199] See Kemme, D. (2012). Sovereign wealth fund issues and the National fund(s) of Kazakhstan. The William Davidson Institute at the University of Michigan. Working Paper No 1036, August.

accelerate the development of non-commodity industries and particularly to increase the share of manufacturing in the GDP, to improve productivity in agriculture, and to boost the country's technological potential.[200] In this regard, the government employs state procurements in order to support and finance the national economy. Today, the government and SOEs are one of the most solvent and reliable customers. Significant state funds continue to be distributed to the private sector in the form of government contracts. In fact, the share of state procurements accounted for approximately 24.0 percent in 2014.[201]

In general, the analysis of the stock markets in transition economies has demonstrated that conservative portfolio investors have generally been reluctant to invest in such countries as Kazakhstan. Weak contract enforcement, an opaque judicial system and limited opportunities for risk diversification have created the situation, where the main players of these markets are speculative foreign and local portfolio investors seeking to invest in seriously undervalued assets with a high potential for short-term growth.[202] In turn, that narrow and short-term interest prevents further liquidity in the capital markets and corporate governance reforms. Therefore, although there has been the positive impact of foreign investments on corporate governance of firms in Kazakhstan, their real effect is quite limited, especially with respect to the development of alternative industries and the implementation of socio-economic agendas in Kazakhstan.

In this situation, the government has become a substitute for private investments in terms of financing, monitoring and implementing national industrial projects. Accordingly, public expenditures

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It worth mentioning that there is no official statistics on the share of state ownership in Kazakhstan. In one of his interviews, Minister of Finance of the Republic of Kazakhstan Bakhyt Sultanov mentioned that this share could be approximately 40.0 percent of GDP. Retrieved from web-portal Tengri.news (October 29, 2014).

[200] From the Strategy of Industrialization and Innovation Development of Kazakhstan approved by the President Decree from May 17, 2003. In Russian.

[201] See Podderzhka otechestvennogo businessa v usloviyakh WTO by Nurlan Sakuyov (2015, July 3). In Russian. Retrieved from the web-portal of the National Chamber of Entrepreneurship. http://palata.kz/ru/articles/19018.

[202] Belikov, I. (2004). Corporate governance in Russia: Who will pay for it and how much? Online Resources of Center for International Private Enterprise, April. Available at http://www.cipe.org/publications/detail/corporate-governance-russia-who-will-pay-it-and-how-much.

have been increasing rapidly. A growing share of public expenditures (up from US$4.0 billion to US$25.0 billion between 1999 and 2007) was assigned for social programs, housing, infrastructure, and public employment.[203] Those policy decisions were very much favored by the population and strengthened the power and the status of the political and socio-economic course of the government.

Development Institutions in Kazakhstan

In order to address their socio-economic agenda, Kazakhstani policymakers have established a system of "development institutions" grounded in the concept of the best standards of corporate governance and accountability. The concept defines the relationship between the government and SOEs as a form of co-operation, where the former delegates some of its functions to the market and largely acts through stimulation and regulation. The government plans to decrease the entire state market share and thus, to diminish market monopolization through co-financing of sound investment projects, and creating favorable and equal conditions for both state and private actors. SOE management is expected to switch to a customer-oriented model grounded in such market categories as profitability, competition, transparency, business initiatives and equal access to capital.[204] The new concept of state management also implies an active involvement of private organizations in activities traditionally carried out by the state sector in Kazakhstan. The eventual objective of the new concept is to increase SOE efficiency with a primary focus on the citizens' needs by the transfer of many economic functions to the market. However, domestic policymakers consider the process of marketization of state management simultaneously with preserving control over strategic state assets in order to accomplish state policies of development.

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[203] Palazuelos, E., & Fernández R. (2012). Kazakhstan: Oil endowment and oil empowerment. Communist and Post-Communist Studies, 45, 27–37.

[204] See the Law on the Fund of National Welfare from February 1, 2012.

The existing system of development institutions originally emerged in the early 2000s - a period of rapid growth for the Kazakhstani economy, when the country's GDP increased by nine-to-ten percent during the first five years of the new century. Considering those favorable conditions, Kazakhstani policymakers decided to change the historical commodity orientation of the economy by implementing the first programs of industrial modernization. Those programs called for the creation of institutions, which would carry out the state policy of industrialization.

During the first decade of the 2000s, the system of development institutions was reformed twice. In early 2006, all the institutions were integrated into a single holding company, "Kazyna." At the end of 2008, "Kazyna" and another state holding company, "Samruk," which managed state assets in the real sector of the economy, were merged into a single sovereign wealth fund, "Samruk-Kazyna" (hereinafter "Samruk-Kazyna" or "the Fund"). Later, some of the Fund's assets were transferred back to the government.[205]

Today, Kazakhstan's development institutions generally can be classified into two groups. The largest one aims to ensure economic diversification and the development of non-commodity industries, agriculture and SMEs through different financial instruments. For example, in order to facilitate

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[205] At that time, the Ministry of Industry and New Technologies obtained an actual control under the Development Bank of Kazakhstan and the Investment Fund of Kazakhstan, the Ministry of Regional Development – under the Entrepreneurship Development Fund "Damu." Later, at the beginning of 2013, political leadership made another attempt to modernize the existing model of resource allocation in order to improve corporate governance in SOEs. In particular, President Nazarbayev announced the creation of a special national organization consolidating all the state development institutions under its control. In his speech, the President emphasized that there is a need to establish an agency that will precisely determine industries and projects in which the state will invest. In this regard, in 2013 President Nazarbayev issued a decree regarding the creation of a joint-stock company, "National Holding Company "Baiterek", the core activity of which is the management of state shares in national development institutions. The decree outlines the list of entities transferred to the new holding company, among which are the National Agency of Technological Development, The Kazakhstani Mortgage Company, the Development Bank of Kazakhstan, the Investment Fund of Kazakhstan, and the Entrepreneurship Development Fund "Damu". In return, Samruk-Kazyna gets certain objects of infrastructure, named by the government, in its possession. Speaking on the Presidential decision, a representative of Samruk-Kazyna noted that the merger of "Kazyna" and "Samruk" essentially was an anti-crisis measure. Thus, the policymakers consider the creation of a new state holding company as an institutional arrangement that allows dealing with socio-economic challenges Kazakhstan faces. The source: national information agency KazInfrom, http://www.inform.kz/. See also V Samruk-Kazyna prokommentirovali cozdanie holdinga Baiterek (2013, May 27). In Russian. Retrieved from web-portal Tengri News, http://tengrinews.kz/money/v-ao-samruk-kazyina-prokommentirovali-sozdanie-holdinga-bayterek-234896/.

technological transfers and stimulate the inflow of private capital, development institutions employ such financial tools as loans, guarantees, subsidized interest rates, capital investments, and innovation grants. In the majority of cases, taking a portion of risks and investing their own assets by entrepreneurs are the basic conditions for obtaining state financing. The second group of development institutions is designed to provide non-financial informational, analytical, and advisory support for private entities.

However, notwithstanding their different objectives, Kazakhstan's development institutions now carry out an identical goal: diversification and growth of the national economy. Sustained economic growth is a basis for social stability and the population's welfare. Thus, along with industrialization, the government employs state ownership structures to implement its social projects. One of the recent examples is the pension sector's reform.

State Pension System. The reform of the pension sector has become one of the key prerogatives of the country's socio-economic policy. Introducing the reform in Parliament on March 11, 2013, the Minister of Labor and Social Protection stated that the reform aims to secure the investment return on pension assets, to balance pension benefits with previously received revenues, to increase living standards, and to maintain financial sustainability of the entire pension sector.[206]

The main idea of the reform is the creation of a single state pension fund (hereinafter "the SPF"), which is going to gradually replace private pension funds. The SPF is incorporated as a non-commercial joint stock company. The government is declared as its sole shareholder. This fund will eventually be the only institution empowered to attract mandatory pension contributions. The state remains the guarantor of the safety of pension assets. [207]

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[206] From the speech of the Minister of Labor and Social Protection on the Parliament session in March 11, 2013.

[207] The National Bank of Kazakhstan fulfills an investment management function. Pension assets are consolidated in a separate account at the National Bank, which keeps records of the accumulation and allocation of pension assets and their investment income. The National Bank is free to choose organizations that manage investment portfolios in accordance with an approved investment strategy. These organizations should be professional domestic or foreign actors. The main criteria for their selection will be their professional reputation in the market and their ability to provide a sufficient level of investment returns. Currently existing pension funds will keep their own assets and will

Needless to say, the return on pension assets is a very sensitive issue for any society. In the case of Kazakhstan, the 28th provision of the Constitution guarantees a minimum amount of pension and social security protection for all citizens. The state ensures and provides the safety of pension accumulation taking into account an inflation rate.

After 1991, Kazakhstan was the first post-Soviet state that privatized pension funds and implemented a privately managed pension system. The main principle of that reform was a gradual transition from a distribution pattern based upon solidarity of savings to an accumulating system based on individual pension savings in pension funds (a contribution scheme).[208] Consequently, as of December 1, 2012, the Kazakhstani pension system included eleven accumulation pension funds.[209] As of January 1,

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continue to operate as investment portfolio managers or pension funds running voluntary (complementary) pension deposits. In other words, private pension funds have a choice to liquidate, to convert to voluntary pension funds or to become pension asset management companies that will select by the National Bank on a competitive basis.

[208] Citizens transferred mandatory pension contributions to pension funds at a rate determined by the Pension Law. They were free to choose a particular pension fund as well as to switch funds, but they were permitted to have only one pension account for mandatory pension contributions based on a pension agreement with only one pension fund. That practice allowed maintaining a single database of mandatory pension deposits and a single list of individuals, who had signed pension agreements. Employees could choose between the state accumulation pension funds (the GNPF) and one of privately managed accumulation pension funds. The GNPF was also a default fund for non-choosers, which picks up many low-income participants. Each pension fund was allowed to hire just one asset management company. That company could be engaged in investment activities for more than one pension fund. The asset management companies could invest just in certain types of financial instruments in the manner established by law; regularly evaluate pension assets; and report on their activities. Their assets limited the liability of investment management companies. The liability of a pension fund's shareholders was limited by their equity shares. Contributors, in turn, were not liable for the obligations of the pension fund, and the pension fund were not liable for the obligations of its contributors. Nevertheless, pension funds were obliged to maintain a minimum investment income on their pension portfolio. The rate of such a minimum income depended on the particular type of investment portfolio (conservative or moderate).[208] If an actual rate of nominal investment return were less than the established minimum rate at the end of a calendar year, the asset management company running the pension assets would be required to compensate the difference between the nominal and minimum return.

[209] The law defined certain legal requirements to a corporate form and governance of accumulation pension funds. In particular, all pension funds were incorporated as joint stock companies. Their corporate governance and reporting system had to comply with provisions of the Law on JSCs. Their shares were listed on the Kazakhstani stock exchange. The minimum equity capital for pension funds was equal to at least 2 billion tenge (US$13.34 million).

The government and the National Bank of Kazakhstan were the key regulators of the pension sector. They were in charge of monitoring of the pension funds' activities in order to reveal and prevent factors deteriorating pension assets including the suspension of operations of any pension fund and organization engaged in investment management of pension assets or the obligation of additional capitalization.

2013, the total amount of pension assets exceeded 3.183 billion *tenge*[210] or more than 10.0 percent of the national GDP.[211] In the same period, the number of individual pension accounts for mandatory pension contributions amounted to almost 8.5 million while the number of economically active people was 9.0 million.[212] The government supervised the industry through such mechanisms as licensing, monitoring, financial reporting, and regulation.

However, after twenty years, the pension system appears to be in stagnation. One of the reasons for the pension market's failure is that pension funds are limited in their investment policies. Notwithstanding an illiquid domestic market, they have been restricted from investing abroad in more attractive financial instruments.[213] As a result, their portfolios have largely included the securities of government issuers. Non-government securities of domestic issuers represented by state national companies took second position with 26.0 percent. With respect to investing their own assets, pension funds followed the same pattern. As of January 1, 2013, pension funds heavily invested their own assets

[210] From the Annual report 2012 of the Committee on supervision of the financial market and financial organizations of the National Bank of the Republic of Kazakhstan.

Tenge is an official currency of the Republic of Kazakhstan. For the purpose of this research, I refer to an exchange rate of tenge to the US Dollar as US$1=154 tenge in average. This rate is unofficial and approximate since the National Bank of Kazakhstan revises the official currency rates on a daily basis.

[211] According to the Committee of statistics of the Republic of Kazakhstan the total amount of GDP in 2012 was equal to 30, 218.5 billion tenge.

[212] From the Annual report 2012 of the Committee on supervision of the financial market and financial organizations of the National Bank of the Republic of Kazakhstan.

[213] The Kazakhstani securities market has historically functioned with the long pension money. After the pension reform of 1998, the stock market received a huge inflow of pension assets, which had to be invested in. As a result, the bond market emerged. Pension funds became the largest investors in the market. Unsurprisingly, commercial banks appeared to be highly interested in attractive pension assets. At that time, they actually monopolized the securities market through equityholding of pension funds, insurance and investment companies forcing out individual investors and small investment firms. The creation of financial holding companies with commercial banks on the top reduced competition and led to price manipulation. On the other hand, the state authorities facilitated the development of the banking industry. The largest SOEs allocated their money on bank deposits. Later, deposit insurance and other favorable conditions increased the competitiveness of commercial banking and made it a more attractive source of capital compared to the securities market. See Batisheva, T. (2011). Staraya pesnya o glavnom. Expert Kazakhstan, 48(338). In Russian. Available at http://expertonline.kz/mag/2011/48/.

in government securities - 47.4 percent. At the same time, 30.6 percent of the assets were allocated to commercial banks on the deposit accounts of pension funds.[214]

The fact that all the pension funds were listed on the domestic stock exchange did not affect their performance because investors seemed to be quite skeptical toward domestic listing standards. In his interview to Total.kz, the Chairman of the Association of Pension Funds of Kazakhstan, Mr. Alibayev, mentioned that Kazakhstani pension funds had demonstrated a negative rate of investment return on pension assets for the last five years. Particularly, in 2008 the industry demonstrated a negative investment income in the amount of 32.4 billion *tenge*. That trend continued to persist and, in January 2013, the average nominal income ratio amounted to 4.0 percent, which was considerably lower than 6.0 percent of the official annual inflation rate.[215] The actual rate of return would be even less if all the funds evaluated pension assets according to their market value instead of their book value. Despite the constant growth of pension savings, the share of net investment income in the total amount of pension assets gradually decreased from 28.1 percent in 2008 to 21.0 percent in the beginning of 2013.[216] That means that pension assets could barely cover inflation and the state guaranteed amount of pension contributions.[217]

Hence, depositors could not expect to receive any investment income on their contributions, although that was the fundamental idea behind pension reform.[218] Also, since depositors did not enjoy the

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[214] See the Annual report 2012 of the Committee on supervision of the financial market and financial organizations of the National Bank of the Republic of Kazakhstan.

[215] In case of the cumulative inflation rate for the last 36 months (2010-2013), it has exceeded the nominal income ratio almost twice. See http://pensia.kz.

[216] From the Annual report 2012 of the Committee on supervision of the financial market and financial organizations of the National Bank of the Republic of Kazakhstan.

[217] In this regard, managers of pension funds blamed the government for the industry's poor results and specifically for its insufficient efforts to construct an effective legal framework and a liquid securities market as well as for the limitation to invest internationally. See K chemu privodyet sliyanie pensionnykh fondov Kazakhstana. In Russian. Available at http://online.zakon.kz/Document/?doc_id=31324821.

[218] Despite the fact that the safety of pension deposits is guaranteed by the government, the investment income is left up to managers of pension funds. Until recently, the Criminal Code of Kazakhstan established liability only for

opportunity to influence investment policies and were largely deprived of investment decision-making, they had the only option to switch to another pension fund. However, in terms of the domestic market's limited liquidity, that measure could not bring about a significant positive change in investment income. Therefore, many depositors were indifferent to the investment policy of their pension funds. At the same time, the absence of investment income made them worry that the funds' management possibly would misuse their pension contribution without their oversight. In order to resolve that collective action problem, to improve the entire sector's financial performance, and to prevent the growth of the costs of state guarantees, the political leadership proposed the pension reform.

However, the lack of liquidity, few investment opportunities, and the lack of competition in the industry bind the SPF's investments to the domestic market and state policies. The state guaranteed return on pension contributions weakens the incentive of individual depositors to monitor SPF management. The latter also lacks strong incentives to pursue better performance as a result of soft budget constraints. Therefore, the government has to maintain strong motivation to pursue the SPF's positive returns. In particular, it is a subject of state interest to diminish the possibility of the guaranteed reimbursement of the entire amount of pension contribution since it can eventually affect the state budget and hamper or delay the implementation of other state programs and obligations. Being the SPF's single shareholder, the government is interested in avoiding the SPF's financial losses since the SPF's poor performance will challenge the government's credibility among the population and may undermine social stability in the country.

Nonetheless, the SPF's mere creation and the unification of the system of pension accounts do not solve such institutional shortcomings as the lack of comprehensive and liquid capital markets and low standards of accountability in corporate management.[219] To mitigate these shortcomings, the government

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bankers and financiers for unfair manipulation with depositors' money, omitting the liability of pension fund managers.

[219] At the same time, the question whether the Kazakhstani securities market will become attractive for issuers and investors will depend on subjective decisions of the largest investor – the state pension fund, which will essentially be a monopolist in the industry and therefore will be able to dictate the market conditions. In other words, if the SPF

has introduced the set of state development programs with Samruk-Kazyna as a key driving force.[220] The Fund is accountable for strategic industrial and innovation projects, investment and industry-specific programs that aim to boost domestic markets, to support domestic producers, and to promote the best standards of corporate governance.[221] The government expects to finance about 40.0 percent of the cost of

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gives priority to safe state securities and infrastructure bonds, the market will no longer be an alternative to bank lending for private issuers, which in turn will strengthen the position of commercial banks and block the further development of the securities market in Kazakhstan. see Gribanova, S., & Batisheva T. (2013). Ob'edinyaisya i vlavstvuyi. Expert Kazakhstan, 5(397). In Russian. Available at http://expertonline.kz/a542/.

[220] Another Kazakhstani SWF mentioned above is the National Fund of Kazakhstan (the NFK). The fund was established in August 23, 2000 by the Presidential Decree as an off-budget account of the government managed by the National Bank of Kazakhstan on its behalf. Since the day of its inception, the NFK has been designed to fulfill two objectives: (1) to provide macroeconomic stability and reduce the economic impact of volatile oil prices and (2) to save oil income for future generations. In other words, the NFK carries out two functions: the accumulation of financial resources for future generations (the saving function), and reducing the dependence of the economy on adverse external factors (the stabilizing function).

According to the Chairman of the National Bank of Kazakhstan, the NFK investment income at the end of June 2012, since its inception in 2001, amounted to US$6.2 billion. The assets of the NFK reached US$55.413 billion in September 2012. Their principal sources were taxes from the oil sector including corporate income tax, royalties, shares in production-sharing agreements, and rent tax on exported crude oil and gas condensate. Proceeds from the privatization of state property and the sale of agricultural land have been also accumulated in the NFK. The projected accumulations are US$90 billion or 30 percent of GDP to 2020. The NFK is the subject to the close oversight of the President of Kazakhstan. In fact, the President determines the volume of investments, authorizes investment policies of the NFK, and approves its annual financial reports. Presidential decrees define the NFK's operational framework. Moreover, other state bodies involved in corporate governance of the NFK, such as the government and the National Bank, are also directly accountable to the President of Kazakhstan.

The National Bank has recently delegated the investment management of the NFK assets to a newly created subsidiary – the National Investment Corporation of the National Bank of Kazakhstan. The National Bank is a sole shareholder of the corporation. According to an official press release, the corporation is a financial institution specializing in the management of foreign exchange reserves of the National Bank and the NFK. In particular, the corporation is supposed to improve asset management, increase the return on assets in long-term, and implement best practices in corporate governance. To achieve these objectives, the corporation will invest in traditional and alternative instruments with investment horizons of 10-20 years.

Therefore, since the NFK is largely positioned as a passive investor, this paper considers this fund as less relevant to corporate governance of the companies the NFK invest in.

[221] The Fund was the main operator in the implementation of the government's action plan to stabilize the economy and the financial system for 2009-2010. The Fund is one of the key operator in the implementation of the annual addresses of the President of the country and a number of government programs, including the Strategy of Industrialization and Innovation Development of Kazakhstan, Program "30 corporate leaders of Kazakhstan", state housing programs, and others.

these projects. The large share of such financing has already been channeled into the real economy and will be further invested through Samruk-Kazyna.[222]

Samruk-Kazyna: Managing State Assets.[223] The mission of Samruk-Kazyna is the growth of national wealth by increasing state asset values through effective management. To implement this mission, the Fund serve the following strategic objectives: 1) increasing the competitiveness and profitability of SOEs; 2) introducing best practices in corporate governance; 3) fostering innovation, new technologies, and economic diversification; and 4) attracting investments to the country.

To implement its strategic goals, the Fund has made certain efforts to construct an operative organizational structure, clearly define responsibilities, optimize business processes, and develop SOEs on a business-like basis. Those efforts have been induced by the critical need to accomplish the restructuring of the SOE assets and to separate policy and regulation from operational activities.[224] In order to get rid of non-core assets and to facilitate new inflows of foreign investments, the government has announced the new wave of privatization. In accordance with the Minister of Finance Bakhyt Sultanov, the main goal of privatization is a reduction in the state ownership's share and reorganization of

[222] The state plans to finance about 40 percent of the cost of projects to develop innovation national companies of Kazakhstan using such tools as equityholding and loans. Almaty. October 11, 2014. KazTAG - Akzhol Sadeshov.

[223] It is claimed that the Kazakhstani structure of state asset management was created in the image of Singaporean and Malaysian funds in order to stabilize the economy and provide its sustainable growth. In 2003, President Nazarbayev visited Singapore and Malaysia and was inspired by their SWF systems tightly linked to the ruling families and the government. After that trip, McKinsey was hired to advise on the possible structure of Kazakhstani SOEs based on comparative studies of state companies around the world, from oil funds of the Gulf States, Temasek and Khazanah to the Scandinavian funds, including Norway. In fact, the corporate web-site of Samruk-Kazyna refers to Temasek Holdings and Khazanah Nasional Berhad as the example of its corporate structure. See Ellis, E. (2008). Samruk: The outsider's inside story. Euromoney, 39(465), 74-80.
However, as long as Kazakhstani political systems have evolved, Kazakhstani funds have obtained certain features of other SWFs, for instance the Chinese CIC, in terms of political influence on Samruk-Kazyna's decisions and activities. The activities and policies of the NF and Samruk-Kazyna and the latest crisis, in particular, have demonstrated how closely two funds and the Kazakhstani political leadership are intertwined. Both funds (Samruk-Kazyna at large extent) are the primary vehicles for Kazakhstani policymakers to achieve strategic economic goals, provide stability and retain political control. Samruk-Kazyna has become a crucial instrument to accelerate innovations and accomplish industrialization of the resource-dependent economy.

[224] Ellis, E. (2008). Samruk: The outsider's inside story. Euromoney, 39(465), 74-80.

the SEs' quite obsolete governance structure.[225]

Today, Samruk-Kazyna runs strategic state assets evaluated as being from 50.0 to 80.0 percent of the country's GDP. It was incorporated in 2008 by Presidential Decree through the merger of two state holding companies: the Fund of Sustainable Development, "Kazyna," and the Kazakhstani Holding for the Management of State Assets, "Samruk." Taking into account the unique role of Samruk-Kazyna for the economy, President Nazarbayev signed the Law "On The Sovereign Wealth Fund" in 2012 (hereinafter – "the Law on the Fund"), which tends to comprehensively describe the legal status, objectives, activities, and powers of Samruk-Kazyna, and to clearly define the way Samruk-Kazyna collaborates with the government. The Law on the Fund determines that the government shall not intervene in the Fund's operational activity. In 2012, the government approved an agreement between the government and the Fund, which establishes basic principles of cooperation between the parties and intends to further separate the two functions of the government: as a shareholder and as a regulator.[226] The interaction between the government and the Fund's subsidiaries is supposed to occur through the Fund exclusively, more precisely through its corporate board. In other words, the government and its officials shall not directly interfere in the decision-making process of the Fund. The Development Strategy of the Fund approved by its corporate board in 2010 expressly proclaims that the government should not replace the Fund in the process of management of the Fund's assets.

To manage state assets, the Fund has a vertically integrated structure of SOEs with the Fund on

[225] Mr. Sultanov also mentioned that out of 200 thousand enterprises, operating in Kazakhstan, about nine thousand are state-owned. Many of them are represented by a quite obsolete form of SEs. Therefore, the government has decided to privatize 861 SOEs and liquidate 300 SOEs. Retrieved from web-portal Tengri.news (October 29, 2014). In Russian.
The new policy of privatization was initially introduced by President Nazarbayev in February 2014, when he declared that the share of state ownership in Kazakhstan shall be decreased to 15.0 percent of GDP until 2020. Retrieved from web-portal Kazinform (February 14, 2014). In Russian.

[226] The project of the agreement between the Government and SWF Samruk-Kazyna approved by the government regulation No. 1599 from December 14, 2012.

the top (hereinafter “the Group”).[227] The Fund controls 593 companies – members of the Group.[228] These companies represent such key economic segments as oil and gas, mining, transportation, energetics, telecommunications, nuclear power, finance, post service and development institutions. Sixteen companies of the Group are subjects of natural monopoly or have a dominant position in the market. These companies represent the major driving force for the national economy and its infrastructure. The Group members have corporate structures similar to the Fund. In particular, all of them are joint stock companies with a traditional set of corporate bodies including boards of directors and executive boards.[229] Each Group member is responsible for operations in a particular industry. Nonetheless, all the business processes are accumulated in the Fund as a corporate center entitled to manage and coordinate activities of the entire Group. With respect to the Group members, the Fund is positioned to be an "active shareholder." This means that it is supposed to critically analyze the companies’ efficiency, provide them with directives and monitor their performance.

In this regard, the Fund has created four committees: a credit committee, a committee for assessment and planning, an investment and innovation committee, and a human resources committee. These committees review the operations of all the Group members. In addition, the Fund has adopted a system of management reporting, the purpose of which is to provide the Fund and its board of directors with accurate and timely information. In particular, the reporting system includes quarterly reports on the consolidated financial results of the Group, its key performance indicators, major investment projects, and social programs. Along with an outside auditor, the Fund has an audit division that supervises similar divisions within the Group and is directly accountable to the Fund’s corporate board. Finally, the Fund has instituted the Council of Corporate Secretaries and has adopted basic corporate governance

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[227] “During Kazakhstan’s transition period, when formal institutions signaling trustworthiness were lacking, the emergence of business groups seemed to be a rational entrepreneurial method to secure supply and marketing links as well as access to capital through risk diversification.” From Wandel, J., & Kozbagarova, B. (2009). Kazakhstan: Economic transformation and autocratic power. Mercatus Policy Series, Country Brief No. 4.

[228] As of the first half of 2012.

[229] General Approaches to the Organizational Structure of the Corporate Center of Samruk-Kazyna SWF. Power Point Presentation. Available on the corporate website. Accessed on November 13, 2013.

documents, including the Corporate Governance Code and the Code of Corporate Ethics.

In 2009, the Fund accomplished the diagnostics of corporate governance among the seven largest companies of the Group. The study was conducted by the Fund together with KPMG. The applied methodology ranked the companies depending on their compliance with corporate governance best practices.[230] As a result, four companies out of seven surpassed the 50.0 percent threshold, where 100 percent is a maximum score. In 2010, six companies out of seven entities participating in the review exceeded 50.0 percent.[231] Hence, one may conclude that the Group demonstrates positive dynamics in adopting best standards. By 2022, the average rating of corporate governance in large companies of the Group is expected to reach 85.0 percent.[232]

However, although on the surface many SOEs in Kazakhstan, including the Fund, the entire Group and the SPF, have applied many of the best practices of corporate governance in order to become independent from the state,[233] it is a challenging task to implement such independence in practice since

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[230] The study was grounded on the GAMMA methodology of Standard & Poor's, requirements of Fitch and Moody's rating agencies, OECD Principles of Corporate Governance, OECD Guidelines on Corporate Governance for companies with state participation, the UK Corporate Governance Code, and recommendations for state associated companies prepared by KazanahNasionalBerhad (Malaysia). From the official website https://www.sk.kz/page/diagnostika-korporativnogo-upravlenija Accessed on November 13, 2013.

[231] In accordance, the analysis of the corporate governance practice in the Group covered three major components: (1) the structure, (2) processes and (3) transparency. Precisely, each component was split up on particular benchmarks; each was ranked from 1 to 100 percent. The final score looked like a summary of all the benchmarks. For example, the fist part (the structure) measured how the companies dealt with conflicts of interests, transactions with affiliates and decision-making procedures. The second component evaluated the issues of corporate social responsibility, risk-management, financial planning and monitoring. Finally, the level of transparency was analyzed in light of internal and outside audit and the extent of public disclosure.

[232] The government regulation No.1202 from September 14, 2012.

[233] The Fund and all the Group members have been organized as JSCs with corporate and executive boards as a part of their governance structures. The latter is vertically integrated and tends to explicitly assign responsibilities eliminating duplication of functions. The structure is divided into 4 blocks:

(1) Economics and Finance: responsible for all the issues of economic planning, financing, and supervision of commercial banks with a separate Treasury Department;

(2) Strategic Projects: accountable for economic development, industrial and innovation projects, investment and industry-specific programs including a special division of local supply;

(3) Operational Activities and Manufacturing: responsible for industrial sectors such as: oil and gas, mining, energy, transport and communications; and

(4) Back Office, which includes corporate governance, legal services, risk management, audit and human

the government is the sole or largest shareholder of these entities as well as the key capital provider. As a result, the government and its officials are able to interfere in the decision-making processes of SOEs for the sake of their political considerations. In fact, state regulations and SOE bylaws provide the government with the possibility to intervene in SOE operations and strategic plans, many of which are subject to government approval. Moreover, since the majority of SOE top managers are affiliated with the state apparatus, their independence from the government may be questioned. These factors ultimately cause an increase in the costs of state ownership in Kazakhstan.

Costs of State Ownership in Kazakhstan

The reforms of state asset management have not fully resolved shortcomings of the state ownership system - for example the presence of a significant number of SOEs, duplication of their functions, the lack of effective economic planning, and poor return on state investments.[234] In 2009, the government introduced a single system of state planning with the emphasis on long-term (over five years), medium-term (from one to five years) and short-term (up to one year) strategic plans. Later, the

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resources management.

The management structure of the Fund also contains 4 committees: credit committee, assessment and planning committee, investment and innovation committee, and human resources committee. These committees review the issues of all the subsidiaries on a systemic basis. In addition, the Fund has adopted a reporting system, the purpose of which is to provide the state shareholder and the board of directors with accurate and timely information. Along with an outside auditor, the Fund has established internal audit divisions functioning in every company within the Group, which are directly accountable to the corporate boards. Finally, since the majority of companies in the Group are monopolists, it is important to carry out a comprehensive and objective analysis of their impact on the economy. This function is executed by a special committee involving the representative of the State Accounting Committee. The results of this analysis are submitted for the overview of the board of directors. Finally, the Law on the Fund and the Fund's by-laws unambiguously state that governance of the Group is within the liabilities of their corporate boards and executives. This means that, in theory, policymakers expect the Fund to be independent from the government. The Fund and Group members are subject to international accounting standards.

[234] The project of the Presidential Decree on the Concept of the modernization of the system of state management in the Republic of Kazakhstan approved by the government regulation No. 612 from June 1, 2011.

President's Decree from March 4, 2010, reinforced a unified system of state planning on all the levels of state economic governance, including SOEs. The new system of state planning and control has been designed to consolidate all the development programs in a single map of the country's economic development. The emphasis has been on the development of new products in manufacturing and other industries where Kazakhstan can provide a sufficient supply of raw materials.[235]

However, the attempt to introduce the new approach of state economic planning has led to a situation where more than 800 new policy documents, with several thousands of different indicators, have been approved in the last few years. Apart from the state programs of industrialization, the system of state planning includes the Development Strategy 2030, the Strategic Development Plan of the Republic of Kazakhstan 2020, the National Security Strategy of the Republic of Kazakhstan, regional development programs, forecasts of socio-economic development, and the strategic plans of state agencies and SOEs; many different reports are issued annually. As the consequence of an enormous quantity of documents, a substantial part of them lacks sufficient attention. Therefore, in order to make economic planning effective and economic analysis feasible, the number of strategic goals, policy documents and outcome indicators needs to be systematized and ultimately reduced.[236]

The numerous policy documents with no systemic approach to their indicators might be one of the reasons why actual diversification has not been achieved yet. For instance, in 2008 the share of agriculture in GDP was only 5.8 percent. The share of manufacturing in GDP fell to 11.8 percent, while

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[235] The state programs of industrialization firstly target the expansion of local goods and services in the procurements of national companies and state agencies. In particular, domestic demand for agricultural equipment is supposed to be fulfilled through the purchase of domestic equipment with further leasing of this equipment by state-owned "KazAgroFinance." To estimate an actual share of domestic supply, the government introduces the key performance indicators for procurements of state-owned national companies at the end of each year. The next desired step is a gradual transition from domestic supply to the export of Kazakhstani goods and services abroad.

[236] For instance, there are just 6 strategic outcomes in the system of government planning in Singapore. Its efficiency is measured according to 4 principles with appointing concrete state officials personally liable for the failure of the state strategic goals.

the share of mining increased to 18.7 percent in 2008. The share of mechanical engineering in the total volume of industrial production dropped from 15.9 percent in 1990 to 2.9 percent in 2008.[237]

Even though a hierarchical structure of SOEs, which is an important element of the country's entire economic governance, may be quite a reasonable arrangement to achieve economic diversification and accelerate industrialization, the structure still raises criticism with respect to the absence of effective methods of coordination, monitoring and control. In line with this argument, experts suggest that indicators by which the government estimates the efficiency of SOEs do not fully reflect their real performance.[238] In particular, Samruk-Kazyna implemented more than 160 projects in 2011. And only about fifty projects were analyzed by the Fund from the perspective of their efficiency. This means that the Fund has not yet obtained a clear understanding of the appropriateness and effectiveness of many projects implemented by the Group. Furthermore, the absence of clear indicators of the state sectors' performance in a particular industry, as well as the lack of market competition, makes the analysis of SOEs' efficiency difficult and misleading.

Another source of costs is the role of politics in SOE management. Notwithstanding formal limitation on the government's ability to interfere,[239] there is no real separation between the government and SOE management. The Law on the Fund provides the government and its officials with the possibility to intervene in decision-making processes within the Group if regulations or the President of Kazakhstan find it necessary. Government officials can directly address their questions to top managers of

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[237] The statistics is borrowed from the Strategy of Industrialization and Innovation Development of Kazakhstan approved by the President Decree from May 17, 2003.

[238] For instance, Executive Director of the National Center of Crisis Economy Mr. Dzhusangaliev assumes that the basic indicator of development programs should be an ongoing number of new jobs rather than the GDP growth.

[239] As I have mentioned above, based on the experience of Singapore, the government has been making efforts to manage SOEs on a business-like basis in order to accomplish the restructuring of the SOE assets and to separate policy and regulation from operational activities. Policymakers have been undertaking certain steps to limit government interference in the Fund's operational activity. For instance, the agreement between the government and the Fund 2012, which formally separates two functions of the government: as a shareholder and as a regulator and promulgate that he interaction between the government and the Fund's subsidiaries should occur through the Fund exclusively, more precisely through its corporate board. Moreover, the Development Strategy of the Fund 2010 establishes that the government should not replace the Fund in the process of asset management.

any of the Group members and discuss with them any issues they find significant for the Group. In addition, the government defines what information regarding the Group and the Fund might be publicly available except for the Fund's financial reports allocated on the Fund's website. The reason for this limited disclosure is quite clear: many of the Fund's assets are strategic property of the state. Based on its consideration, the government can label any relevant information as confidential and thus restricted from public overview.[240] Furthermore, each member of the Group as well as any other SOEs in Kazakhstan must subordinate its development and investment policies to state policies. This means that state agencies, not corporate boards, largely determine the development strategies of the Group as well as monitor and oversee their implementation. For example, many of the Fund's strategic documents are subject to government authorization. Moreover, the government is entitled to approve, monitor, evaluate and oversee the fulfillment of the Fund's strategic plans.[241]

Other challenges in SOE management are the opacity of management appointments, frequent rotation of managers, ineffective and non-transparent system of performance assessment, remuneration and motivation. In particular, remuneration of top managers of the Fund is not subject to public disclosure. Although the Corporate Governance Code of the Fund requires disclosing this information in annual financial reports, there is no open data on the income of top managers.[242] Government officials represent the overwhelming majority of the Fund's board chaired by the Prime Minister of the Republic of Kazakhstan. The board includes representatives of state agencies and the Presidential Administration.[243] The current CEO of the Fund, Mr. Shukeyev, served as the First Deputy of the Prime Minister before his appointment to the Fund at the end of 2011. The majority of corporate officials of the

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[240] See the Rules on allocation of reports on the internet website of the sovereign wealth fund approved by the government regulation No. 1384 from October 31, 2012. In Russian.

[241] See the government regulation No. 673 from June 20, 2011. In Russian.

[242] For example, at the government hour regarding the Fund's financial results in the Upper House of the Parliament of Kazakhstan, top managers of the Fund were questioned about the remuneration fund but did not give a clear answer. See Zunusova, Z. (2012). Storozhevyie psy budut vezde, gde est' khoty by tyinka narodnikh deneg. In Russian. Online News Portal ZONAkz.

[243] In particular, the Fund's corporate board consists of 11 members, and only 3 of them are independent directors.

Fund has been previously, or is currently, assigned to various positions in the state apparatus. After all, frequent changes of executives and constant corporate reorganizations resulted in cronyism and the diminished feeling of succession and responsibility among corporate officers.[244] Moreover, it causes the lack of a "fresh" and objective look on internal processes within the Group. Hence, one may conclude that the SOE management is quite politicized in Kazakhstan.

Taking into account political costs as one of the factors decreasing SOE profitability, the existing system of SOEs has been subject to heated debates within Kazakhstani society. Experts express concerns that nationalization of strategic assets as a single policy measure will not bring positive results.[245] In this context, Kazakhstani SOEs, and particularly the National Fund of Kazakhstan (hereinafter "the NFK") and Samruk-Kazyna, are usually blamed for limited transparency with respect to their investment policies. The lack of public disclosure in terms of Kazakhstani SOEs provides experts with grounds to claim that state executives might have wide discretion in managing state assets. For example, in the case of the SPF, state ownership precludes citizens from the opportunity to decide on the investment of their pension assets. Despite the fact that the private pension system has largely excluded depositors from investment decision-making, this trend can be amplified in terms of the state's management of pension assets. The inability of the population to impact the SPF's investment decisions in a proper manner can increase corruption and abuse the interests of depositors.

Another negative effect emphasized by experts is that many SOEs inevitably eliminate any competition in their industries.[246] However, even the status of a monopoly does not improve SOE performance since the local markets are very limited. This is, for instance, the case of the SPF. A few

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[244] Experts estimate frequent changes in the organizational structure and managers' composition of SOEs and development institutions as just a reshuffle inside the political elite. Considering the fact that the Industrial Program is entering its final stage, critics assume that the decision to create new holding companies implies the intention of policymakers to veil the possible failures of the program. See Amalbayev, A. (2013). Ledokoly v kotlovane. Expert Kazakhstan, 20(412). In Russian. Available at http://expertonline.kz/a10943/.

[245] Tretjakov, V. (2013). Lutshee – vrag khoroshego. Expert Kazakhstan, 11-12(404). Available at http://expertonline.kz/a10493/.

[246] K chemu privodyet sliyanie pensionnykh fondov Kazakhstana. In Russian. Article is available at http://online.zakon.kz/Document/?doc_id=31324821.

attractive financial instruments and reliable issuers make it legitimate to assume that the SPF should enjoy an opportunity to purchase foreign financial instruments as a matter of diversification. Earlier, similar ideas were expressed by the World Bank. In particular from an efficiency perspective, the World Bank's experts proposed to rearrange the management of pension assets and allocate them in the global financial market based on the experience of the NFK's investment management.[247] However, the current structure of the SPF's investment portfolio demonstrates a quite opposite allocation. To be precise, as of April 1, 2014, the SPF's investment portfolio included state securities (47.42 percent), bonds of domestic issuers (21.38 percent), and deposits (6.96 percent). The share of foreign securities was just 5.0 percent.[248] As a consequence, the average rate of investment income, demonstrated by the SPF in March 2014, amounted to 5.15 percent on the SPF's total pension assets.[249] Hence, analytics largely do not find a reasonable basis for the increase in the SPF's investment return in terms of the existing investment strategy.[250] "There is no

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[247] The World Bank's experts argue that the only alternative for achieving an adequate investment income on pension assets is to invest in foreign equities since the domestic equity market is small, undeveloped, and illiquid. Finally, they suggest consolidating the function of keeping accounts and a single entity. See Palmer, E. (2007). Kazakhstan - Pension reform and the development of pension systems: An evaluation of World Bank assistance. Independent Evaluation Group (IEG) working paper series. Washington DC: World Bank. Available at http://documents.worldbank.org/curated/en/2007/01/7475918/kazakhstan-pension-reform-development-pension-systems-evaluation-world-bank-assistance.

[248] From the official website www.enpf.kz/9902.

[249] From the official website www.enpf.kz/9902.

[250] In general, pension funds in developed and emerging market countries are largely characterized by investment restrictions such as portfolio ceilings for stocks and international assets. These restrictions are relatively strict in emerging market countries (Solnik and McLeavey 2009). They have important impacts on the investment performance for pension funds, and ultimately on retirement benefits. To mitigate the effect of these restrictions, there should be reasonably developed and sufficiently deep and liquid domestic financial markets for growing pension funds to invest domestically. However, domestic markets in emerging market countries are not in a position to provide the amount of financial assets required by rapidly growing institutional investors like pension funds (Chan-Lau 2005).

One argument against international diversification is that a pension fund's local investment raises the total volume of stock traded, stimulates the financial infrastructure, and promotes national savings. However, Meng and Pfau (2010) estimate that the positive impacts of pension funds on financial market development are only significant for countries with highly developed financial markets already.

This finding adds to the existing literature by providing a stronger case for international diversification over a long horizon than seen with single-period mean-variance portfolio optimization models. Participants in emerging market countries with different attitudes toward risk can benefit from international diversification. This results in part reason to believe that the single fund's returns will be higher than it would be in private pension funds," was the findings of Halyk Finance analysts Sabit Khakimzhanov.[251] Experts argue that if the current situation persists, the government will have to transfer enormous amounts from the state budget annually in order to comply with the state guarantees.[252]

Meanwhile, to diversify its risks, the SPF has the option to invest in infrastructure projects as an alternative investment opportunity. In fact, President Nazarbayev first mentioned the idea of the SPF in a speech on economic growth and infrastructure development. In this regard, experts and politicians assume the possibility of pension money being used for further industrialization with no necessity to attract additional borrowing from abroad. Even though the SPF might be reluctant to finance infrastructure because of the default of the first infrastructure projects,[253] the government is able to exercise its shareholding power to induce the SPF's management to pursue this investment. However, the core issue is whether such investment will provide the SPF with a positive financial return. The depositors' legitimate concern is whether the constructed facilities will bring profit on their pension assets. For instance, if pension money is invested in building pavilions for Expo-2017, what will depositors receive from these facilities after the event?[254]

Thus, there are many factors that escalate transaction costs of state ownership in Kazakhstan. The set of SOEs in Kazakhstan includes a range of companies, from highly profitable commodity corporations

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because financial markets in emerging market countries tend to be quite volatile.

See Kumara, A. Sisira, & Pfau W. Donald (2013). Would emerging market pension funds benefit from international diversification: Investigating wealth accumulations for pension participants. Ann Finance, 9, 319–335. doi 10.1007/s10436-011-0187-5.

[251] Gribanova, S., & Batisheva T. (2013). Ob'edinyaisya i vlavstvuyi. Expert Kazakhstan, 5(397). In Russian. Available at http://expertonline.kz/a542/.

[252] To meet the state guarantee obligations and to cover losses caused by inflation, the republican budget of 2012-2014 was burdened with 1.2 billion tenge in 2012. The government plans to spend 1.5 billion tenge in 2013 and the same amount in 2014.

[253] For example, the construction of the railway Shar--Ust-Kamenogorsk.

[254] Gribanova, S., & Batisheva T. (2013). Ob'edinyaisya i vlavstvuyi. Expert Kazakhstan, 5(397). In Russian. Available at http://expertonline.kz/a542/.

to non-profit organizations that are subsidized by the government. In fact, the Group has a significant portion of non-profile assets, which negatively impact its operational and financial statistics. The situation appears to be even more complicated since many of the Group companies are not publicly traded and/or are monopolists in their industries. Unlisted companies suffer from the lack of an objective market evaluation and can only be assessed in accordance with the methodology approved by the Fund. Thus, there are no reliable market indicators of the Group's value except for a small fraction of large listed SOEs evaluated in accordance with their stock price.[255] The question is why do SOEs exist in Kazakhstan?

Benefits of State-Owned Enterprises

There is a value generated by SOEs in Kazakhstan. In fact, the state budget benefits from the operations of the Group not only through a decrease in state expenditures on different social projects but also, and most importantly, through tax revenues and dividends. To be specific, the Group facilitates the expansion of the state taxable base in several ways. First, investments in local production potentially increase the production capacities and the employment rate of domestic enterprises and, consequently, enlarge state tax revenues. Second, the Fund itself is one of the largest taxpayers in the country since it covers key economic segments, such as oil and gas, mining, transportation, energy, telecommunications, and finance.[256] The Group's share of state tax revenues was 727 billion *tenge* or 10.0 percent of all taxes collected in 2011, which is 20.0 percent more than in 2010.[257]

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[255] To improve the long-term value of the Group, the government emphasizes the importance of focusing on core business activities. In this regard, until 2015 the Group plans to adopt a new program of asset restructuration.

[256] Large commercial banks bailed out by the government as a part of the anti-crisis program with a great share of non-profit loans are not officially included in the Group. This means that these banks with their losses are excluded from the balance sheet of the Fund and do not officially impact its consolidated income.

[257] Form the Annual report 2011 issued by Samruk-Kazyna. Available at the corporate website.

Another source of income for the government is dividends. In fact, in 2010 the Fund managed to pay dividends to its sole shareholder in the amount of more than US$60.6 million. In 2011, consolidated equity capital of the Group amounted to US$40.0 billion. During the same period, its consolidated book value was almost US$90.0 billion (or 13,413.1 billion *tenge*).[258] The consolidated revenue of the Group reached 6.34 trillion *tenge* or 23.0 percent of GDP in 2011.[259]

In addition to official dividends paid by the Group, social expenditures not related to commercial activities of the Group exceeded US$1.7 billion (or 258.7 billion *tenge*) in 2011. In 2011, the amount of losses related to non-profit activities amounted nearly US$1.3 billion (200 billion *tenge*).[260] For instance, the Fund's subsidiary Kazakhtelecom JSC assumed losses from providing local telecommunication services.

One of the non-profit, but beneficial activities of the Fund is sponsorship. For example, the Fund grants financing to sport federations and teams, such as cycling, hockey, soccer, basketball, wrestling, tennis, and volleyball. According to CEO of the Fund Mr. Shukeyev, in 2011 the Group financed fourteen sport federations in an amount of more than US$55.3 million. The Fund was an official partner of the Kazakhstani team during the Summer Olympic and Paralympic Games in London;[261] so in total in 2011 more than US$250 million was spent on sponsorship.

The Fund actively participates in many social programs. For instance, the program "Affordable Housing" aims to provide the socially vulnerable segment of the population with inexpensive housing. Within this program, the government plans to construct one million square meters of rental housing annually. The Fund is accountable for the half of this project. The project's expenditures are US$6.5

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[258] See the government regulation No. 1202 from September 14, 2012.

[259] From the Annual report 2011 issued by Samruk-Kazyna. Available at the corporate website.

[260] Those investments included sponsorship, subsidized services of public transportation and communication, lower oil and gas prices for domestic consumers. From the speech of Managing Director Mr. Rakhmetov at the meeting on the final results of 2011. Available at http://sk.kz/news/view/3208/7. In Russian.

[261] АО «Самрук-Қазына» является официальным партнером национальной сборной Казахстана на XXX летних Олимпийских играх 18.06.2012. Available at http://sk.kz/event/view/118?lang=ru. In Russian.

billion (983.8 billion *tenge*) with the Fund's share being more than 70.0 percent.[262]

Therefore, during the period 2005-2012 the obligations of the Group significantly increased. As of October 1, 2011, the external debt of the Fund including its subsidiaries (but excluding commercial banks) amounted US$21.4 billion or 17.4 percent of the gross external debt of Kazakhstan.[263] In this regard, Fund management intends to accomplish separate accounting of both commercial and non-commercial activities of the Group. This measure is considered to provide the Fund with clear market indicators and real evaluation of the commercial component.

Another policy task of the Fund is to increase local production. In 2010, the portion of local procurements equated to 50.0 percent of the total volume generated by the Group.[264] It is expected that by 2020 the portion of domestic producers will exceed 66.0 percent for goods and 93.0 percent for services.[265] The rules on procurements, adopted by the Fund, establish certain preferences for local suppliers, such as the opportunity for long-term contracting.[266]

Nonetheless, implementation of state programs does not make SOEs more competitive or profitable. For many SOEs state programs can be treated as a burden, because these SOEs must implement social projects, which are essentially unprofitable. To mitigate this burden, the government reimburses SOEs through different channels.[267] Typically, the government takes into account the Fund's non-profit activities when it provides the Fund with cheap financing. In particular, the Law on the Fund grants the Group an opportunity to receive non-expensive state funding and government guarantees in case of implementation of low-profit social, industrial or innovative programs. Thanks to its special

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[262] From the presentation of the Fund's Deputy CEO Mr. Bishimbayev at the Board's meeting. Available at http://sk.kz/news/view/3212/4. In Russian.

[263] From the speech of Managing Director Mr. Rakhmetov at the meeting on the Fund's financial results in 2011. Available at http://sk.kz/news/view/3208/7. In Russian.

[264] From the speech of CEO Umirzak Shukeyev at the Fund's corporate meeting 04.02.2012. In Russian.

[265] The Development Strategy of SWF Samruk-Kazyna for 2012-2022 approved by the government regulation No. 1202 from September 14, 2012.

[266] From the Fund's Annual report 2010, book 1.

[267] Pereverzev, I. (2012). Sbrosil ballast. Expert Kazakhstan, 19(360).

status, the Group also enjoys a privileged position in the market. For instance, the Fund gets priority with respect to the purchase of facilities, property rights, and corporate shares.

SOEs are not the only actors that enjoy state support. Private actors have also been granted a portion of state investments, particularly in such industries as residential construction, SMEs, and agriculture.[268] In particular, state investments lessened the impact of the recession of 2008 and provided growth of 1.2 percent of GDP in 2009, 7.0 percent in 2010, and 7.5 percent in 2011.[269] The SMEs' share in GDP almost reached its pre-crisis level and accounted for 20.2 percent of GDP in 2010. As a consequence of low interest rates subsidized by government programs (for example, the State Road Map for Business and programs of the State Entrepreneurship Development Fund "DAMU"), new lending to firms and individuals expanded. According to official statistics, bank lending to the real sector increased by more than 15.0 percent by the beginning of 2012 compared with 2009 and constituted US$58.2 million (or 8.8 billion *tenge*).[270]

To support the private sector, the Fund has implemented twenty-four investment projects with a value of US$17.0 billion (2.55 trillion *tenge*) within the State Program of Accelerated Industrial and Innovative Development.[271] These projects are eventually intended to create more than 28,000,000 jobs.[272] It is assumed that the new portfolio will additionally include 120 projects with a total value of

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268 In February 2009, the government channeled approximately 120 billion tenge to banks for lending small- and medium-sized enterprises. See Amalbayev, A. (2012). Adam Smith v Astane. Expert Kazakhstan, 50(391). In Russian.

269 Amalbayev, A. (2012). Adam Smith v Astane. Expert Kazakhstan, 50(391). In Russian.

270 However, it is hard to say whether the new loans from commercial banks represented actual new lending or just refinancing of previously provided loans. See Banki – eto gosudarstvo (2013). Editorial article. Expert Kazakhstan, 20(412). In Russian. Available at http://expertonline.kz/a10939/.

271 In 2010, the Fund implemented 21 projects within the state program of industrial and innovation development with the amount of US$20 billion, which was almost half of the program investments. In particular, the Fund provided 93 percent of investments in energetics, 86 percent in oil refining and infrastructure, and 84 percent in chemistry and pharmacy. Form the address of ex-CEO of the Fund Mr. Kulibayev, the supplement of the annual report 2010.

272 From the presentation of the Fund's Deputy CEO Mr. Bishimbayev at the Board's meeting. 04.02.2012. Available at http://sk.kz/news/view/3212/4.

roughly US$30.0 billion.[273] The volume of the Fund's investments in the development of new technologies was equal to US$53.0 million (8.0 billion *tenge*) in 2011. In 2012, it was raised by more than ten times, to 92.9 billion *tenge*. This trend continued in 2013, with total investment of 99.2 billion *tenge*. Along with that, the Fund actively promotes the "Park of Innovations" (the Kazakhstani analogue to Silicon Valley).

As the net inflow of foreign lending dropped dramatically at the end of 2007, access to foreign financing for Kazakhstani companies froze, resulting in a drastic decline in bank reserves, problems with liquidity, and a credit crunch.[274] To cope with the financial downturn, the state authorities provided substantial support to the banking sector using such financial instruments as reverse repurchase agreements (repo), loans and subsidized interest rates.[275] State capital continues to persist as one of the

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[273] From the presentation of the Fund's Deputy CEO Mr. Bishimbayev at the Board's meeting. 04.02.2012. Available at http://sk.kz/news/view/3212/4.

[274] "In third quarter 2007, the net inflow of foreign lending to the financial sector was just US$200 million - a decline of US$8.9 billion compared to the previous six months. This decrease led to a sudden weakening of the national currency (KZT), which fell to 126.25 to the U.S. dollar in August 2007." From Kazakhstan: Microfinance and financial sector diagnostic study. Final report (2008-2009). International Finance Corporation and KfW Bankengruppe.

[275] The government focused on saving the country's largest banks and distributed more than US$7 billion to stabilize the financial sector, uphold the housing program, and support small and medium-size enterprises. The state anti-crisis program included the allocation of 400 billion tenge of budget assets in 2007-2008 and the transfer of extra US$10 billion (1.2 trillion tenge) to the banking sector in 2009-2010. As the part of the program, in 2010 the Fund received US$3.2 billion (486 billion tenge) for the stabilization of the financial sector, US$1.9 billion (290 billion tenge) for improving the housing sector, US$0.8 billion (120 billion tenge) for the support of small and medium-sized business, and almost US$1.3 billion (191.5 billion tenge) for the implementation of investment projects. Samruk-Kazyna allocated 91 percent of these funds. See the Fund's Annual report 2010, book 1.

"A recent survey of commercial banks indicate that low interest rates subsidized by the government programs (e.g. the Road Map for Business and programs of SME Development Fund DAMU) provided incentives for large and medium-size enterprises to refinance existing debts but also to borrow for working capital needs and investment in fixed capital. In retail banking, one-third of surveyed banks confirmed that demand for mortgage increased and a half of the banks indicated that other consumer loans continue to be demanded. We note, however, that there still no available data on restructured loans. Therefore, it is not yet possible to say whether the new loans from commercial banks in 2010-11 represent genuine new lending or just refinancing of previously provided loans." From Kazakhstan: prompt recovery, slower growth. (2012). Kazakhstan Economic Update, 1. The World Bank – Kazakhstan Report 68215.

major sources of funding for commercial banks that have not been able to absorb their losses yet.[276]

Therefore, in the absence of sufficient and sustained institutions, SOEs have undertaken the mission of economic diversification and social welfare. Today, private actors in Kazakhstan possess very limited capital and technological resources to invest in long-term industrial projects. Private firms are vulnerable to compete in the international product market and call for state support. As the result of private actors' market weakness and the inadequacy of traditional financial sources, government financing and SOEs become the driving force of the national economy's development and growth. Moreover, as the result of limited domestic capital and technological capacities, access to international capital and new technologies becomes crucial for the governments and SOEs. This means that the government has a strong motivation to pursue better performance of SOEs and commit itself to international listing and accounting standards.

What Makes State Companies Efficient in Kazakhstan

In the case of Kazakhstan, the issue of SOE efficiency is based largely on the tradeoff between costs and benefits of state ownership. These costs and benefits have been determined by the institutional conditions existing in Kazakhstan and precisely by the lack of well-developed institutions. This, in turn, creates the main sources of the SOE costs in Kazakhstan: multitasking and political considerations.

[276] Banks are still unable to gain independence from state financing. In this regard, the Director of Financial Institutions Divisions of Fitch, Dmitry Abramov, draws attention to the fact that the slight growth of the banking sector is mainly related to industries and companies subsidized by the state. He also emphasizes the high dependence of commercial banks on state capital in terms of funding – a direct correlation with the deposits of national companies. "Funding is largely determined by the investment policy of Samruk-Kazyna. Any volatility in funds of the national companies has a significant impact on the short-term liquidity of banks," - says Mr. Abramov. See Banki – eto gosudarstvo (2013). Editorial article. Expert Kazakhstan, 20(412). In Russian. Available at http://expertonline.kz/a10939/.

Also, the Chairman of the Board of domestic CenterCredit Bank Mr. Vladislav Lee points out that 15.0 percent of the bank's loan portfolio is subsidized by the government. See Banki – eto gosudarstvo (2013). Editorial article. Expert Kazakhstan, 20(412). In Russian. Available at http://expertonline.kz/a10939/.

Multitasking creates a challenge for SOEs because they have to comply with different priorities stated in state strategic programs and find a compromise between state and corporate interests. This compromise is typically at the costs of SOE profitability. SOEs have to follow many policy documents and comply with multiple indicators. This obligation generates a wide range of tasks, duplication of function and poor economic planning. Many SOEs in Kazakhstan deal with numerous, often conflicting, agendas. On the one hand, they are positioned as private companies seeking profit maximization. One the other hand, they have to fulfill socio-economic--typically non-profit--objectives. For instance, implementing its investment policy, Samruk-Kazyna shall consider such often-contradictory indicators as profitability, on the one hand, and investments for the country's future development, on the other hand.

Another challenge for SOEs is political considerations that trigger the incentive problem and the lack of managerial autonomy. Opaqueness of management appointments and remuneration, as well as affiliation with the political leadership, undermines the SOEs' independence from political influence in decision-making. The lack of transparency in SOE management and operations brings about the case when SOE managers are appointed based on their adherence to the political course not their professional knowledge and experience. Bringing political populists into SOE management, who do not have solid experience in a particular industry but make advances to the political leadership in order to get short-term political gains for themselves, cause the threat of poor management and the creation of misleading policies.

As a consequence, state industrialization and economic diversification programs have barely achieved their objectives. Still, the Fund heavily invests in commodity industries.[277] In 2010, these investments amounted to 43.0 percent of total investments by the Fund. Transportation and infrastructure, as well as energy, were the second and third industries the Fund invested in at 30.0 percent and 8.0

[277] Even in case of state investments in innovative development, there has been a problem to figure out what works best for Kazakhstan. In particular, Berentayev (2010) claims that most of innovative development programs focus on technologies (e.g.: nanotechnology, biofuels and etc.) that the Kazakhstani economy cannot currently take advantage of. See Instituty razvitia Kazakhstana: A effectivnost v chem? (2010) Gazeta.KZ, March. In Russian.

percent, respectively.[278] The commodity companies continue to be the most profitable in the Group. In 2011, the national oil company KazMunaiGas generated the highest net profit in the Group: more than US$3.2 billion (486 billion *tenge*), which is approximately four times higher than the second most profitable company, the national railroad monopoly Kazakhstan Temir Zholy.

However, the government as a controlling shareholder can assume current failures and losses in profit of SOEs. Policymakers prefer to focus on long-run agendas of diversification and social stability. In this context, the government considers the benefits of SOEs and measures their value not from the position of their short-term profitability but rather from the perspective of public goods, including socio-economic benefits, subsidies, dividends and tax revenues generated by SOEs as well as their long-term investment activities. Furthermore, since the pension and social security systems in Kazakhstan are still evolving, SOEs bear the task of maintaining stable social and employment conditions for the populations.

Thus, the application of the private sector's benchmarks to assess SOE efficiency fails to work properly.[279] As in case of private companies, SOEs in Kazakhstan have certain transaction costs. At the same time, their existence demonstrates that, in the situation when there are no adequate capital markets, sufficient formal institutions and competitive products markets, SOEs can bring particular benefits to the national economy and the population. In other words, similar to private enterprises, SOEs have the balance of costs and benefits, although the nature of these costs and benefits is different. In turn, the approach of how to measure SOE efficiency should be different as well.

In this regard, the State Accounting Committee responsible for state financial control assesses the SOE efficiency as full and effective budget spending in accordance with state strategic goals. This means from a policy perspective, the SOEs' efficiency implies the achievement of outcomes outlined in the

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[278] From the Fund's Annual report 2010, book 1.

[279] Historically, one of such benchmarks has been the "standard" corporate model, which functions to maximize shareholder wealth and considers the firm as a contract between managers and shareholders generally ignoring interests of other corporate constituencies (e.g., creditors, employees, government, and communities). Consequently, corporate performance has been evaluated exclusively by the amount of profit the corporation is able to generate for its owners. From these perspectives, state-owned companies (including state-owed banks) having other priorities, for instance social and public policy issues, rather than just a financial gain have been understandably estimated as less efficient.

strategic documents of each SOE and state policy programs as well as the full and effective use of state funds.[280] Therefore, many SOEs run on a business-like basis. Large SOEs apply many of the standards inherent in the best practice of corporate governance in order to be effective.

Thus, the lack of developed markets and sufficient institutions brings about the situation where state ownership structures and the welfares they produce, including taxes, dividends, investments, employment, and social benefits, determine the corporate efficiency of SOEs in Kazakhstan and thereby become the substitute of absent institutions in terms of market and institutional failures.

[280] See Methodological guide for the state financial control of effectiveness approved by the order of the Chairman of the State Accounting Committee from February 15, 2012.

Central state agencies and municipal administrations are also subject to the efficiency check. In particular, in 2010 the President of Kazakhstan approved the System of annual evaluation of the effectiveness of each central and local state body. The evaluation of the performance of government agencies is grounded on several benchmarks including the implementation of strategic objectives in the assigned industry/area/region, budget management, the quality of provided services, and the application of information technologies. The results of this analysis are considered to help the government to reveal the facts of the state property's misuse.

The state agency responsible for state planning carries out the analysis of other state agencies' efficiency on an annual basis. Political state officials (i.e.: ministers and vice-ministers) are personally liable for the timely and proper implementation of such an annual evaluation in their ministries. They are also personally responsible for the accuracy of information submitted for the efficiency check. The performance of state bodies is assessed in accordance with the methodology approved by the Presidential Administration. The methodology aims to display the degree to which the strategic goals, put before a particular state agency, have been accomplished. See the order of the Head of the Presidential Administration No. 01-38.8 from January 14, 2011.

"The way to make the transition from a traditional planned economy to a market economy is just like crossing the river by groping the stones beneath the surface."

Deng Xiaoping

CHAPTER 3

THE CHINESE APPROACH TO TRANSITION: FROM SOCIALISM TO "CAPITALISM WITH CHINESE CHARACTERISTICS"[281]

The coexistence of state ownership and private ownership in China has puzzled many academics. Does state ownership benefit the country's political elite or has it facilitated Chinese economic development? What is the rationale behind China's gradual reforms of the state sector?[282]

Both property rights theory (Alchian 1965) and agency cost theory (Jensen and Meckling 1976) argue that government interference is usually at the cost of corporate profitability as government officials are driven by political considerations. However, China's economic growth in the context of state ownership and the partial privatization of state assets provide a ground for the argument that government may play a helping-hand role in China.[283]

Since the beginning of economic modernization in 1978, China has been demonstrating a notable rate of development and has quickly emerged as one of the world's major economic powers. China's

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[281] This term is borrowed from Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[282] Bai, Lu and Tao (2006) raise similar questions and offer a theory of SOE reform in China, and make predictions regarding the types of SOEs to be chosen for privatization and the results of privatization. They present empirical evidence supporting the basic premise of the theory and its theoretical predictions. Bai, C-E., Lu, J., & Tao, Z. (2006). The multitask theory of state enterprise reform. Empirical Evidence from China. The American Economic Review, 96(2), 353-357.

[283] Zhan, W., & Turner, J. D. (2012). Crossing the river by touching stones? The reform of corporate ownership in China. Asia-Pacific Financial Markets, 19, 233–258.

annual growth rate between 2005 and 2010 was equal to 11.2 percent, a remarkable progress compared to almost 4.0 percent in 1982.[284] Private consumption also increased from US$1,434 in 1982 to US$12,000 in 2011.[285] From the early 1980s, contracted FDI inflow to China rose from approximately US$1.5 billion a year to over US$40.0 billion in 1999.[286] According to one of the surveys on foreign capital in China, roughly 90.0 percent of companies in the West and Japan have set a ''China first'' strategy.[287] Since 1978 China has been successfully implementing the transition from a mainly agricultural to a primarily knowledge economy driven by technological progress.[288] With US$60.0 billion invested in research and development in 2001,[289] China ranks third in the world, behind the US and Japan.[290] Although agriculture still represents the main sector in terms of employment, the service sector grew from 12.0 percent of the total active population in 1978 to almost 32.0 percent in 2003.[291] Unsurprisingly, China's rapid economic growth has attracted close attention to the Chinese path of development. A great number of empirical and theoretical studies examine China's transition to a market-based economy. Most of the research emphasizes peculiarities and deficiencies in the performance of SOEs in China.[292] The majority of studies have largely focused on the linkage between ownership and firm performance based on a widely accepted idea that privatization is a major instrument to attain corporate efficiency.

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[284] Statistical Yearbook for Asia and the Pacific 2012 – ESCAP Statistics Division, China's profile p. 19.

[285] Statistical Yearbook of the Republic of China 2011, p. 151.

[286] See Tan, J. (2009). Institutional structure and firm social performance in transitional economies: Evidence of multinational corporations in China. Journal of Business Ethics, 86, 171–189.

[287] This means that many international companies consider the Chinese market as the priority in terms of trade and export. China's Foreign Trade, 2000.

[288] See Motohashi, K., & Yun, X. (2005). China's innovation system reform and growing industry and science linkages. RIETI Discussion Paper Series, March11, March 2005.

[289] More than 1 percent of GDP.

[290] US$282 billion and US$104 billion, respectively. See Huchet, J-F. (2006). The emergence of capitalism in China: An historical perspective and its impact on the political system. Social Research, 73(1), 1-27.

[291] China Statistical Yearbook, 2004.

[292] Chun, L. (2008). Against privatization in China: A historical and empirical argument. Journal of Chinese Political Science, 14(1), 21-48; Cheng, J. (2008). Chinese Law: Context and transformation. Leiden/Boston: Martinus Nijhoff.

However, the truth is that "even for an institution that we are certain will bring a lot of benefit, we have to consider the costs needed for its establishment and future running, before we recommend it."[293] Therefore, China's policymakers may not be irrational or driven by selfish motives in maintaining the system of SOEs. The latter may be a reasonable choice grounded in an alternative framework of efficiency.[294] Many strategic industries in China are represented by SOEs.[295] In order to satisfy domestic consumption and successfully compete in the international product markets, these SOEs need commercialized technologies. To address these challenges, China's policymakers have implemented a series of national programs to protect intellectual property rights, to develop science and technology education in China, and, as a result, to produce competitive local products.[296]

To start with, this chapter highlights the main differences in economic transition in China and Kazakhstan. Although in Kazakhstan and China the governments carry out the key roles in the countries' economic performance, their paths of transition have been different. Apart from many of the obvious distinctions between China and Kazakhstan, i.e., the size of the market and GDP rate, the population, commodity reserves, culture and ideology, all of which certainly affect the formation and characteristics of institutions in both countries,[297] China has followed the course of a socialist market economy with gradual privatization of very limited state assets in terms of an existing command system and central planning. Whether the Chinese approach to governance of SOEs is unique or whether it can be a viable alternative to universal corporate governance standards remains an open question for academics and

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[293] Chang, H-J. (2011). Institutions and economic development: Theory, policy and history. Journal of Institutional Economics, 7(4), 473–498.

[294] Chang, H-J. (2011). Institutions and economic development: Theory, policy and history. Journal of Institutional Economics, 7(4), 473–498.

[295] 64 percent of Chinese companies are SOEs who are pressured by SASAC. Zhao, M. (2012). CSR-based political legitimacy strategy: Managing the state by doing good in China and Russia. Journal of Business Ethics, 111, 439–460.

[296] See Wu, W., & Zhou, Y. (2012). The third mission stalled? Universities in China's technological progress. The Journal of Technology Transfer, 37, 812–827.

[297] North, D.C. (1990). Institutions, Institutional Change and Economic Performance. Cambridge University Press, Cambridge.

policymakers including the author.[298]

Nonetheless, despite all the differences between Kazakhstan and China, they share the same priority of sustained economic growth as well as similar institutional challenges. This chapter reviews the set of institutional reforms in China grounded on the principles of economic liberalization, decentralization of economic powers and corporatization of domestic SOEs. The eventual goal of those reforms was the introduction of market principles in terms of China's socialist economy. However, the main feature of China's institutional reforms is their gradualism. Even though, the Chinese government favors the private sector, it has never agreed on substantial or complete privatization of state assets. Instead, it has transformed an obsolete form of state entities into shareholding companies built on the modern standards of corporate governance with a corporate board on the top.

Gradualism in institutional reforms and the government interference in the economy have reasonable grounds. Similar to Kazakhstan, there are no sufficient capital markets and formal governance mechanisms in China. Private firms have a few options for raising capital. Foreign investors demonstrate quite narrow and, typically, short-term interests. Additionally, China has quite monopolistic product markets and a very small market for managerial talents; for example, major commercial banks in China are state-owned. In this situation, state financing and investments become important for further economic development and almost the only option for private firms. As a consequence, in order to obtain capital, entrepreneurs have to nurture government connections and participate in political networks. So-called "*guanxi*" networks (relationships) continue to be the powerful instrument of corporate governance in China being a substitute for legal protection and access to financing granted by formal institutions.

State capital and "*guanxi*" networks provide the government with the opportunity to intervene in SOE activities. SOEs in China carry out state development programs and guarantee employment, social

[298] The evidences from China suggest that the improvement of SOEs' performance may occur even without outright privatization. Meanwhile, the question of weather China's economic reforms coupled with privatization could lead to even better economic development still puzzles many economists. See Zhu, X. (2012). Understanding China's growth: Past, present, and future. The Journal of Economic Perspectives, 26(4), 103-124; Wei, Z., Varela, O., D'Souza, J., & Hassan, M. K. (2003). The financial and operating performance of China's newly privatized firms. Financial Management, 32(2), 107-126.

services, and social security to the population.[299] The government employs SOEs to implement industrial and infrastructural projects bypassed by private investors. At the same time, SOEs generate a large share of dividends and tax revenue that the government is able to reinvest in the country's further socio-economic programs, technology transfer and research. In particular, a significant contribution to the state revenue is made by China Investment Corporation, a SWF that runs China's foreign exchange reserves. This SWF is responsible for the stability of financial inflows into the economy and the mitigation of China's resource dependence. In this regard, this chapter presents a brief overview of the SWF's mission and investment activities.

The chapter also emphasizes that China's SOEs fall into the same trap as their Kazakhstani counterparts - the trap of political considerations and multitasking. That, in turn, causes a deficiency in SOE management. Finally, the chapter argues that, on balance, China's SOEs are beneficial because, to a certain extent, they fill institutional gaps and serve as a driving force of China's economy. In this regard, Chinese policymakers have made considerable efforts to improve SOE management through the corporatization of SOEs and the application of market principles to SOE operations. Those efforts tend to find the tradeoff between state socio-economic agendas and profit orientation. Even though SOEs in China suffer from similar challenges as SOEs in Kazakhstan, including multitasking, political considerations and the lack of independence from the government in terms of decision-making, state ownership is a reasonable corporate structure for the current stage of China's development in terms of the

[299] In this context, many economists and policymakers believe that privatization may cause mass layoffs and thus have an adverse social impact. "Privatization can cause job losses in two ways. One is direct and takes place at the firms being privatized. As state-owned enterprises are privatized, the newly- privatized enterprises often eliminate redundant workers in order to cut costs and improve efficiency and profits. The other source of job loss is due to the secondary effects of the increased efficiency that privatization brings about (Kikeri 1998). The remaining SOEs in an industry will face increased competition from the growing and increasingly more efficient private sector, and they, too, may thus be forced to lay off workers and cut wage costs in order to survive…" From Chang, G. H., & Brada J. C. (2011). A model of the macroeconomic effects of privatization on employment in transition and developing countries with an application to China. Transition Studied Review, 18, 310–327. doi 10.1007/s11300-011-0206-2.

existing institutional and market drawbacks.[300]

What makes China Different From Kazakhstan

China and Kazakhstan have come to similar policy decisions today from originally opposite courses of transition from a planned to a market economy. Following Russia's example, Kazakhstan applied a "shock therapy" strategy through total privatization and liberalization of the economy during the first years of its independence. From the beginning, Kazakhstan declared itself as a market-oriented economy and took the course towards the establishment of a self-enforcing private ownership system. The government gave up its shares in almost all SOEs including strategic industries such as oil and gas, mining, metallurgy, banking, and air transportation. Kazakhstan abandoned the old governance mechanisms straight away and allowed the "invisible hand" of the market to put the right motivations in place. The relatively small scale of the market gave a chance to accomplish privatization and a new economic course in a quite short period. Eventually, the national economy was dominated by private capital. However, despite powerful private incentives, economic transition to a market economy was originally driven by full privatization of the SOEs instead of the rise of newly founded private entities.

Later, as a result of private management's failures, the government reinvested some of its assets through the bail-out of private enterprises. The mass bail-out also took place at the time of the last global recession in 2008 when the government took charge in order to maintain socio-economic stability and mitigate systemic risks. Thus, the state role in the national economy and the extent of government interference has substantially increased in Kazakhstan over the last seven years. For instance, before the global recession in 2008 the banking industry in Kazakhstan was totally dominated by private commercial banks as opposed to a few state-owned banks, which have always controlled the financial sector in China.

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[300] For additional discussion see Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

However, by the time the state increased its control and became a major creditor, its actions had been limited by the already established market systems and commitments to foreign investors. After all, state interference in Kazakhstan was primarily driven by concerns over sustainability and diversification of the domestic market economy. Therefore, the system of state asset management in Kazakhstan is represented by shareholding companies that, although owned by the government, maintain all the features of corporate governance existing in private firms. Nonetheless, the central government of Kazakhstan maintains the high concentration of economic power with respect the SOEs' budget planning and spending. This substantially limits the incentive of SOE management and regional authorities to increase output, because it means more contributions to the center and fewer fund allocations to the regions and SOEs themselves.

In turn, China present an alternative model of transition based on successive tactics, i.e., when the government gradually gives away its absolute position in selected industries. China began its economic reforms in 1978 with the intention to adhere to a socialist economic course. The purpose of the post-1978 reforms in China was a gradual introduction of market forces into the framework of a planned economy. China's economic reform has never relied on outright privatization of SOEs. Instead, the Chinese transition was initially characterized by the emergence and expansion of a big number of newly created private companies, which largely contributed to a high GDP growth rate.

The gradualism of China's reforms has brought a number of specific challenges. Among those challenges, Wu (2006) highlights "solving the remaining problems of the old system, resolving the contradictions generated during the period when the new and the old systems coexisted, and establishing a suitable environment for the new one."[301] This means that, although the impact of a state-centered regime has been diminished, its institutional arrangements have remained particularly strong and deeply rooted in China's economy. Accordingly, while operating in the market, state assets in China have been managed by state commissions and bureaus. Therefore, scholars suggest that the co-existence of international

[301] Cited in Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

principles of corporate governance with a powerful state and the legacy of a command economy has created a unique form of Chinese capitalism.[302]

In order to achieve better competition, the central government of China has implemented the policy of decentralization from the center to regional authorities. The new fiscal reform launched in 1994 clearly defined fiscal responsibilities and rights of all levels of local government in China. It provided local governments with strong incentives to improve the corporate performance of SOEs operating in their jurisdictions because of a larger share of the tax revenue channeled to local budgets.[303] Hence, some research suggests that the possibility of regional competition for profitable SOEs might induce local governments to enhance corporate governance in the SOEs they control.[304]

Summing up, notwithstanding all the differences, the governments of Kazakhstan and China demonstrate the same focus on building competitive domestic industries and local enterprises. Despite privatization, both governments have demonstrated small interest in completely transferring control of state assets to private actors. Instead, many of Kazakhstani and Chinese SOEs have been corporatized and transformed into shareholding companies, where the governments exercise their control rights through corporate means. The few options for raising capital have made state programs and state-owned banks important sources of funding for domestic entrepreneurs. In this situation, political and personal connections with state banks and the government have become critical for obtaining access to state

[302] Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[303] "During the reform process, China launched two tax reforms which introduced a clear distinction between national and local tax, and established a national tax bureau and local tax bureaus with each responsible for its own tax collection (Cao et al. 1999; Jin et al. 2005). The first reform was launched in 1984, which allowed local governments to retain a certain amount of the tax after paying the central government a pre-determined rate. The second reform, introduced in 1994, made a clear distinction between central and local government tax, and this allowed local governments to become the major claimant of the local tax revenue (Jin et al. 2005). The major local taxes are the income taxes from all local enterprises, business tax from the sales of services, and person income tax (Jin et al. 2005). Moreover, the fiscal reform in 1994 also determined that value added tax would become the major indirect tax to be shared by the national and local governments at a fixed ratio of 60: 40 (Cao et al. 1999)." From Zhan, W., & Turner, J. D. (2012). Crossing the river by touching stones? The reform of corporate ownership in China. Asia-Pacific Financial Markets, 19, 233–258.

[304] Crossing the River by Touching Stones?: The Reform of Corporate Ownership in China, Wenwen Zhan, John D. Turner, Asia-Pacific Finan Markets (2012) 19:233–258.

financing. At the same time, the narrow focus of investments demonstrated by private actors has left other strategic industries largely undercapitalized. Hence, both governments employ SOEs, including SWFs, to diversify the economy and support domestic industries and industrial projects overlooked by private investors. Both governments have to bear the role of the main investor, the guarantor of the minority shareholders' protection and the principal monitoring force for SOE management. Additionally, in the absence of a solid social security system, the governments engage SOEs to provide employment and social services to the population and to maintain social stability in their countries.

Thus, there are certain grounds for the special role of SOEs in China, including the lack of sufficient capital markets, formal governance tools and institutional conditions typical for developed economies.

Institutional Reforms in China

Since the 1970s, China has implemented significant institutional reforms to uphold the course of transition from a low-income agricultural country to a developed economy. Those reforms reflect China's approach to SOE management and corporate governance. In the 1970s, the Chinese planned economy was totally dominated by the state and collective ownership systems in almost every sector.[305] The economic performance of the SOE sector in China has been very poor. The per capita income was low, and the major part of the population lived in absolute poverty.[306]

To break that pattern and significantly raise the level of living in China, Deng Xiaoping in 1978

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[305] A small industrial sector of China's economy consisted of about 78percent of state-owned enterprises (SOE) and 22percent of collectively community-owned (CCOE) in 1978. Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333.

[306] Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333.

announced the "Great Opening" strategy of economic and institutional reforms. That process was grounded on the principles of economic liberalization and decentralization of economic powers, as well as the integration of the Chinese economy into the global world economy.[307] With the process of economic integration, significant changes have taken place in China's state sector. Hence, in order to understand the role of state ownership, one must know the major institutional changes resulting from those reforms.

Since the beginning of market liberalization in 1978, the process of transition has included: (1) gradual decentralization of economic decision-making from central state planning to a market-oriented judgment by managers of SOEs, (2) liberalization of international economic activities, (3) allowance to set up private enterprises (hereinafter "POEs") and foreign invested enterprises in the Chinese territory, and (4) corporatization of SOEs. In general, Deng Xiaoping defined the reforms as two "separations": (1) the separation of the government from the enterprise and (2) the separation of the Communist Party of China (hereinafter "the CCP" or "the Party") from the government. The former separation was supposed to provide an institutional base for a "socialist market economy," while the latter had the goal of reducing arbitrary interference by the Party in government affairs.[308] In 1992, the reform was expanded after Deng Xiaoping's famous "southern tour."[309] Accordingly, between 1994 and 1995, the share of industrial output controlled by the central government declined by 5.8 percent, while the output controlled by regional

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[307] See Kornai, J. (1980). The economics of shortage. Volumes A and B. North-Holland: Amsterdam.

[308] "In 1982 the Twelfth Party Congress proposed 'planned economy as the main pillar and market economy as a supplementary element'. The market economy did not gain even a theoretical legitimacy. In 1987, at the Thirteenth Party Congress, Zhao Ziyang, the then General Secretary of the Party; proposed 'combining planned and market economies', arguing that China was still in a primary stage of socialism. Thus, the market economy gained an equal position to that of the planned economy in the Party ideology." Following Deng Xiaoping's southern tour in 1992, the Party officially named China as a socialist market economy." Later, "…the Second Plenary Session of the Ninth People's Congress in March 1999 passed a third constitutional amendment, which legitimated private economic activities and other forms of non-state ownership that had been practiced for many years." From Zheng, Y. (1999). Political incrementalism: Political lessons from China's 20 years of reform. Third World Quarterly, 20(6), 1157-1177.

[309] See Zheng, Y. (1999). Political incrementalism: Political lessons from China's 20 years of reform. Third World Quarterly, 20(6), 1157-1177.

governments increased by 36.1 percent.[310]

The main distinguishing feature of the chosen path of reforms is a gradualism in the implementation of transition.[311] The state has delegated the part of decision-making competence to SOE management while preserving ownership and control.[312] The partial decentralization of decision-making has included two policy courses: decentralization from the central government to local governments and decentralization from the government to basic economic units such as enterprises and households.[313] The reform is intended to some extent decentralize economic and decision making powers, awarding the private sector with greater control and residual claim rights. Local governments and private enterprises have been granted the set of incentives.[314]

Among other important changes in China's economy scholars mention fiscal and accounting reforms, the rise of self-employment among individuals, the expansion of private enterprise, the development of a diversified property rights structure, and the adoption of new management responsibility and contract systems.[315] Those reforms indicate that China's policymakers aim to build a

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[310] Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147. Also see National Bureau of Statistics of China, Reports 1994, 1995.

[311] Lin, J. Y., & Wang Y. (2012). China's integration with the World: Development as a process of learning and industrial upgrading. China Economic Policy Review, 1(1): "This approach has been piecemeal, partial, incremental, and often experimental. It has not been guided by a well-founded theory or followed a pre-determined blueprint."

[312] Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333

[313] Qian, Y. and Weingast, B.R. (1995) China's Transition to Markets: Market-Preserving Federalism, Chinese Style, Working paper, Stanford University.

[314] For example, in 1988, China launched the Torch Program to encourage local governments to establish high-tech parks together with universities and private enterprises, where universities enjoyed preferential tax and land leasing exemption, governments utilized universities' R&D resources to promote regional economies, while enterprises made the most of universities' research capacity and innovation talents to improve market competitiveness. See Zou, Y., & Zhao, W. (2014). Anatomy of Tsinghua University science park in China: Institutional evolution and assessment. The Journal of Technology Transfer, 39(5), 663-674. Also see Qian, Y., & Weingast, B.R. (1995.) China's transition to markets: Market-preserving federalism. Chinese Style. Journal of Policy Reform, 1, 149-185; Qian, Y., & Roland, G. (1998). Federalism and the soft budget constraint. American Economic Review, 88(5), 1143–1162; Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147.

[315] For a more comprehensive description of China's reforms see Chen, S. (2002). Economic reform and social

market economy while keeping planning and delivering long-term economic growth and social welfare under the government control.

Contract Responsibility System. To increase the SOEs' managerial autonomy, the Chinese central government introduced the contract responsibility system, which aims to specify and divide responsibilities and rights between the state and SOEs so that the SOE managers obtain a certain degree of independence in decision-making.[316] The system includes *a profit-retention scheme* that allows SOEs to keep some of their profits after netting off amounts that have been paid to employees and the state. Contracts have been signed to deliver a required quantity of output to the state. After fulfilling those obligations, SOEs are permitted to sell the rest in the market at market prices.[317]

Profits, in turn, can be further invested in the market thanks to a *dual-track system*. Under the dual-track system, SOE resources can be allocated in two ways: through the market and through the state plan. In other words, SOEs are still given state quotas on both production inputs and output transacted at official prices, but they are also allowed to buy inputs and sell output beyond quotas at a market price. Moreover, the non-state enterprises, including collective firms, small private entities, and foreign firms in special economic zones, have been allowed to enter the market.[318]

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change in China: Past, present, and future of the economic state. International Journal of Politics, Culture, and Society, 15(4), 569-589; Karmel, S.M. (1994). Emerging securities markets in China: Capitalism with Chinese characteristics. China Quarterly, 140, 1105-1120.

[316] Yifu, J., Cai, F., & Li, Z. (1999). Fair competition and China's state-owned enterprises reform. MOCT-MOST: Economic Policy in Transitional Economies, 9(1), 61-74.

[317] Therefore, 90 percent of industrial SOEs adopted the contract responsibility structure by the end of 1987. See Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789; Yifu, J., Cai, F., & Li, Z. (1999). Fair competition and China's state-owned enterprises reform. MOCT-MOST: Economic Policy in Transitional Economies, 9(1), 61-74.

[318] "As the share of a commodity that was allocated under the planned price was gradually reduced due to the growth of non-state sectors and the outside-the-plan production activity of the SOEs, the government would then give up the planned price, allowing the price to converge to market prices. By 1988 only 30 percent of retail sales were made at planned prices, and the SOEs obtained 60 percent of their inputs and sold 60 percent of their outputs at market prices... By 1996, with the exception of a few raw materials and coal, fuel, and transportation, the prices of most commodities and services had been liberalized." From Lin, J. Y., & Wang Y. (2012). China's integration with the World: Development as a process of learning and industrial upgrading. China Economic Policy Review, 1(1).

In effect, SOEs have become more sensitive to market conditions. The system has also strengthened profit incentives among SOE managers and workers. They have begun to receive additional income in the form of bonuses after meeting stipulated performance standards.[319] That, in turn, has directly affected the SOEs' productivity growth. For instance, the number of loss-making SOEs fell from an average of 29.0 percent in the mid-1970s to 16.3 percent in the 1980s.[320]

Township and Village Enterprises (hereinafter "TVEs"). TVEs have been recognized in China as a driving force of the rural industrialization that reduced poverty and raised productivity.[321]

Before 1978, China's agriculture had been organized into collective farms of which a substantial part experienced serious mismanagement problems and stagnation. The first steps of the sector's reform were the implementation of a family contract system and the de-collectivization of agricultural production. Communes were dissolved. Land was leased to individual families, which became responsible for their farms' performance. They were obliged to sell a certain amount of agricultural products to the state at an official price and to pay taxes, but could keep any surplus they produced.[322] Thus, the old commune-based system was replaced with a *household responsibility system*.[323]

The creation and rapid expansion of TVEs led the way to the growth of the non-state sector. The

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In 1987, the dual-track system was applied to 40 percent of all production materials and accounted for 75 percent of total transactions in production materials. From 1979 to 1992, the number of industrial products controlled by the State Planning Commission decreased twice. See Zhu, X. (2012). Understanding China's growth: Past, present, and future. The Journal of Economic Perspectives, 26(4), 103-124; Yifu, J., Cai, F., & Li, Z. (1999). Fair competition and China's state-owned enterprises reform. MOCT-MOST: Economic Policy in Transitional Economies, 9(1), 61-74.

319 Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

320 Cai, H., & Treisman, D. (2006). Did government decentralization cause China's economic miracle? World Politics, 58(04), 505-535.

321 Huang, Y. (2010). China's other path. The Wilson Quarterly, 34(2), 58-64.

322 Wen, D. J. (2009). China's rural reform: Crisis and ongoing debate. Economic and Political Weekly, 43(52), 86-96.

323 Lin, J. Y., & Wang Y. (2012). China's integration with the World: Development as a process of learning and industrial upgrading. China Economic Policy Review, 1(1).

number of TVEs increased from 1,520,000 in 1978 to 18,880,000 in 1988.[324] Between 1978 and 1988, the share of total employment in non-state enterprises increased from 15.0 percent to 39.0 percent. The increase in employment in the non-state sector was also accompanied by total productivity growth averaging 5.87 percent a year during that period.[325] In particular, the annual growth rate of TVEs in total output value was three times more than the growth of SOEs in the same period. In 1993, the output of TVEs accounted for more than one-third of total industrial output in China. The share of industrial output from non-state enterprises increased from 22.0 percent in 1978 to more than 75.0 percent in 2003.[326]

At the time of the reform, credit and land markets were largely missing. Under those circumstances, entrepreneurs had to cooperate with local governments to get resource support. On the other hand, local governments engaged entrepreneurs in solving social agendas in their regions, such as employment, education and healthcare. In particular, about 40.5 percent of workers in TVEs were hired through local officials. Moreover, about 75.0 percent of managers in those enterprises were appointed by township and village administrations.[327] TVEs also had a significant social responsibility such as support of primary education and public health.[328] As a result, control allocation in TVEs has become highly dependent on local government decisions. For example, in terms of management decision-making in TVEs, studies show that in the 1990s more than two-thirds of decisions were made solely by township

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324 National Bureau of Statistics of China, Report 1999.

325 Zhu, X. (2012). Understanding China's growth: Past, present, and future. The Journal of Economic Perspectives, 26(4), 103-124.

326 With respect to the agricultural sector, almost all of the productivity growth was attributed to the introduction of the household responsibility system. See Lin, J. Y. (1992). Rural reforms and agricultural growth in China. American Economic Review, 82(1), 34–51. As a result of productivity growth, China's agricultural output increased by 47 percent during this period. See Zhu, X. (2012). Understanding China's growth: Past, present, and future. The Journal of Economic Perspectives, 26(4), 103-124.

327 Chen, J. (1995). The property rights structure and its effects on resource allocation. Economic Research Journal, 9, 24–32.

328 Wang, Y., & Li, M. (2009). Costs and benefits of relational contracting in China's transition. Transition Studies Review, 16, 693–709.

governments or jointly by those governments and TVEs.[329]

Special Economic Zones (hereinafter "SEZs"). The creation of SEZs substantially contributed to the expansion of foreign investments and trade in China. Those economic zones provided a set of support measures and favorable conditions for foreign investments. That policy decision pushed forward a huge investment inflow into China from abroad.[330] China has become the second largest recipient of FDI worldwide and enjoys the biggest inflow of FDI among developing countries.[331] The country has attracted a quarter of the total foreign investments going to developing countries over the last ten years.[332] FDI has also become the main source of technology transfer.[333] Multinational manufacturing firms have moved their businesses to China, bringing advanced technologies.

The shares of foreign trade and export in the country's GDP grew from about 9.8 percent and 4.62 percent in 1978 to 60.4 percent and 31.1 percent, respectively, in 2003.[334] Foreign companies have also been responsible for the rapid growth in foreign trade, which was equal to 55.0 percent of total Chinese exports in 2003.[335] Within about two decades China has emerged as a major trading nation.

After joining the World Trade Organization (hereinafter "the WTO") in 2001, the growth in trade and foreign investments has continued. Since then total trade has been expanding at an average annual rate of more than 35.0 percent. Total trade value exploded from US$510 billion in 2001 to US$2,174 billion in 2007. Today, China is an integral part of the global supply chain, and one of the manufacturing

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[329] Chen, J. (1995). The property rights structure and its effects on resource allocation. Economic Research Journal, 9, 24–32.

[330] According to the Ministry of Foreign Trade and Economic Cooperation, in 2000 the contracted FDI reached an amount of about USD 62.4 billion, and in 2001, of about USD 69.2 billion.

[331] Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333.

[332] Huchet, J-F. (2006). The emergence of capitalism in China: An historical perspective and its impact on the political system. Social Research, 73(1), 1-27.

[333] Fan, X. E. (2003). Technological spillovers from foreign direct investment – A survey. Asian Development Review, 20(1).

[334] Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333.

[335] Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333.

centers of the world.

Managerial Responsibility System reform was introduced to link managers and workers' income to the revenue of SOEs, in other words, to grant this group the incentive of profit maximization.[336] The rationale of the reform was based on the traditional principal-agent approach proposed by Jensen and Meckling in 1976. Jensen and Meckling demonstrated that there are the conflicts of incentives in a firm (the agency conflicts). One of them appears to be between corporate owners, on the one hand, and corporate managers, on the other hand.[337] This conflict cause considerable agency costs arising from the divergence of the interests. Therefore, the main purpose of the managerial responsibility system was to minimize agency costs faced by SOEs and the government and, as a result, to improve SOE efficiency.

In this regard, empirical studies suggest that the system had some positive effect on SOE productivity. For instance, Li (1997) evaluated the total factor productivity of industrial SOEs between 1980 and 1989 and concluded that their growth could be attributed to stronger incentives, increased market competition and better allocation of production inputs.[338] Groves, Naughton, Hong, and McMillan (1994) also reported a positive incentive effect of the managerial responsibility system on the productivity of SOEs.[339]

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[336] Zhu, X. (2012). Understanding China's growth: Past, present, and future. The Journal of Economic Perspectives, 26(4), 103-124.

[337] Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. Journal of Financial Economics, 3(4). Available at SSRN: http://ssrn.com/abstract=94043.

[338] Li, Wei. 1997. "The Impact of Economic Reform on the Performance of Chinese State Enterprises, 1980-1989." Journal of Political Economy 105(5): 1080-1106.

[339] "The combination of greater autonomy, tougher constraints and better incentives in the new contract responsibility system is generally perceived to have resulted in improved enterprise performance. Hay et al (1994) note that China's GDP grew at an impressive annual rate of 10.6 percent during the 1980s, with the state-owned industrial sector growing at over 8 per cent per annum in the period and at nearly 12 per cent per annum in the main reform years (1983-88). The authors are, however, quick to add that even faster productivity growth in private enterprises and collectively owned enterprises suggests that ownership reform must remain a priority for China." From Ram Mohan, T. T. (2004). Privatization in China: Softly, softly does it. Economic and Political Weekly, 39(45), 4904-4909. See also Groves, T., Naughton, B., Hong, Y., & McMillan, John (1994). Autonomy and incentives in Chinese state enterprises. Quarterly Journal of Economics, 109(1), 183-209.

Administrative Reform. Since 1978, Chinese regulatory institutions have been restructured several times to achieve higher effectiveness of state governance. That process has included a reduction in the number of sectorial ministries in order to reduce state regulatory interference, on the one hand, and to establish new state commissions and SOEs in order to take responsibility for certain functions that previously had been handled by central ministries, on the other hand. [340] The reform originally intended to diminish the power and influence of the central government. It aimed to institute smaller and more efficient governmental bodies.[341] Furthermore, it involved detaching business monopolies from ministries that previously controlled them and splitting up many of those monopolies in order to introduce limited competition.[342] Altogether, the reform had the goal of increasing the role of market forces in the implementation of state economic policies.

Today, there are several major commissions responsible for supervising the economy and state assets in China. Although, these state bodies do not manage and monitor SOE everyday operations, their powers remain quite strong. In particular, the State Development and Planning Commission (hereinafter "SDPC") makes basic decisions as to which industries should receive major government investments. The SDPC is deeply involved in key regulatory decisions and carries out some of the regulatory functions of price setting and licensing. In 2003, the State Council assigned the SDPC responsibility for the

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[340] For instance, "… streamlining of the Ministry of Petroleum resulted in the establishment of three new major companies: China National Offshore Oil Corporation (1982), China Petrochemical Corporation (1983) and China National Petroleum Corporation (1988). As a result of these institutional and allied initiatives the Ministry of Petroleum was emptied of its functions and abolished in 1988." From Brødsgaard, K. E. (2012). Politics and business group formation in China: The party in control? The China Quarterly, 211, 624 - 648.

[341] "Presumably the new arrangement would solve the SOEs' many problems connected with the systemic characteristics of these huge enterprises that obligated the state to inject them continuously with funds from the state budget. Furthermore, the State Planning Commission (SPC) was renamed the State Development Planning Commission (SDPC) with appropriate alteration of its functions… As a result of renaming and restructuring, the new Commission had lost its managerial functions. The chief function of the new Commission is to formulate plans for China's long-term development strategies." From Zheng, Y. (1999). Political incrementalism: Political lessons from China's 20 years of reform. Third World Quarterly, 20(6), 1157-1177.

[342] Zheng, Y. (1999). Political incrementalism: Political lessons from China's 20 years of reform. Third World Quarterly, 20(6), 1157-1177.

formulation of state industrial policies and their implementation.[343] In addition to the SDPC, in 2003 the government created the China Banking Regulatory Commission in order to achieve better monitoring of the banking industry.[344]

The management of SOEs affiliated with the central government has been placed in the hands of the State Asset Supervision and Administration Commission (hereinafter "SASAC") established in March 2003. The new commission is in charge of China's largest SOEs on behalf of the State Council. The SOEs affiliated with local governments are directly controlled and managed by state assessment management bureaus (hereinafter "SAMBs").[345]

SASAC and SAMBs serve as government agents. They are entitled to decide on the appointment of top executives, to monitor their performance and to approve transactions with state assets.[346] Several empirical studies show that the productivity and profitability of Chinese SOEs has improved following the administrative reform that clearly assigned control functions within the state ownership structure (Xu et al. 2005; Jefferson et al. 2005; Jefferson and Su 2006). Li Rongrong, Chairman of SASAC, reported that in 2006, the profits made by state-invested companies increased by 147.3 percent as compared to 2003 when total assets increased by 45.7 percent.[347] Thus, while the majority of international experts and scholars argue that institutional reforms are more effective in the context of privatization,[348] the Chinese government prefers to withhold state assets and launch the reform without a significant change in

[343] Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

[344] Berger, A. N., Hasan, I., & Zhou, M. (2009). Bank ownership and efficiency in China: What will happen in the world's largest nation? Journal of Banking and Finance, 33(1), 113-130.

[345] Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

[346] Berger, A. N., Hasan, I., & Zhou, M. (2009). Bank ownership and efficiency in China: What will happen in the world's largest nation? Journal of Banking and Finance, 33(1), 113-130.

[347] Berger, A. N., Hasan, I., & Zhou, M. (2009). Bank ownership and efficiency in China: What will happen in the world's largest nation? Journal of Banking and Finance, 33(1), 113-130.

[348] See World Bank, Building institutions for Markets: World Development Report 2002 (New York: Oxford University Press, 2002.

ownership.[349]

At the same time, new market and financial incentives and the stock market's development required significant legal reforms. Those reforms had a goal to match the new business environment and, as a consequence, to maintain China's sustained economic growth and social stability.[350]

China's Corporate Law. As a part of SOEs' corporatization, new laws and regulations have been approved. In particular, the Company Law of 1993 (hereinafter "the Company Law") promulgated a modern enterprise system in terms of the socialist market economy. The Company Law defined new corporate forms and governance structures operating in order to maintain the existent socio-economic order. In particular, SOEs, organized or corporatized under the Company Law, have introduced new corporate forms of state ownership. The Company Law defines the terms "companies" as limited liability companies (LLCs) and companies limited by shares or joint stock companies (JSCs).[351] These types of companies largely resemble their Western counterparts. Their governance structure consists of the board or general meeting of shareholders, the board of directors, a supervisory board, an executive body, and a labor union.[352] The board or general meeting of shareholders is the major body of power. The board of directors operates the company on a day-to-day basis and works closely with management; it is accountable directly to shareholders. The supervisory board is supposed to provide independent views and

[349] See Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147.

[350] In particular, "SOEs first became shareholding enterprises in 1984 through a process called gufenhua or shareholding transformation. The Chinese equity market has enabled wealth-sharing with investors, managers, and employees, and adopting Western financial reporting requirements has forced greater transparency and accounting standards. Many SOEs also adopted a contracting system (chengbao zhi) in 1987 (which became national law in 1993). The state significantly diminished its interference in SOE operations, giving them more freedoms including competitively selecting its CEO to act as its legal representative and be responsible for operations, as well as permitting them to retain more of their profits." Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[351] Company Law of the People's Republic of China (Revised in 2013). Accessed on October 19, 2015. Available at: http://www.fdi.gov.cn/1800000121_39_4814_0_7.html.

[352] Clarke, D. C. (2003). Corporate governance in China: An overview. China Economic Review, 14, 494–507.

monitor management and the board of directors; it consists of independent shareholders and employees and reports to shareholders.[353] The labor union is deemed to implement democratic management through the employees' representation in corporate governance. For instance, the Company Law establishes that when a company discusses and decides on restructuration and other major issues concerning its business operation or formulates major rules, regulations and policies, it shall solicit opinions from the labor union.[354] Also, any company should establish an organization of the Communist Party of China (the Committee) to carry out the activities of the Party in accordance with the charter of the Communist Party of China. Companies are obliged to provide the necessary conditions for the activities of this organization.[355] Thus, despite the novelty of the Company Law's provisions, Chinese politics and ideology continue to exert a strong influence on the development of corporate governance. The Communist Party Committees, labor unions, and employees' representatives co-exist with the new corporate bodies: general meetings of shareholders, boards of directors, and supervisory boards.

Also, along with general provisions of the Company Law applied to all enterprises, there are special norms that refer to the organizational structure of SOEs.[356] First, SOEs do not have the board of shareholders. Its functions are exercised by a supervising state agency (a state controlling shareholder).[357]

[353] "In practice, the supervisory committee is headed by the Communist Party leaders of the firm and does not have finance and audit sub-committees. More importantly, it is only equipped with the right of supervision, without the right to select managers and directors and to veto the decision of the board or management. Hence, the supervisory committee is more decorative than functional." See Su, D., & He, X. (2012). Ownership structure, corporate governance and productive efficiency in China. Journal of Productivity Analysis, 38, 303–318.

[354] Company Law of the People's Republic of China (Revised in 2013). Accessed on October 19, 2015. Available at: http://www.fdi.gov.cn/1800000121_39_4814_0_7.html.

[355] Company Law of the People's Republic of China (Revised in 2013). Accessed on October 19, 2015. Available at: http://www.fdi.gov.cn/1800000121_39_4814_0_7.html.

[356] For the purposes of the Company Law, the term "wholly State-owned company" refers to a limited liability company of which the State is the sole investor and the State Council or a local people's government authorizes a State-owned assets supervision and administration authority of the people's government at the same level to perform the responsibilities of the investor.

[357] Chen, G., Firth, M., & Xu, L. (2009). Does the type of ownership control matter? Evidence from China's listed companies. Journal of Banking & Finance, 33, 171–181. The authors mention that "…in China, the state's ownership of firms is undertaken by different types of agencies and we argue that the objectives of these agency-types dictate the extent of political intervention and the degree of commercialization of the listed companies they

As a result, the state controlling shareholder approves such major corporate decisions as: merger, division, dissolution, increase or reduction of registered capital and issuance of corporate bonds. Furthermore, merger, division, dissolution or bankruptcy of strategic SOEs are subject to the government's final approval.[358] Second, SOEs' board members are appointed by the state controlling shareholder, including the chairman and vice-chairman of the board. The same requirement is imposed for the appointment of the supervisory board's members. This, in effect, provides the state controlling shareholder and the government with an ultimate approval authority over SOEs directors and top managers. Therefore, state controlling shareholders can exert significant influence over SOE corporate decisions.[359]

Therefore, the process of SOE corporatization has brought about new corporate governance forms. At the same time, old governance structures still persist in China. This duality of old and new institutions is a distinctive feature of corporate governance in China that makes management in China's companies even more complicated. As a result, important corporate and business decisions often confer on informal institutions such as "guanxi" networks.[360]

Summing up, all of the reforms mentioned above provide evidence that China's policymakers are not keen on the full transfer of control over state assets to the private sector. Gradualism, typical for China's way of economic transition, can be traced in the reform of Chinese SOEs. Instead of substantial privatization of state assets, that process has involved the transformation of SOEs into shareholding companies with a board of directors as the major body to exercise control. The process was referred to as

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invest in. We classify state owners in China's listed companies into three major types based on their political and economic interests: SAMBs (state asset management bureaus), SOE-CGs (SOEs affiliated to the central government), and SOE-LGs (SOEs affiliated to the local government). We argue that these three types of state owners have very different objectives when it comes to the listed firms they control."

[358] The State Council defines which SOEs are deemed to be strategic.

[359] Firth, M., Wong, S., & Yang, Y. (2014). The double-edged sword of CEO/chairperson duality in corporatized state-owned firms: evidence from top management turnover in China. Journal of Management and Governance, 18(1). doi: 10.1007/s10997-012-9225-6.

[360] These networks will be discussed in the following parts.

the corporatization of SOEs, with the state retaining a large portion of corporate shares.[361] Clarke (2003) describes this approach as the following: "[T]he state wants to maintain full or controlling ownership in enterprises in several major sectors, and it wants these enterprises to be run along commercial lines in the service of wealth maximization."[362] Furthermore, new forms of enterprises have emerged, including TVEs, joint ventures and other non-state firms in order to create jobs and boost economic growth through the development of new private forms and the introduction of market forces into the state sector.[363]

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[361] "[T]he pace of privatization in China varies depending on the industry. In particular, health care went through substantial privatization in the mid 1980s through the 1990s, which was accompanied by dramatic decline in service quality and accessibility to the poor. In contrast, the state preferred to withhold the control in the financial sector." From Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789. Also see Firth, M., Wong, S., & Yang, Y. (2014). The double-edged sword of CEO/chairperson duality in corporatized state-owned firms: evidence from top management turnover in China. Journal of Management and Governance, 18(1). doi: 10.1007/s10997-012-9225-6.

[362] Clarke, D. C. (2003). Corporatization, not privatization. China Economic Quarterly, 7(3), 27.

[363] China's POEs adopted a corporate governance model that resembles the Western corporate traditions such as maximizing shareholder value, improving efficiency and increasing management autonomy. The State Council promulgated the first regulation on private business in 1981. By that time, many small individual and family businesses had already operated in response to increasingly liberal economic conditions. The regulation specified those who were permitted to set up private firms as well as the nature and scope of private activities. In 1989, the legality of the private sector was officially recognized by the Amendment to the Constitution of the People Republic of China, which guaranteed state protection of private interests and permitted the private sector to exist and develop within the limits prescribed by law.

There have been several types of private corporate forms in China including sole proprietorships, partnerships, and limited liability companies. All of them are required to pay taxes on profit and to invest at least half of their profit for business expansion. Largely thanks to the new regulation, the private sector has experienced steady growth. To be specific, by 1997 the sector accounted for one-third of the national industrial output and one-fifth of national non-farm employment. In accordance, the 15th National Congress in 1997 further recognized the legal status of private property, which was acknowledged as an "important component" of the socialist market economy. In 1999, GDP generated by private firms increased more than ten-fold (1608.3 billion yuan) above the numbers for 1989. Ziegler (2000) estimated that the private sector was responsible for 75 percent of Mainland Chinese GDP.

In 2001, General Secretary Jiang Zemin requested the Party to consider the admission of successful domestic entrepreneurs to the Party's membership. That was an important shift in recognition of POEs in China as a political force. Recently, the central government has invited private entrepreneurs to join the People's Congresses and People's Political Consultative Conferences at the national and provincial levels (Zhou 2008). The central government's position has changed from direct interference to support of domestic business, especially after joining the WTO in 2001. POEs have been granted an opportunity to venture into industries that previously was closed to the private sector.

That produced a positive socio-economic outcome. For instance, between 1998 and 2007, the share of total urban employment in domestic private enterprises and foreign-invested enterprises increased from 8 to 24 percent. The increase in the manufacturing sector was even more pronounced. By 2007, domestic private enterprises alone

Hence, any attempt to analyze the system of corporate governance in China has to consider existing institutional conditions and the special role of SOEs.

Why Do State Companies Exist in China?

One of the justifications for state ownership in China is the absence of sufficient capital markets and formal governance mechanisms. When describing China's institutions, many academics emphasize a weak legal system, poor law enforcement, monopolistic product markets, and an inadequate market for managerial talent.[364] These necessary institutional conditions for the application of the traditional concept of corporate governance are still evolving in China. Therefore, private enterprises enjoy very few options for raising capital, one of which is bank financing. Although the Chinese banking sector has been experiencing considerable reforms,[365] the government still controls approximately half of economic

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accounted for 51 percent of total urban employment in the manufacturing sector.

Airlines and railways, which were regarded as strategically important industries allocated under the state exclusive control, have become open for private investments. However, in May 2005 two private enterprises bought 65 percent ownership of Shenzhen Airlines, the seventh largest Chinese airliner (People's Daily, 25 May 2005), and in August 2006, a private enterprise successfully acquired a regional railway in Southern China.

See Chow, C. K. W., Fung, M. K. Y., Lam K. C. K., & Sami, H. (2012). Investment opportunity set, political connection and business policies of private enterprises in China. Review of Quantitative Finance and Accounting, 38(3), 367-389. doi: 10.1007/s11156-011; Zhou, W. (2008). Bank financing in China's private sector: The payoffs of political capital. World Development, 37, 787-799 ; Zhu, X. (2012). Understanding China's growth: Past, present, and future. The Journal of Economic Perspectives, 26(4), 103-124.

364 Tan, J. (2009). Institutional structure and firm social performance in transitional economies: Evidence of multinational corporations in China. Journal of Business Ethics, 86, 171–189; Dunfee, T. W., & Warren, D. E. (2001). Is guanxi ethical? A normative analysis of doing business in China. Journal of Business Ethics, 32, 191–204; Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

365 "China has made an effort to stimulate competition among the SOCBs and also to introduce competition from other banks with different ownership structures. In 1986 and 1996, the first joint stock commercial bank (Bank of Communication) and the first private joint stock commercial bank (China Minsheng Banking Corp., LTD. (CMBC)) were created, respectively. Moreover, foreign financial institutions were allowed to setup representative offices in China in 1981. Foreign banks were allowed to setup branches in most important coastal cities in 1994 and were allowed to conduct RMB business in Shanghai and Shenzhen two years later…" See Cheng, X., & Degryse, H.

activity through SOEs and a state-controlled banking system.[366] For many years, bank loans have been largely allocated to SOEs.[367] To mitigate risks, banks impose burdensome transaction costs and collateral requirements on private enterprises, which deter all but the largest and most profitable firms from seeking loans.[368] In other words, China's banks favor SOEs not only because of their government affiliation but also because many POEs (especially small and medium-size) frequently suffer from the lack of financial sustainability and liquid collateral. As a result, Chinese bankers often do not consider private enterprises to be primary borrowers and prefer to offer state-guaranteed commercial financing to SOEs.[369] Despite

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(2010). The impact of bank and non-bank financial institutions on local economic growth in China. Journal of Financial Services Research, 37, 179–199.

366 "The system is overwhelmingly dominated by four major state- owned banks… By 1998 the state credit plan was formally abolished. At the same time measures were implemented to recentralize the branch systems of the four state banks to reduce local interference.

Previously, local governments, through their control over personnel appointments in bank branches, had often pushed bankers to lend to locally favored firms, often in direct violation of central credit quotas. Now, personnel issues would be controlled from the individual bank in with these the center headquarters Beijing. Coupled changes, adopted new, commercially oriented standards to measure bank performance and developed strict rules to hold individual bankers responsible for the issuance of bad loans…" See Steinfeld, E. S. (2002). Moving beyond transition in China: Financial reform and the political economy of declining growth. Comparative Politics, 34(4), 379-398.

367 "The private sector hardly remains immune from this prevailing credit culture. That Chinese banks still loan primarily to state-owned enterprises is often interpreted as evidence of direct government mandate or banker bias, the implication either way being that banks remain handmaidens of the state. The unfortunate reality, however, is that most Chinese private firms are not organized in such a way as to make them reasonable loan candidates. For a variety of reasons, most Chinese private firms keep their financial structure intentionally opaque and often do not have audited, reliable financial statements.39 While this lack of transparency allows the firms to accommodate market and regulatory uncertainties, it does not set them up to be prime borrowers. Thus, Chinese bankers are right to point out that the private sector as currently constituted offers relatively few opportunities for commercially sound debt financing…" See Steinfeld, E. S. (2002). Moving beyond transition in China: Financial reform and the political economy of declining growth. Comparative Politics, 34(4), 379-398. Also see Chow, C. K. W., Fung, M. K. Y., Lam K. C. K., & Sami, H. (2012). Investment opportunity set, political connection and business policies of private enterprises in China. Review of Quantitative Finance and Accounting, 38(3), 367-389. doi: 10.1007/s11156-011.

368 Gregory, N., & Tenev, S. (2001). The Financing of Private Enterprise in China, Financing and Development, 38(1).

369 Therefore, analytics expect that existing capital and regulatory constraints for POEs can exacerbate external financing problems, and thus impede further entrepreneurial development in China. See Steinfeld, E. S. (2002). Moving beyond transition in China: Financial reform and the political economy of declining growth. Comparative Politics, 34(4), 379-398; Zhou, W. (2008). Bank financing in China's private sector: The payoffs of political capital. World Development, 37, 787-799.

the legal recognition of POEs, they have to compete with SOEs for capital resources, and cannot expect much support from the state-owned banks.[370]

Today, the problem of raising capital continues to be an issue for many non-state companies in China.[371] Not surprisingly, some studies show that private entrepreneurs rely primarily on internal sources, namely retained earnings and principal owner financing.[372] Due to the lack of formal financing, the majority of capital for the private sector (especially for unlisted firms) has been obtained from informal financial sources built on a borrower's reputation and personal relationships.[373] Scholars usually name personal savings (74.0 percent) and contributions from friends and relatives (16.0 percent) as alternative financing channels for business in China where only 10.0 percent is obtained externally.[374] Along with borrowing from relatives and friends, China's rural informal financial market involves credit associations, micro-finance organizations and other informal financial institutions.[375]

However, the studies find that external financing remains the important source of capital for

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[370] "Until 1998 most private enterprises while legally allowed to export directly, for practical convenience, did it mostly via the help of SOEs. Bank loans were commonly available to SOEs but were virtually inaccessible to private enterprises. Although the economic output of private firms increased by 1600 percent during the six- year period that ended in 1997, the volume of the bank loans to these firms by the state- owned banks barely rose during the same period." See Chow, C. K. W., Fung, M. K. Y., Lam K. C. K., & Sami, H. (2012). Investment opportunity set, political connection and business policies of private enterprises in China. Review of Quantitative Finance and Accounting, 38(3), 367-389. doi: 10.1007/s11156-011. Also see Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147.

[371] Researchers argue that private entrepreneurs are often wealth constrained in China. To pursue their opportunities private actors have to obtain external financing, making financing central to the process of entrepreneurship. See Zhou, W. (2008). Bank financing in China's private sector: The payoffs of political capital. World Development, 37, 787-799.

[372] For instance, Zhou (2008) studies sources of finance (post-start-up investments) in Chinese private enterprises. Zhou, W. (2008). Bank financing in China's private sector: The payoffs of political capital. World Development, 37, 787-799.

[373] Allen, F., Qian, J., Qian, M., 2005. Law, finance, and economic growth in China. Journal of Financial Economics 77, 57–116.

[374] Chow, C. K. W., Fung, M. K. Y., Lam K. C. K., & Sami, H. (2012). Investment opportunity set, political connection and business policies of private enterprises in China. Review of Quantitative Finance and Accounting, 38(3), 367-389. doi: 10.1007/s11156-011.

[375] Cheng, E., & Xu, Z. (2004). Rates of interest, credit supply and China's rural development. Savings and Development, 28(2), 131-156.

POEs. In the absence of alternative capital markets for the private sector, bank lending still plays the leading role, while the role of the securities market remains insignificant.[376] Scholars explain this insignificance by the fact that until recently both markets in China have served primarily to finance the state sector.[377] Securities have been mainly issued by institutions and companies controlled by the central and local governments.[378]An important breakthrough for China's capital market was the establishment of the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange in 1991. The stock exchanges initially functioned in terms of partial privatization of SOEs.[379] Later, the government strongly encouraged IPOs in state and private sectors to expand capital and the industrial base.[380] As a result, the number of issuers and listed companies dramatically increased from ten in 1990 to 1,160 by year-end 2001.[381]

To obtain access to state banks' financing, POEs have to nurture political connections and participate in state activities.[382] Entrepreneurs build long-term relationships with bank officials, the central

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376 A market for private, non-bank debt has yet to be established. There is no active merger or takeover activity in stock markets to discipline management. See Su, D., & He, X. (2012). Ownership structure, corporate governance and productive efficiency in China. Journal of Productivity Analysis, 38, 303–318.

377 In 1997, for example, 32.6 percent of the private firms in a national survey reported that they relied primarily on bank financing for post-start-up investment compared to 2.45 percent that relied on public and private equity markets. See Zhou, W. (2008). Bank financing in China's private sector: The payoffs of political capital. World Development, 37, 787-799.

378 The issuance of such securities "is subject to administrative approval by the National Development and Reform Commission (NDRC). They are characterized by limited disclosure requirements and the lack of monitoring of the credit rating of the issuer after the issuance." Geretto, E., & Pauluzzo, R. (2012). Stock exchange markets in China: Structure and main problems. Transition Studies Review, 19, 89–106.

379 The presence of over 54 million shareholders in China by year-end 2000 may be the strongest evidence of the credibility of its privatization program. See Wei, Z., Varela, O., D'Souza, J., & Hassan, M. K. (2003). The financial and operating performance of China's newly privatized firms. Financial Management, 32(2), 107-126.

380 Gross, C. M. (2013). The growth of China's technology transfer industry over the next decade: Implications for global markets. The Journal of Technology Transfer, 38(5), 716-747.

381 Wei, Z., Varela, O., D'Souza, J., & Hassan, M. K. (2003). The financial and operating performance of China's newly privatized firms. Financial Management, 32(2), 107-126.

382 "Khwaja and Mian (2005) show that politically connected firms are able to borrow 45 percent more from government banks than non-con- nected firms. In like manner, almost all securities companies are controlled by the government (Firth et al., 2010), and politically connected issuing firms enjoy significant benefits of their preference

and local governments through various formal and informal channels merely to secure access to financing and to minimize the costs of capital. Often, such ties have a reciprocal personal character – a so-called "*guanxi*".[383] In this regard, scholars define China's institutional frameworks as "network capitalism."[384]

The emergence of "guanxi"-based networks has been catalyzed by the economic reforms since the late 1970s.[385] The opening-up to the world market has increased competition and tendency toward inter-firm networks and "guanxi" relationships. A key element of these relationships is better transparency in terms of information, knowledge and capital exchange between firms and other economic agents including universities, government agencies, research centers and foreign investors.[386] This means that by entering "guanxi"-based networks, firms are able to overcome informational asymmetries and signal their intention to collaborate and be transparent to other members of the network.

In this regard, "guanxi" is suggested to lessen transaction costs for member-firms through granting relational advantages and privileged access to information and capital and, as a result, to improve the competitive potential of the firm.[387] This mechanism is hardly new and has been widely analyzed in

(Francis et al., 2009). Given these institutional features, firms with state ownership in the Chinese stock market tend to be less affected by the damaged credibility and thus have less strong incentives to ensure that fraud does not occur." See Hou, W., & Moore, G. (2010). Player and referee roles held jointly: the effect of state ownership on China's regulatory enforcement against fraud. Journal of Business Ethics, 95, 317–335.

[383] "The first part of the word, guan, equate to "transferable"…The second part of the word, xi, translates as ties and connections… Thus, the literal explanation of guanxi suggests that it creates transferable ties and connections—useful in developing relationships between a network of individuals, firms, and government agencies…" From Huang, F., & Rice J. (2012). Firm networking and bribery in China: Assessing some potential negative consequences of firm openness. Journal of Business Ethics, 107, 533–545.

[384] Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147.

[385] Huang, F., & Rice J. (2012). Firm networking and bribery in China: Assessing some potential negative consequences of firm openness. Journal of Business Ethics, 107, 533–545.

[386] Huang, F., & Rice J. (2012). Firm networking and bribery in China: Assessing some potential negative consequences of firm openness. Journal of Business Ethics, 107, 533–545.

[387] In particular, in interviews with executives in Chinese state-owned, collective-hybrid, and private companies Xin and Pearce (1996) found, as expected, private-company executives relied significantly more on building connections with government officials to defend themselves against threats like appropriation or extortion. See Xin, K. R., & Pearce, J. L. (1996). Guanxi: Connections as substitutes for formal institutional support. The Academy of

the literature.[388] In terms of China, many scholars have concluded that "guanxi" has been nurtured by China's institutional context. This means that "guanxi"-based connections serve as a substitute for the kind of formal institutional protection taken for granted in developed countries.[389] Lee Kuan Yew once pointed out that the Chinese use "guanxi" "to make up for the lack of the rule of law and transparency in rules and regulations."[390]

Management Journal, 39(6), 1641-1658; Huang, F., & Rice J. (2012). Firm networking and bribery in China: Assessing some potential negative consequences of firm openness. Journal of Business Ethics, 107, 533–545.

[388] "[T]he concept is by no means culturally unique [to China]; the terms blat in Russia and pratik in Haiti refer to the same type of instrumental-personal tie. Guanxi is not a sociologically precise term: it refers to instrumental-personal ties that range from strong personal loyalties to ceremonial bribery (Walder, 1986)." Cited in Xin, K. R., & Pearce, J. L. (1996). Guanxi: Connections as substitutes for formal institutional support. The Academy of Management Journal, 39(6), 1641-1658.

[389] Nee (1992) noticed that "China's transitional economy is characterized by weak capital market structures, poorly specified property rights, and institutional instability, of which a lack of coherent business laws is an example. These characteristics make market exchanges uncertain and costly. Under these circumstances, private companies have difficulty getting capital, because the banks, which are state-owned, favor state-owned companies. Further, in a country with uncertain property rights, the potential for threatening interference and expropriation from party and governmental officials is great... Chinese private companies, which do not have the institutional protection of government ownership that state-owned and collective-hybrid companies do, are subject to arbitrary extortion by officials and others since the society lacks a reliable rule of law." For the reference see Xin, K. R., & Pearce, J. L. (1996). Guanxi: Connections as substitutes for formal institutional support. The Academy of Management Journal, 39(6), 1641-1658.

[390] Cited in Dunfee, T. W., & Warren, D. E. (2001). Is guanxi ethical? A normative analysis of doing business in China. Journal of Business Ethics, 32, 191–204.

The tradition of guanxi often involves the exchange of gifts, which are considered as equitable investments. However, this underlying idea of gift-giving and resource exchanges in order to cultivate the relationship has made it difficult to distinguish between mere cultural traditions and bribery. This misperception mostly lies in the different attitudes in the West and China toward the role of relationships in conducting business. Ambiguity in the interpretation of guanxi generates the ethical ambiguity in business dealings. Moreover, in case of weak legal environment this ambiguity becomes even worse taking the form of bribery. At the same time, guanxi networks help private entrepreneurs to avoid burdensome administrative barriers and bureaucratic delays. To bypass them, managers sometimes resort to bribing officials in order to ensure certain actions occur, and occur quickly. Furthermore, the absence of clear legal rules can bring about potential conflicts between the law and informal interpersonal relations. In this situation, firms can pursue their competitive advantage and defend their commercial interest by means of corruption. Consequently, some government officials may lack the interest in improving bureaucratic efficiency and implementing institutional reforms. In recent years, China has been commonly criticized for high levels of corruption and inappropriate business practices. Transparency International (TI) ranks China as 80 among 176 countries in its corruption perception index 2012 (See the country's profile on http://transparency.org/country#CHN Accessed on October 31st, 2013). In the last decade, more than 40 thousand public officials are registered and inspected by the national prosecutor office every year because of their corrupted behavior. According to the data of the Office of the Supreme People Prosecutor of China, from 2003 to 2007 the

Along with state funds, FDI have been another large source of capital, stimulating the development of China's markets since 1978. Foreign entities contributed more than one fifth of total tax revenues in China. They have also been responsible for rapid growth in foreign trade, totaling about 55.0 percent of total exports in 2003.[391] FDI have also been the main source of technology transfer to China, with a share of 57.0 percent of total technology transfer. Consequently, the Chinese economy has become highly dependent on FDI inflow.[392] However, the 2007 financial recession demonstrated that this inflow is volatile. Furthermore, studies show that FDI have been concentrated in the manufacturing sector of particular regions, while other enterprises and sectors have been largely ignored. This pattern can be explained by foreign investors attempting to utilize China's market advantage, namely low-cost labor.[393]

Such allocation of FDI has the potential to create unequal regional development, especially

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system registered and inspected a total of 35,255 large corrupt cases. 13,929 officials of all levels were found to be involved in crime (See National Bureau of Statistics of China 2010).

In general, bribery is an inevitable evil for private business in many economies in transition. Entrepreneurs are rational and pragmatic in their decisions. Therefore, researchers conclude that a "firm will select to bribe government officials when it perceives the potential benefit of doing that exceeds the cost it incurred." This means that a firm's propensity to conduct bribery increases with the increase of its perceived benefit or the decrease of its transaction costs as oppose to the cost of bribery. In particular, Gao (2010) proves that a positive relationship exists between a firm's perceived benefit and its behavior of bribery.

See Tan, J. (2009). Institutional structure and firm social performance in transitional economies: Evidence of multinational corporations in China. Journal of Business Ethics, 86, 171–189; Huang, F., & Rice J. (2012). Firm networking and bribery in China: Assessing some potential negative consequences of firm openness. Journal of Business Ethics, 107, 533–545; Gao, Y. Q. (2011). Government intervention, perceived benefit, and bribery of firms in transitional China. Journal of Business Ethics, 104, 175–184.

391 Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333.

392 "Compared with a far smaller public sector in other Asian countries, the high FDI to capital formation ratio in China shows a substantial reliance of the Chinese economy on FDI. The FDI inflow to capital formation ratio in China has increased from 3.8 percent in 1981 to 11.8 percent in 1996. Between 1992 and 1998 the average FDI inflow to total capital formation (inclusive of investments by SOE) ratio of all firms accounted about 13 percent annually and ranked at the second highest ratio after Singapore in Asia." See Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333.

393 In 2003, about 74 percent of foreign investments in China was in manufacturing. See Lin, J. Y., & Wang Y. (2012). China's integration with the World: Development as a process of learning and industrial upgrading. China Economic Policy Review, 1(1).

between the rural and urban areas as well as between the eastern coast and the western provinces.[394] Thus, in the case of quite narrow interest by foreign investors, the government, not foreign actors, must deal with unemployment and allocate funding to undercapitalized industries and regions. The desire to sustain the country's long-run economic growth makes central and local governments more likely to solve agency conflicts rather than tunneling assets away from the firms they control.[395] As evidence, some findings indicate that minority shareholders in Chinese listed firms place a higher value on firms where the controlling shareholder is a local government.[396] In the absence of sufficient legal enforcement and strong rule of law, private companies cannot be monitored with the same level of scrutiny that the state controlling shareholder is able to deliver. China's legal system provides few options for minority

[394] In this regard, scholars mention the economic gap between inland and coastal regions, high structural unemployment or disguised unemployment in the inland rural areas and a much higher per capita income in the fast developing coastal regions in the south and east provinces than in the slowly developing regions in the central, northern, and western provinces. See Vijverberg, W. P. M., Fu, F-C., & Vijverberg, C-P. C. (2011). Public infrastructure as a determinant of productive performance in China. Journal of Productivity Analysis, 36(1), 91-111. doi: 10.1007/s11123-011-0211-9; Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333; Taylor, R. (2010). China's developing infrastructure: The impact of globalization. Transition Studies Review, 17, 668–685.

[395] "During the economic reform process, all levels of local government have had very strong incentives to improve corporate performance as controlling shareholders because they take a large share of the tax revenue that is collected from companies operating in their jurisdiction since the new fiscal reform which was launched in 1994 (Walder 1995; Cao et al. 1999; Green 2004, pp. 26–48; Jin et al. 2005 and Cheung 2008). The large share of local tax revenue also provides a commitment that local governments will not engage in rent-seeking activities (Che 2002). In addition, the resultant intensified regional competition serves as a "disciplinary device" to punish inappropriate market intervention by local governments, and there- fore provides another important incentive device for local governments to enhance corporate performance (Qian and Weingast 1997; Cheung 2008). This vigorous horizontal regional competition provides an incentive to local governments to ensure that the corporations they control operate efficiently so as to maximize the funds available for the expansion of the local economy." See Zhan, W., & Turner, J. D. (2012). Crossing the river by touching stones? The reform of corporate ownership in China. Asia-Pacific Financial Markets, 19, 233–258.

[396] "This study contributes to the literature on Chinese ownership structure and partial privatization by investigating the different types of controlling shareholders in Chinese listed firms… Concomitantly, firms controlled by individuals are less valuable to minority shareholders. However, individual-controlled firms where the local government is the second largest shareholder have a higher value than other individual controlled firms." See Zhan, W., & Turner, J. D. (2012). Crossing the river by touching stones? The reform of corporate ownership in China. Asia-Pacific Financial Markets, 19, 233–258.

shareholders to take private enforcement action against the misconduct of large shareholders.[397] Hence, privately-controlled listed firms may be subject to a greater risk of asset diversion by large shareholders.[398] This means that, while sufficient institutions have not been established yet to regulate private activities, state dominant shareholders can be an intermediate step to protect minority shareholders.[399]

At the same time, SOEs have been going through substantial modernization of corporate governance. In 1993, the 3rd Plenary of the 14th Central Committee of the Communist Party of China approved the program of SOEs' corporatization.[400] That policy decision intended to convert SOEs into Western-style profit-oriented shareholding companies with the majority of shares controlled by the state.[401] The reorganization of the SOEs was carried out in the following ways: (1) the merger of several SOEs to found a new, bigger one, (2) the sale of some of the SOEs to private entrepreneurs, and (3) joint ownership of state and private stakeholders. With the establishment of the Shanghai and Shenzhen Stock

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397 Hou, W., & Moore, G. (2010). Player and referee roles held jointly: the effect of state ownership on China's regulatory enforcement against fraud. Journal of Business Ethics, 95, 317–335.

398 Chen, G., Firth, M., & Xu, L. (2009). Does the type of ownership control matter? Evidence from China's listed companies. Journal of Banking & Finance, 33, 171–181.

399 The presence of a controlling shareholder can potentially limit de facto power enjoyed by a CEO even when he/she also occupies the position of chairman. When compared to private firms with a controlling shareholder, state shareholders are very likely to enjoy greater control over their CEOs because the CEOs are in fact government officials who are subject to administrative controls from governments (Chang and Wong 2009). The potential greater control of state shareholders over their CEOs suggests that CEO duality may not be able to provide a CEO with de facto greater power, particularly when state shareholders have a strong incentive to exercise control over their firms and CEOs. See Zhan, W., & Turner, J. D. (2012). Crossing the river by touching stones? The reform of corporate ownership in China. Asia-Pacific Financial Markets, 19, 233–258.

400 The program involved 100 large and medium SOEs at the central level and 2,500 at the local level.

"By 1997, 4,14,400 companies had been formed… Of the 2,500 local SOEs, 1,080 had been transformed by the end of 1997 into either limited liability or shareholding companies with diversified equity ownership." See Ram Mohan, T. T. (2004). Privatization in China: Softly, softly does it. Economic and Political Weekly, 39(45), 4904-4909.

401 The combination of greater autonomy and better incentives along with the new contract responsibility system is generally perceived to have resulted in improved enterprise performance. Hay et al (1994) note that China's GDP grew at an impressive annual rate of 10.6 percent during the 1980s, with the state-owned industrial sector growing at over 8 per cent per annum in the period and at nearly 12 percent per annum in the main reform years (1983-88).

Exchanges in 1990 and 1991, respectively, those corporatized SOEs began to issue shares to the public.[402] A defined portion of shares was offered to non-state enterprises and individuals. The adoption of Western financial reporting requirements brought about greater transparency and higher accounting standards. In particular, in 1993 China's Ministry of Finance issued Accounting Standards for Business Enterprises grounded in generally accepted accounting principles. In 2001, the government issued Accounting Regulations for Business Enterprises.[403] Consequently, analysts claim that the state officially diminished its interference in SOEs' operations, giving them more operational freedom.[404] State ownership reform established a new corporate governance system with a two-tier board structure, where a corporate board supervises management and evaluates its performance.[405]

Therefore, on the surface, the transformation of many SOEs into shareholding companies has formally made their executives responsible for the SOEs' performance.[406] Corporatization together with gradual privatization, the emergence of the securities markets, and the introduction of reporting and accounting standards have yielded greater independence and accountability in terms of business judgment and corporate governance of SOEs. That, in turn, has changed the allocation of incentives.[407] Many listed

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[402] Wong, S. (2006). China's stock market: A marriage of capitalism and socialism. Cato Journal, 26, 389–424.

[403] Wong, S. (2006). China's stock market: A marriage of capitalism and socialism. Cato Journal, 26, 389–424.

[404] Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[405] The Company Law of 1993 specified the following goals: to meet the needs of establishing a modern enterprise system; to standardize the organization and activities of domestic companies; to protect the legitimate rights and interests of shareholders and creditors; and to promote the development of the socialist market economy. See Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[406] Li (1997) provides evidence that improved incentives during the early stage of enterprise reform increase the productivity of SOEs. See Li, W. (1997). The impact of economic reform on the performance of Chinese state enterprises, 1980–1989. Journal of Political Economy, 105, 1080–1106. In addition, Lin and Su (2009) demonstrate that management pay and turnover are tightly linked to firm performance for publicly listed firms, suggesting that enterprise restructuring has improved corporate governance in China. See Lin C, Su D. W. (2009). Does state control affect managerial incentives? Evidence from China's publicly listed firms. Journal of Business Economics and Management, 10, 291–311.

[407] For example, Aivazian, Ge, and Qiu (2005) attribute this improvement to setting up the board of directors and its committees resulted in better monitoring and greater independence in terms of the appointment of managers.

See Aivazian, V. A., Ge, Y., & Qiu, J. (2005). Can corporatization improve the performance of state-owned

SOEs have adopted Corporate Governance Codes based on guidelines issued by the Shanghai Stock Exchange at the 2000 International Conference on Corporate Governance.[408] Furthermore, the government has established a new evaluation method for SOE performance based on financial indicators that directly correlate with a management reward system. The application of well-established principles of corporate governance to the state sector in order to formally separate the government from SOEs tends to achieve better SOE performance.[409] Better performance of SOEs positively affects the progress of state development programs since SOEs, as government agents, manage and finance the implementation of these programs. Thus, any losses of SOEs will inevitably undermine state planning and spending.

"Helping Hand" of the Government in China

Along with state development programs, SOEs provide employment, social services and social security to the population.[410] The government employs SOEs to implement further development of prospective domestic industries and infrastructural projects bypassed by private investors.[411] For instance,

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enterprises even without privatization? Journal of Corporate Finance, 11, 791-808.

[408] Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[409] Ralston, D. A., Terpstra-Tong, J., Terpstra, R. H., Wang, X., & Egr, C. (2006). Today's state-owned enterprises of China: Are they dying dinosaurs or dynamic dynamos? Strategic Management Journal, 27, 825-843.

[410] In this context, many economists and policymakers believe that privatization may cause mass layoffs and thus have an adverse social impact. "Privatization can cause job losses in two ways. One is direct and takes place at the firms being privatized. As state-owned enterprises are privatized, the newly- privatized enterprises often eliminate redundant workers in order to cut costs and improve efficiency and profits. The other source of job loss is due to the secondary effects of the increased efficiency that privatization brings about (Kikeri 1998). The remaining SOEs in an industry will face increased competition from the growing and increasingly more efficient private sector, and they, too, may thus be forced to lay off workers and cut wage costs in order to survive…" From Chang, G. H., & Brada J. C. (2011). A model of the macroeconomic effects of privatization on employment in transition and developing countries with an application to China. Transition Studied Review, 18, 310–327. doi 10.1007/s11300-011-0206-2.

[411] "[I]n 2000 the Chinese government launched the Great Western Development Strategy, promoting growth in Central China, in order to reduce coastal-inland regional disparities by massive spending on infrastructure… It is on

during the past twenty years, investments in transportation increased from 33.37 billion *yuan* in 1990 to 1122.45 billion *yuan* in 2006. Since 1998, total expenditures on transport infrastructure have exceeded 5.0 percent of GDP annually.[412] As the consequence of state investment policies and state-driven capital inflows, China now has the second longest expressways in the world, and six out of ten of the world's largest ports.[413] Both central and provincial governments have launched road-building programs.[414] The estimated cost is US$150 billion, and the program is designed to connect all provincial capitals and cities with populations of over a half-million people.

SOEs are heavily engaged in such industries as construction and telecommunication.[415] The government greatly invests in prospective domestic industries overlooked by foreign investors.[416] In particular, total capital investment in China's communication and transportation sectors exceeded 4.0 billion *yuan* during the years 1949 to 2007, of which 2.2 billion *yuan* was invested during the Tenth Five-Year Plan period (2001-2005), when the government emphasized regional and countryside development.

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such terms that the plans for the years up to 2050 have been projected." For a detailed description of China's policy measures to build an efficient transportation infrastructure see Taylor, R. (2010). China's developing infrastructure: The impact of globalization. Transition Studies Review, 17, 668–685.

412 Lin, J. Y., & Wang Y. (2012). China's integration with the World: Development as a process of learning and industrial upgrading. China Economic Policy Review, 1(1).

413 Lin, J. Y., & Wang Y. (2012). China's integration with the World: Development as a process of learning and industrial upgrading. China Economic Policy Review, 1(1).

414 At the national level the intention is to create the National Trunk Highway System, a 35,000-km network including 12 major highways, with 5 North–South and 7 East–West corridors, examples being those linking Beijing to Fuzhou and Shanghai to Chengdu. See Taylor, R. (2010). China's developing infrastructure: The impact of globalization. Transition Studies Review, 17, 668–685.

415 "In its Tenth Five-Year Plan (2001-2005) for Information Industry, the government committed unambiguously to a universal services obligation (uso), with the goals of providing all citizens and regions equal access to telephony and of safeguarding state in formation security. Similarly, since the late 1990s, it has increased efforts to provide lower electricity prices to rural areas (which, in 2000, were 45 percent higher than in urban areas) as well as to develop and expand power transmission capacity in Western China (part of the Tenth Five-Year Plan). The insurance industry is seen as crucial to offloading from the state budget the previous burden of providing certain forms of social security." See Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

416 Lin and Wang (2012) notice that "foreign direct investment has been concentrated in the area of manufacturing, while the primary and tertiary sectors have been largely ignored. This pattern of FDI inflow is consistent with China's comparative advantage, since foreign investment attempts to utilize China's low- cost labor in order to compete in the international market."

To create a nationwide market, China's government defined a comprehensive transportation system as a crucial priority in the Ninth, Tenth and Eleventh Five-Year Plans. Those policy documents contributed to the expansion of railways based on passenger and freight demands. In particular, 5,600 km of new railways were constructed during the Ninth Five-Year Plan (1996–2000), with US$29.0 billion being invested in railway infrastructure construction. The Tenth Five-Year Plan (2001–2005) further increased the size of the railway network.[417] Recently, the Chinese government has introduced public-private partnership (hereinafter "the PPP") mechanisms such as concession agreements, issuance of shares and bonds, and joint ventures to attract private investors to its infrastructure projects and to create a mixed system of state and private railways.[418] However, as a consequence of the inadequacy of funding sources, the achievement of these projects is largely the government' responsibility.[419]

Apart from the state's economic agenda, the government also relies upon SOEs to accomplish certain social programs and maintain social stability.[420] In fact, many large SOEs are important sources of employment. Being large employers, they invest in the private sector in order to create additional work

[417] Taylor, R. (2010). China's developing infrastructure: The impact of globalization. Transition Studies Review, 17, 668–685.

[418] The world practice shows that in case of a limited market for capital, PPPs are one of the alternative tools for the creation, modernization and maintenance of an effective infrastructure. The PPP allows uncovering the potential of private institutional investors and raising additional funds together with maintaining the role of the state in socially important sectors of the economy. The focus on the engagement of private counterparts into activities traditionally considered as the state sphere of interests may provide certain benefits, among which is a lower burden on the state budget. Moreover, the PPP can grant some advantages distinctive for private management such as increased transparency, rapid introduction of new technologies, new sources of investments, risk sharing and a clear focus on the needs of consumers and the quality of services. At the same time, the PPP eliminates the direct hierarchy and supervision typical for the state governance. It involves much more participants with contradicting goals and, therefore, may magnify possible conflicts of interests and make decision-making more complex in case of the PPP projects.

Meanwhile, Kazakhstan has also employed PPP arrangements to implement its concession projects. The total amount of investments in those projects was about 74 billion tenge. Another 15 projects amounted to more than 800 billion tenge were on the stage of planning in 2011. See The Program on the development of the PPP in the Republic of Kazakhstan 2011-2015 approved by the government regulation No. 731 from June 29, 2011.

[419] Taylor, R. (2010). China's developing infrastructure: The impact of globalization. Transition Studies Review, 17, 668–685.

[420] Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

places. Since there is no well-established independent social security system in China, the government keeps SOEs as a second-best way to maintain social guarantees. SOEs must maintain the employment of, or provide welfare to, their surplus workers.[421] Recent studies have revealed that there is as much as 30.0 percent surplus labor in China's SOEs.[422] This, in turn, affects the performance of SOEs, making SOEs' financial performance inevitably poorer than their private counterparts.[423]

Nonetheless, the government has incentives to keep its SOEs afloat since otherwise these losses would place a burden on the state budget.[424] Policymakers are particularly interested in the performance of SOEs. In this regard, to successfully monitor SOE operations, large SOEs have been structured in groups with a state controlling shareholder that closely oversees the groups' activities.[425] The relationships within these groups are usually managed through "*guanxi*" networks, particularly in terms of the appointment and promotion of the SOE managers.[426] In other words, similar to SOEs in other countries, one of the characteristics of SOEs in China is a vertical group structure with a dominant state

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421 "When China opened its ''bamboo curtain'' to the West in 1978, SOEs provided about three-fourths of total industrial output; by 2003, their share had fallen to about one-quarter even while employing nearly two-thirds of urban workers." From Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

422 Bai, C-E., Lu, J., & Tao, Z. (2006). The multitask theory of state enterprise reform. Empirical Evidence from China. The American Economic Review, 96(2), 353-357.

423 Bai, C-E., Lu, J., & Tao, Z. (2006). The multitask theory of state enterprise reform. Empirical Evidence from China. The American Economic Review, 96(2), 353-357.

424 Qian and Roland (1998) argue that loss-making SOEs in China create an enormous drain on government budgets and state-owned banks, and this eventually forced the government to adopt the privatization program. Moreover, subsidizing loss making companies will likely lead to anti-competition claims by foreign governments and firms. Qian, Y., & Roland, G. (1998). Federalism and the soft budget constraint. American Economic Review, 88(5), 1143–1162.

425 79 percent of the publicly listed firms in China had a parent company. From Bai, C-E., Liu, Q., Lu, J., Song, F. M., & Zhang, J. (2004). Corporate governance and market valuation in China. In Beyond transition: The newsletter about reforming economies. World Bank's Europe and Central Asia Department.

426 The selection of managers and their income are usually is subject to the government discretion. This process is concealed from the public. That creates "a basis for the conspiracy between enterprise managers and government officials." However, experts admit that gianxi may also have a positive effect on SOEs' performance. In terms of the underdeveloped manager market, political and social capital of the managers may benefit SOEs. Guanxi networks with the government officials or inside the enterprises may increase the managers' bargaining power and autonomy in business judgment. See Lu, M., Chen, Z., & Zhang, S. (2008.) Paying for the dream of public ownership: Case studies on corruption and privatization in China. Transition Studies Review, 15, 355–373.

shareholder that enjoys significant control over various corporate decisions of the group.[427]

Another argument for state monitoring is the larger share of tax revenue that can be collected from SOEs and their employees as well as the state social programs that can be expanded in the case of higher SOE profitability.[428] Thus, despite the presence of non-profit objectives, state shareholders still have incentives for the SOE to perform and introduce effective corporate governance.

Membership in the WTO has also created competitive pressure on the Chinese government to develop better corporate governance and investment strategies for SOEs, with a focus on innovation projects. International integration listing on international stock exchanges have pursued Chinese SOEs to commit themselves to higher international listing and accounting standards in order to get access to international capital resources and new technologies. During last three decades, Asian economies have

[427] Brødsgaard (2012) observes 121 business groups managed by SASAC on behalf of the State Council. The study is focused "on the 53 largest companies that in reality come under the central nomenklatura as their leaders are appointed and managed by the Organizational Department of the Central Committee of the Chinese Communist Party (CCP). The CEOs of these companies have ministerial or vice- ministerial status and equal government ministers and vice-ministers in rank. The nomenklatura companies operate on their own and have direct contact with government ministries."

Several hundred business groups were formed in the early 1990s. Initially, the Chinese authorities designated 100 of these to receive government support. They were intended and expected to operate with considerable autonomy and were encouraged to be active internationally. In 1997–98, another initiative was taken in an effort to create a "national team" of large internationally competitive Chinese enterprises.

They were selected within sectors considered to be of strategic importance, including power generation, coal mining, automobiles, electronics, iron and steel, machinery, chemicals, constructions material, aerospace and pharmaceuticals. A number of policies were put in place to support the "national team." These included the use of tariffs, as well as non-tariff barriers such as the imposition of technology transfer and local sourcing requirements for foreign firms. National team members also enjoyed enhanced management rights in running their businesses, including in areas such as profit retention, investment and inter- national trade. They were allowed to establish their own financial companies, which operated in a manner similar to that of to the banks in the Japanese Keiretsu system. National team enterprises were also at the forefront of the move to list Chinese enterprises on stock markets in China and abroad. By the end of the 1990s almost all of them were listed on one of the two domestic stock markets, and about half of them had listed companies abroad.

The overarching goal behind the policy of selecting and nurturing a national team of large enterprises was to create truly global Chinese companies that could compete with the large multinational companies that dominated global production chains. China was no longer content to be the workshop of the world. Its leadership also aspired to create global brands which could enter the more profitable segments of global production chains (design, branding, marketing) as lead companies or systems integrators.

[428] Zhan, W., & Turner, J. D. (2012). Crossing the river by touching stones? The reform of corporate ownership in China. Asia-Pacific Financial Markets, 19, 233–258.

emerged as the new centers of world-class innovation. Specifically, the share of Asian developing countries in global high-tech exports grew from 7.0 percent in 1980 to 25.0 percent in 2001. The Asian share of all published scientific papers expanded from 16.0 percent in 1990 to 25.0 percent in 2004.[429]

With respect to China, a move from a centrally-planned economy to a socialist market economy has involved reform of the research sector. Between 1995 and 2005, the central government heavily invested in domestic multinational R&D centers spending from 0.6 percent to 1.3 percent of GDP, respectively.[430] By 2012, China established 105 state-level high-tech parks and eighty-six state-level university science parks nationwide, among which is Zhongguancun Science Park, the so-called "Chinese Silicon Valley."[431] China's scientific progress was so substantial that the U.S. National Science Foundation set up a branch in Beijing to monitor Chinese innovations.[432] Foreign multinational corporations have also set up R&D branches in China. Such corporate giants as IBM, SUN, Ericsson, DuPont, Unilever, and Bayer brought their research facilities to China.[433] A newly-emerging class of entrepreneurs, who aim to boost their innovative capacity, welcomed those institutional reforms. As a result, by 2010 state-level university science parks hosted more than 100 enterprises or start-ups,

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[429] Beech, H. (2006). Asia's great science experiment. Time Magazine, 23 October.

[430] "Much of the funding is flowing into fields where China believes it can make a long-term impact, either because the disciplines are relatively new (genomics and nanotech) or because progress in the West has been impeded by ethical concerns (stem-cell research and genetically modified crops). After years of political mistrust of science—Mao Zedong even denounced Einstein—China awarded more than 30,000 doctorates in 2004, up from 12,000 in 2001. The nation also graduated 200,000 engineers in 2004. Government incentives like hefty tax breaks and prized spots at the nation's 100-plus new science parks, have attracted an army of returnees..." From Beech, H. (2006). Asia's great science experiment. Time Magazine, 23 October.

[431] "China's first university science park—Northeastern University Science Park—was established in 1989, even before the government launched the university science park program nationwide. Since the 1990s, university science parks mushroomed. Currently, 86 state-level university science parks are distributed in 24 provinces or municipalities across the nation." From Zou, Y., & Zhao, W. (2014). Anatomy of Tsinghua University science park in China: Institutional evolution and assessment. The Journal of Technology Transfer, 39(5), 663-674.

[432] Beech, H. (2006). Asia's great science experiment. Time Magazine, 23 October.

[433] Ramesh, S. (2013). China's transition to a knowledge economy, Journal of the Knowledge Economy, 4, 473–491. doi 10.1007/s13132-012-0092-9.

generated 658 million *yuan* as revenue, and provided 3,800 jobs.[434] University-affiliated companies were among the first high-tech suppliers.[435]

Despite the inflow of private capital, state financing continues to play a big role in facilitating the transfer of technological innovation into the real economy.[436] The majority of universities and university-affiliated science parks in China are publicly-owned. This means that they likely share the challenges inherent in state entities.[437] At the same time, they provide capital for R&D activities. Pursuing the goal to increase the international competitiveness of domestic industries, Chinese policymakers have undertaken efforts to create a domestic institutional infrastructure bringing together state agencies, universities, science and technology research parks, technology development zones, regional authorities, and private investors. The new system aims to accomplish the shift from a manufacturing to an "innovation economy."[438] Although state funds continue to persist as the main capital source, the government seeks to increase research institutions' responsibility for their profits and losses and to diversify capital sources for universities and research centers in order to commercialize academic research.[439]

However, notwithstanding state support, even the best universities in China have often been

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[434] Zou, Y., & Zhao, W. (2014). Anatomy of Tsinghua University science park in China: Institutional evolution and assessment. The Journal of Technology Transfer, 39(5), 663-674.

[435] Wu, W., & Zhou, Y. (2012). The third mission stalled? Universities in China's technological progress. The Journal of Technology Transfer, 37, 812–827.

[436] "The government allocates more than 60 percent of the R&D funding to universities and research institutions, and tightly controls the intellectual property rights of the R&D results (Caixin 2012). The commercialization of the R&D results needs to be approved by the authorities. The approval process, however, takes approximately one year or more (Caixin 2012). Due to the delay of approval authorities, many R&D results cannot be commercialized in time." From Zou, Y., & Zhao, W. (2014). Anatomy of Tsinghua University science park in China: Institutional evolution and assessment. The Journal of Technology Transfer, 39(5), 663-674.

[437] Some researchers argue that great financial dependence leads to the high level of bureaucracy at universities and university-linked science parks. See Zou, Y., & Zhao, W. (2014). Anatomy of Tsinghua University science park in China: Institutional evolution and assessment. The Journal of Technology Transfer, 39(5), 663-674.

[438] The science and technology plan of China articulated the goal of becoming an "innovation-oriented" society by the year 2020. See Thompson Reuters. (2011) Chinese patenting: Report on the current state of innovation in China. http://blog.thomsonreuters.com/index.php/category/events/knowledgeexchange/. Accessed on November 5th, 2013.

[439] Ramesh, S. (2013). China's transition to a knowledge economy, Journal of the Knowledge Economy, 4, 473–491. doi 10.1007/s13132-012-0092-9.

behind the curve with respect to commercialized technologies in the global market. Competitive local enterprises still tend to rely on imported technologies.[440] To address these challenges, China's policymakers have implemented a series of national programs, including two key national documents, "Project 211" and "985 Program," which pursue the benefits of the R&D sector.[441] The approved state Twelfth Five-Year Plan, released in 2011, lays out the strategic concept for the development of China up to 2016. In particular, the government plans to heavily invest in effective protection of intellectual property rights and the development of science and technology education in order to change the trend of mere imitation to indigenous innovation.[442] Increased domestic consumption has produced greater demand for competitive local products. In this regard, for the last two decades China's economic policy has endeavored to break through the image of China as the world's cheap workshop.[443]

Summing up, notwithstanding a falling share of output,[444] SOEs retain the central position in China's economy. While China has achieved certain progress in developing its private sector,[445] a

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[440] Wu, W., & Zhou, Y. (2012). The third mission stalled? Universities in China's technological progress. The Journal of Technology Transfer, 37, 812–827.

[441] "Jointly sponsored by the State Planning Commission, Ministry of Finance, Ministry of Education (MOE) and provincial governments, the ''211 Project'' targeted a group of 211 institutions during the 9th Five-Year Plan period (1996–2000). On the heel of the ''Project 211'', MOE launched the ''985 Program'' aimed to turn top universities into world-class research universities." From Wu, W., & Zhou, Y. (2012). The third mission stalled? Universities in China's technological progress. The Journal of Technology Transfer, 37, 812–827.

[442] The government names several emerging industries that are strategic for the development of China as a "technologically advanced nation," for instance, new sources of clean energy, biotechnology, and new-generation IT. The government expects to increase the share of these industries in GDP from 5 percent today to 8 percent by 2015. State spending on R&D will climb as a proportion of GDP from 1.75 percent in 2010 to 2.2 percent in 2015. See Thompson Reuters. (2011) Chinese patenting: Report on the current state of innovation in China. http://blog.thomsonreuters.com/index.php/category/events/knowledgeexchange/. Accessed on November 5th, 2013.

[443] Taylor, R. (2010). China's developing infrastructure: The impact of globalization. Transition Studies Review, 17, 668–685.

[444] In recent years, the share of SOEs in the economy has continued to decline by over 10 percent annually; whereas, the share of POEs has expanded at an annual rate of 20 percent. Private enterprises have generated 95 percent of the new employment opportunities and 80 percent of the Chinese recent economic growth. Also, they have demonstrated higher productivity growth. The rapid expansion of POEs has led to decreasing share of the SOE at the gross industrial output in China from 93.4 percent in 1991 to about 81.6 percent recently. See Zhu, X. (2012). Understanding China's growth: Past, present, and future. The Journal of Economic Perspectives, 26(4), 103-124.

[445] According to the National Bureau of Statistics, the state/collective sector share in industrial output value fell from

substantial part of its economy still depends on SOEs.[446] SOEs are important players in many strategic industries including banking, telecommunications, and construction.[447] Nearly 80.0 percent of listed firms are SOEs with a state agent as the largest shareholder.[448] SOEs provide private entrepreneurs with essential financial and information resources. SOEs are a big source of fiscal revenues.[449] Furthermore, SOEs serve as an instrument of social insurance against risks and uncertainty that likely arise during the process of transition. While the government attempts to create a comprehensive system of health, employment and pension guarantees, SOEs to a certain extent fill institutional gaps and back up social stability and economic development. In this situation, China's policymakers have likely agreed to maintain a trade-off: bear the costs of state ownership in order to maintain jobs and a solid social security system and, as a result, to mitigate its social expenses and guarantee social stability.[450] This means that the government seeks to offset decreased SOE performance with a reduction in social costs and the risk of social distress.[451]

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over 90 percent in 1990 to 70 percent by 1997 and to 30 percent in 2008.

[446] 64 percent of Chinese companies are SOEs who are pressured by SASAC. Zhao, M. (2012). CSR-based political legitimacy strategy: Managing the state by doing good in China and Russia. Journal of Business Ethics, 111, 439–460.

[447] Krueger, D. A. (2009). Ethical reflections on the opportunities and challenges for international business in China. Journal of Business Ethics, 89, 145–156.

[448] Chen, G., Firth, M., & Xu, L. (2009). Does the type of ownership control matter? Evidence from China's listed companies. Journal of Banking & Finance, 33, 171–181.

[449] For instance, 65 percent of industrial taxes were paid by the state sector in 1994. Those taxes represented about 30 percent of total government revenues. Enterprise reform in China: ownership, transition, and performance. (1999). Edited by Gary H. Jefferson, Inderjit Singh. Oxford University Press.

[450] "There is … no well-functioning inde- pendent social security system in China. Firms have to maintain the employment of, or provide welfare to, their surplus workers, which contributes to social stability. Therefore, firms in China face the multiple challenges of production and maintaining social stability, the latter of which has an effect on the performance of all other firms in the economy." From Bai, C-E., Lu, J., & Tao, Z. (2006). The multitask theory of state enterprise reform. Empirical Evidence from China. The American Economic Review, 96(2), 353-357.

[451] In terms of the banking system, "[i]f SOEs are allowed to go bankrupt, the costs will be borne by depositors. If the government decides to recapitalize the banks, the burden will fall on taxpayers. If there is a financial crisis, the entire population will be the losers." However, that is mentioned in the context of privatization in China. The author notices that critics of China's gradualism argue for complete privatization and the transfer of control to private owners. See Ram Mohan, T. T. (2004). Privatization in China: Softly, softly does it. Economic and Political Weekly, 39(45), 4904-4909.

Today, the state still controls virtually all of the strategic enterprises in China including banks,[452] and political connections continue to play an important role in gaining access to finance.[453] China's sovereign wealth funds are among the largest investors in the country. Today, China has four SWFs that account for one-fifth of global SWF assets: China Investment Corporation, SAFE Investment Company, National Social Security Fund, and China-Africa Development Fund.[454] The next part offers a closer look at the largest SWF in China – China Investment Corporation (hereinafter "CIC"), which is in charge of the state investment policy and risk diversification. CIC is a primary instrument of the Chinese

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[452] Four state-owned banks cover around 78 percent of total assets. At the end of 2002 their market share was amounted to 68 percent. In contrast, the market share of the foreign financial institutions reached only 1 percent at the end of the same year.

[453] Firth et al. (2009) claim that the state shareholder, no matter whether it is in a dominant position or not, is able to help either state-owned or private firm to obtain bank loans. Khwaja and Mian (2005) show that politically connected firms are able to borrow 45 percent more from government banks than non-connected firms. Likewise, the government controls largest listed companies (Firth et al. 2010). Politically connected issuing firms enjoy significant state benefits. Also see Hou, W., & Moore, G. (2010). Player and referee roles held jointly: the effect of state ownership on China's regulatory enforcement against fraud. Journal of Business Ethics, 95, 317–335.

[454] "*SAFE Investment Company (SAFEIC)* (est. 1997). SAFEIC is a limited company registered in Hong Kong, prior to the handover of the island to Mainland China. It constitutes one of four overseas investment arms of the State Administration of Foreign Exchange (SAFE). SAFE is the branch of the People's Bank of China, China's central bank, which exclusively manages China's foreign exchange reserves. SAFEIC's primary objective is to retain the value of China's foreign exchange by making portfolio investments overseas.

National Social Security Fund (NSSF) (est. 2000). Established by the State Council, under the auspices of the Ministry of Social Security, NSSF is a public pension fund under China's Social Insurance Law. Its objective is to maintain the real value of public pension proceeds as a means to support future social security expenditures. NSSF can invest 20 percent of its funds outside China.

China Investment Corp. (CIC) (est. 2007). Like SAFEIC, CIC is a "company" but is registered as a state-owned enterprise under China's Company Law. Unlike SAFEIC and NSSF, it is not a legal subsidiary of any government agency and reports like a ministry directly to the State Council, the highest administrative body. Under CIC's Articles of Association, five government agencies – PBOC, SAFE, the Ministry of Finance, the Ministry of Commerce (MOFCOM), and the National Development and Reform Commission (NDRC) – are allowed to nominate one nonexecutive director to CIC's board. CIC has neither a direct funding mechanism nor any statutory limit on its outbound investments.

China-Africa Development Fund (CADF) (est. 2007). CADF is a small fund set up to foster economic ties between China and Africa. It functions as a branch of China Development Bank (CDB), China's largest policy bank, though various government ministries are represented on its board. It is worth noting that CDB is majority owned by Central Huijin, the domestic subsidiary of CIC…" From Koch-Weser, I. N. (2013). China Investment Corporation: Recent developments in performance, strategy, and governance. USCC Policy Analyst, Economics and Trade, U.S. - China Economic and Security Review Commission, June.

government to exercise close oversight over the companies it invests in.

China Investment Corporation: Running Foreign Exchange Reserves. CIC was established by the national government to invest the nation's foreign exchange reserves abroad. From the beginning, China has been different from many other countries with SWFs. Those countries are usually small and possess abundant natural resources. Unlike them, China is a large emerging economy with abundant internal financial reserves and a huge demand for energy resources.[455]

CIC's history can be traced back to 2001, when China joined the WTO. To be admitted, the Chinese government agreed to remove restrictions on the entry of foreign banks into China. At that time, China's commercial banks were undercapitalized and had serious problems with non-performing loans, which created a serious threat of insolvency.[456] Therefore, in order to somehow maintain the competitive position of China's domestic banks, the Central Leading Group on Reforming the Shareholding of State-Owned Commercial Banks was given the task of creating a plan for asset restructuring and bank recapitalization.[457] Simultaneously, China's policymakers looked for a more efficient approach to managing state foreign reserves. In that regard, a special group of state officials and foreign advisors managed by the State Council tried to find a way to utilize the massive foreign exchange reserves

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[455] Liew, L. H., & He, L. (2012). Operating in an inharmonious world: China Investment Corporation. Journal of the Asia Pacific Economy, 17(2), 253–267.

[456] SOEs with a little incentive to repay were responsible for a major part of NPLs. In order to improve the situation, in 1994 the government created three policy banks, which undertook policy lending previously assigned to the "Big Four." Furthermore, the Ministry of Finance issued 30-year government special bonds amounted to US$32.6 billion to recapitalize the "Big Four" in 1998. In 1999, the government created special asset management companies, which were entitled to buy out NPLs from SOCBs.[456] As a result, the NPL ratio declined between 2000 and 2003. High rates of private savings (the ratio of household saving at the GDP increased from 6 percent in 1978 to 70 percent in 1999) and trade surplus helped to avoid a systemic crisis of the sector caused by the high share of NPLs. See Chen, J-R. (2005). China's way of economic transition. Transition Studies Review, 12(2), 315-333; Cheng, X., & Degryse, H. (2010). The impact of bank and non-bank financial institutions on local economic growth in China. Journal of Financial Services Research, 37, 179–199; Berger, A. N., Hasan, I., & Zhou, M. (2009). Bank ownership and efficiency in China: What will happen in the world's largest nation? Journal of Banking and Finance, 33(1), 113-130.

[457] Liew, L. H., & He, L. (2012). Operating in an inharmonious world: China Investment Corporation. Journal of the Asia Pacific Economy, 17(2), 253–267.

accumulated within China.[458] As a result, in 2007 CIC was incorporated under the Company Law of the People's Republic of China as a wholly state-owned company engaging in the investment management of state reserves. For CIC's capitalization, the Ministry of Finance of China issued special bonds totaling RMB 1.55 trillion to provide CIC with initial capital of US$200 billion.[459] In 2012, CIC's total assets were equal to US$575,178 million.[460]

To secure the stability of financial inflows into the economy and to mitigate China's resource dependence, CIC heavily invests abroad and in Africa, in particular, in order to get access to local energy and mineral resources.[461] SOEs have completed deals in Gabon (iron ore), Guinea (bauxite, diamonds, iron ore, uranium), Zambia (copper), and Angola, Sudan and Nigeria (oil). In addition, Chinese companies invested US$4.5 billion and more than US$32.0 billion in Latin America in 2009 and 2010.[462]

Today, CIC carries out its investment policy through two subsidiaries: Central Huijin Investment Ltd. (hereinafter "Central Huijin") and China Investment Corporation International Co., Ltd. (hereinafter "CIC International"). These subsidiaries are distinct entities that fulfill different business functions: domestic versus foreign investment operations. In particular, CIC International was established in 2011 to

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[458] Wu, F., & Seah, A. (2008). The rise of China Investment Corporation. A new member of the sovereign wealth club. World Economics, 9(2).

[459] Wu, F., & Seah, A. (2008). The rise of China Investment Corporation. A new member of the sovereign wealth club. World Economics, 9(2).

[460] From CIC's annual report 2012.

[461] The primary goal of CIC as instrument of state policy is "to diversify China's foreign exchange holdings and achieve higher long-term returns within acceptable risk tolerance." CIC's investment portfolio is mainly composed of equity, fixed income and alternative assets, in both developed and emerging markets. Alternative investments include hedge funds, private equity, commodities and real estates. Recent strategic investments of CIC have been focused on commodities. Those investments seek to mitigate China's dependence on resource imports. As of December 31st, 2012, CIC's global investment portfolio consisted of public equities (32 percent), long-term investments (32.4 percent), fixed-income securities (19.1 percent), absolute return investments (12.7 percent), and cash and other instruments (3.8 percent). See Koch-Weser, I. N. (2013). China Investment Corporation: Recent developments in performance, strategy, and governance. USCC Policy Analyst, Economics and Trade, U.S. - China Economic and Security Review Commission, June, and CIC's annual report 2012.

[462] Liew, L. H., & He, L. (2012). Operating in an inharmonious world: China Investment Corporation. Journal of the Asia Pacific Economy, 17(2), 253–267.

invest and manage overseas assets.[463] It is intended to pursue independent investment decision-making grounded in market conditions.[464] This corporation is driven by the need to diversify China's foreign exchange holdings.[465] To expand its investment opportunities, CIC International opened representative offices in Toronto and Hong Kong.[466]

In contrast, Central Huijin is a primary device for equity investments in domestic financial institutions. In principle, Central Huijin cannot actively seek investment in domestic non-financial enterprises, with the exception of purchasing listed stocks overseas, passive shareholdings and other cases approved by government regulation. Central Huijin holds controlling stakes in key domestic banks (the Industrial and Commercial Bank of China, Bank of China and China Construction Bank), implements state policy in the financial sector, and enlarges state financial assets. From the beginning, this corporation has served as an instrument for providing China's banks with necessary capital.[467] Another role of Central Huijin has been the listing of the Chinese banks abroad by seeking reliable and well-known foreign partners. Following bank recapitalization, Central Huijin invested in China's biggest securities firms and insurance companies.[468] Thus, through capitalization of China's largest financial

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[463] "As of December 31st, 2012, the US equities represented slightly less than a half of CIC's equity portfolio. Another half was almost equally split between non-US advanced economies and emerging markets. In 2012, CIC's overseas portfolio posted a net return of 10.60 percent. Through year-end 2012, our [CIC] cumulative annualized return since inception was 5.02 percent." From CIC's Annual report 2012.

[464] From CIC's official website.

[465] Koch-Weser, I. N. (2013). China Investment Corporation: Recent developments in performance, strategy, and governance. USCC Policy Analyst, Economics and Trade, U.S. - China Economic and Security Review Commission, June.

[466] From CIC's official website.

[467] For that purpose, it received initial capitals of US$45 billion and subsequent US$15 billion from the national reserves.

[468] As of December 31, 2012, financial institutions amounted to 22.3 percent of CIC's equity portfolio, which is twice more than the following IT industry. From CIC's Annual report 2012.

By the end of 2008 CIC had made two major investments: US$3 billion in the Blackstone Group and US$5.6 billion in Morgan Stanley…In 2009, CIC began to invest in energy and natural resources. For example, "China has announced plans to reduce its reliance on the big three miners by 2015 through securing 40 percent of its iron ore imports from its own mines overseas. CIC will target emerging economies for investments in their energy and resource sectors…" From Liew, L. H., & He, L. (2012). Operating in an inharmonious world: China Investment institutions, Central Huijin has been able to provide China's companies with state financial support.[469]

Even though CIC and both of its subsidiaries position themselves as passive investors seeking maximum return rather than active control[470]—and their investments are evaluated in accordance with international accounting principles[471]—they are corporate giants with the shareholding power to elect board members, executive and non-executive directors, as well as the power to exercise close oversight over the companies they invests in.[472]

Despite formal autonomy, the Party continues to exercise close authority over CIC's investment policy and operations.[473] CIC has communist organizations in its corporate structure - Communist Party Committees.[474] On the other hand, CIC is under public pressure to generate high returns on an annual

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Corporation. Journal of the Asia Pacific Economy, 17(2), 253–267.

[469] For instance, CIC's "[s]hare purchases include US$100 million in China Railway Group (2007); US$400 million in Longyuan Power Group (2009); US$710 million in GCL Poly (Hong Kong) Energy Ltd. (2009); US$816 million in Changsha Heavy Industry (2010); and US$250 million in Semiconductor Manufacturing International Corporation (SMIC) (2011)." From Koch-Weser, I. N. (2013). China Investment Corporation: Recent developments in performance, strategy, and governance. USCC Policy Analyst, Economics and Trade, U.S. - China Economic and Security Review Commission, June.

[470] As a member of the International Forum of Sovereign Wealth Funds, CIC is bound to follow the Santiago Principles regarding management and investment disclosure. See http://www.ifswf.org/.

[471] CIC strictly abides "by applicable domestic and prevailing international accounting principles to accurately calculate and evaluate CIC's investments. For public market investments, we calculate our positions mark-to-market; for nonpublic market investments, we commission independent third-party entities to valuate our market positions. The valuation methods we adopt are transparent and acknowledged by external auditors…" From the message of the former CEO Lou Jiwei. See CIC's corporate website.

[472] Wu, F., & Seah, A. (2008). The rise of China Investment Corporation. A new member of the sovereign wealth club. World Economics, 9(2).

[473] Koch-Weser, I. N. (2013). China Investment Corporation: Recent developments in performance, strategy, and governance. USCC Policy Analyst, Economics and Trade, U.S. - China Economic and Security Review Commission, June.

[474] This requirement is established in the Company Law of the People's Republic of China as of January 1, 2006. According to the Company Law adopted on October 27th, 2005 and revised on January 1st, 2007, the merger, division, dissolution and application for bankruptcy of important wholly stated-owned companies shall, after examination and verification by the said institution, be submitted to the people's government at the corresponding level for approval (article 67). The members of the board of directors of a wholly stated-owned company shall be appointed by the State-owned assets regulatory institution; but the representatives of the staff and workers among such members shall be elected by the conference of the representatives of the staff and workers of the company. The Chairman and members of a board of supervisors shall be also appointed by the State-owned assets regulatory

basis in order to justify state funding and accomplish state programs of development. As a result, CIC has to bear significant transaction costs in terms of volatile returns on its international portfolio.[475]

Therefore, CIC is another example of the contradictory nature of SOEs. As in the case of many SOEs, CIC is quite a cost corporate arrangement. The question is whether its costs can be overweighed by its benefits.

Value of State Companies in China: Costs and Benefits

In many developed countries, government interference in the economy is relatively minimal and limited to the role of a regulator. The government mission in these countries is bounded by providing favorable conditions for private actors to compete with each other in a free market. From this perspective, government interference in China is usually at the cost of corporate profitability since government officials have incentives to use corporate wealth according to their political considerations. SOE performance is evaluated against the political leadership's agenda that often conflicts with the traditional understanding of corporate efficiency and brings about few profit incentives or incentives to innovate on behalf of SOE management.[476] Hence, state ownership in China is considered to produce two main

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institution (article 68). The source: China Securities Regulatory Commission website http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/statelaws/200904/t20090428_102712.htm.

[475] Koch-Weser, I. N. (2013). China Investment Corporation: Recent developments in performance, strategy, and governance. USCC Policy Analyst, Economics and Trade, U.S. - China Economic and Security Review Commission, June.

[476] In this context, "[m]any analysts of the monitoring problem in the state sector point to the absence of an ultimate principal as a key problem. According to this analysis, an agent of the state monitors the enterprise managers and another agent must monitor the monitor; however, no matter how far up the chain of monitors we go, we never run into an ultimate principal—or to be more accurate, the ultimate theoretical principal in the case of state ownership, the citizenry of China, is far too dispersed and powerless to play any real role. As a result, effective monitoring cannot take place because there is nobody in the chain of monitors with the appropriate incentives; nobody who is entitled to the increase in asset value that effective monitoring would bring about." From Clarke, D. C. (2003). Corporate governance in China: An overview. China Economic Review, 14, 494–507. Also see Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of

shortcomings in management: lack of autonomy and lack of incentives.[477]

These shortcomings are grounded in the presence of political considerations as the major sources of transaction costs for China's SOEs. The fact that corporate boards in China's SOEs are largely selected through political and administrative processes, rather than endogenously chosen in the competitive managerial market, is suggested as weakening the commitment of state officials to monitor SOE management, on the one hand, mitigating the incentive of managers to achieve better performance, on the other hand.[478] Despite administrative reforms, "the actual function of an independent regulatory structure is far from established."[479] Even though new regulation delegates much of the power to the corporate boards of SOEs,[480] state controlling shareholders have power to exert significant influence over the appointment and dismissal of CEOs as well as over the SOEs' operations. They accomplish this influence through several channels. First, state controlling shareholders typically have representatives in the boards. Second, even if the state controlling shareholder does not have formal representation in the board it can still exert indirect influence on the directors as the largest shareholder in the firm. Third, the government enjoys approval rights on top management appointments and dismissal. In other words, the government obtains an ultimate approval authority over executive appointments. Thus, the government has the capacity to exercise strong control over the CEO turnover decisions in China's SOEs, which could

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International Business Studies, 37(1), 127-147(3875219).

[477] This conclusion has been made after the investigation of 744 publicly listed manufacturing firms in China between 1999 and 2006. See Su, D., & He, X. (2012). Ownership structure, corporate governance and productive efficiency in China. Journal of Productivity Analysis, 38, 303–318, for a comprehensive literature review on the corporate governance of Chinese firms.

[478] See Su, D. (2005). Corporate finance and state enterprise reform in China. China Economic Review, 16, 118-148.

[479] "Regulatory independence is constrained by the broader political-institutional context … that possesses four salient features: continued state ownership of strategic [industries]; continued dominance of state and party "comprehensive" institutions with authority over economic development; the bureaucratic origins of regulators in the former line ministries; and the fragmented, ambiguous authority of the regulator." From Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

[480] According to China's Company Law of 1993, the board to draft plans and make strategic decisions (Art. 112). A board has one full-time executive chairperson and may have one or two vice-chairpersons, who are elected by the affirmative votes of more than half of all the board members (Art. 113). Board members are also responsible for the appointment and dismissal of the general manager (CEO).

potentially reduce the de facto powers of SOE top management.[481] This raises the question of political considerations in the corporate governance of SOEs in China.

Moreover, the fact that SOE managers own on average only 0.1 percent of the SOEs' shares mitigates their incentive to improve operational efficiency. Instead, SOE managers prefer to focus on expanding operations rather than improving efficiency, because their income and social status usually depend on the size of the SOEs they run.[482]

Another major channel of state influence on the SOEs' activities is "leading small groups" ("*lingdao xiaozu*"), which are joint groups of top officials of the CCP and the central government in a given sector.[483] Government officials, CCP leaders and SOE top managers are routinely reshuffled between ministries, state agencies, the CCP bodies and SOEs. Even though this migration of staff might provide succession and expert knowledge in SOE management, it often reinforces a cozy relationship between SOE management, the government and the CCP.[484]

Despite de jure operational independence from the State Council and the CCP, the presence of

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[481] Firth, M., Wong, S., & Yang, Y. (2014). The double-edged sword of CEO/chairperson duality in corporatized state-owned firms: evidence from top management turnover in China. Journal of Management and Governance, 18(1). doi: 10.1007/s10997-012-9225-6.

[482] Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147(3875219).

[483] "The Finance and Economics Leading Small Group, for example, is an extremely powerful oversight and coordination body for the securities regulator, CSRC. In 1996, the State Council formed the State Informatization Leading Group (SILSG), which is headed by senior officials in the sector and is responsible for national informatization strategy. Twenty-four commissions, ministries, and other interested offices participated in the SILSG at its height, although recently, its role has been pared back in favor of its former subordinate, the State Council Informatization Office (SCIO). There is also a leading small group for electric power reform." From Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

[484] Also analyzing firms' annual reports from 1999 to 2001, Bai et al. (2004) found that government ownership has negative effects on market valuation. The number of SOEs running at a loss has been increasing. The SOEs' contributions to the state budget have been declining as well. For example, "[i]n 1993 the total losses form SOEs was 45.3 billion yuan, about 14 times of that of 1985." See Yifu, J., Cai, F., & Li, Z. (1999). Fair competition and China's state-owned enterprises reform. MOCT-MOST: Economic Policy in Transitional Economies, 9(1), 61-74; Yifu, J., Cai, F., & Li, Z. (1999). Fair competition and China's state-owned enterprises reform. MOCT-MOST: Economic Policy in Transitional Economies, 9(1), 61-74; Fu, F. C., Vijverberg, C-P. C., & Chen, S. C. (2008). Productivity and efficiency of state-owned enterprises in China. Journal of Productivity Analysis, 29, 249–259.

CCP officials in SOE boards and government officials in SOE management makes it difficult to adequately determine the extent of the SOEs' independence from political influence when making important decisions.[485] For instance, out of the twenty-five individuals in the CIC board of supervisors, board of directors, and executive committee, only three individuals are not current or former government officials. Five government agencies are represented in the CIC corporate board. The latter also includes former heads of the Bank of Communications, China Construction Bank, and the Export Import Bank.[486] The appointment and removal of the CIC corporate director is subject to the approval of the State Council. Notwithstanding the presence of so-called "independent directors," the definition of who can be considered independent is vague and very narrow. For instance, although it includes direct non-affiliation of a director with CIC as an entity, it omits the possibility of conflict resulting from an independent director's affiliation with the shareholder (the State Council) or CIC's subsidiaries and their officials.[487]

Along with the incentive problem and the lack of managerial autonomy, shortcomings in corporate governance in China are often attributable to multiple tasks of SOEs and institutional deficiencies, including poor law enforcement, a monopolistic product market, an inadequate labor market, and an underdeveloped capital market.[488] A large group of China's SOEs is represented by organizationally and economically inefficient remnants overloaded by illiquid assets, unmotivated

[485] Koch-Weser, I. N. (2013). China Investment Corporation: Recent developments in performance, strategy, and governance. USCC Policy Analyst, Economics and Trade, U.S. - China Economic and Security Review Commission, June.

[486] Another example is that "CIC Chairman Lou was appointed Minister of Finance, essentially returning to his former employer, where he had served as vice minister until 2007." Each of the National Development and Reform Commission, the Ministry of Finance, the Ministry of Commerce, the People's Bank of China and the State Administration of Foreign Exchange shall nominate one of their officials in charge as a nominee for the non-executive director positions. Also there is no non-Chinese in CIC's supervising and corporate boards as well as among its corporate executives and non-executive directors. From Wu, F., & Seah, A. (2008). The rise of China Investment Corporation. A new member of the sovereign wealth club. World Economics, 9(2).

[487] Among 443 members of CIC's staff, only 41 had overseas citizenship as of June 30, 2012. From CIC's official website.

[488] Lin, C.: 2001, ''Corporatization and Corporate Governance in China's Economic Transition'', Economics of Planning 34(1–2) 5–35.

managers, obsolete technologies, and financial losses.[489] Since their bankruptcy or restructuring will inevitably lead to mass lay-offs, the government must bear huge budget expenditures to maintain their operations. In fact, the government grants its SOEs certain advantages and privileges and, thus, diminishes competition in the domestic market.[490] Such differential approach, when state industrial policies create more favorable and privileged institutional settings for certain SOEs usually indicated as "strategic," has produced disparities in economic performance across regions, industries, and enterprises in China.[491]

However, while state ownership can cause management inefficiencies and profit losses, it also brings about certain advantages and monitoring mechanisms through the benefit of government control.[492]

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489 Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

490 In particular, Brødsgaard (2012) emphasizes that national champions enjoyed "… enhanced management rights in running their businesses, including in areas such as profit retention, investment and international trade. They were allowed to establish their own financial companies, which operated in a manner similar to that of to the banks in the Japanese Keiretsu system. National team enterprises were also at the forefront of the move to list Chinese enterprises on stock markets in China and abroad. By the end of the 1990s almost all of them were listed on one of the two domestic stock markets, and about half of them had listed companies abroad." That privileged treatment contributes to high market concentration in hands of strong business groups of large SOEs. Their increased autonomy and immense economic resources triggers the situation, when these groups have actually become "small kingdoms." "The origin of this shift in the economic relationship between enterprises and government dates back to 1994, when in the wake of tax reforms the State Council ruled that the SOEs were no longer required to remit their after-tax prof- its to the government. Companies grew more and more powerful. They didn't pay out a dividend. Rather they retained the profit and used the surplus cash according to their own preferences. Most of this retained profit was used for reinvestment, contributing significantly to the extremely high investment rate in China in recent years. Following several years of groundwork, in 2007 the SASAC managed to convince the State Council to pass a set of regulations which introduced a system whereby profits would be remitted to the government." From Brødsgaard, K. E. (2012). Politics and business group formation in China: The party in control? The China Quarterly, 211, 624 - 648.

491 Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147.

492 According to Pearson (2005), at this point it is clear that "[t]he Chinese government clearly will retain a significant role in the market system, and not solely because of its tradition of central planning. Political economy scholarship has argued persuasively that, in even the most market-oriented systems, firms rely extensively on governments using consistent regulatory systems to foster conditions for successful markets… Moreover, as countries deepen their integration into international markets, as China has done, the role of states remains far from minimal." From Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

State shareholders still have incentives to ensure their SOEs are profitable. There are several rationales behind this motivation. First, the government wants to avoid corporate losses, since otherwise they will place a burden on the state budget. Second, in order to attract private investments and to decrease state spending, the government must demonstrate that SOEs can earn positive returns.[493] And the third reason to maintain the SOEs' profitability is the possibility of de-listing,[494] as well as the fact that loss-making SOEs may signal failure of the China's entire economic policy.[495] In China, the central and local governments are almost the only actors interested in and actually capable of monitoring the SOE managers.[496] SOEs are government agents to provide employment and free social services.[497] In this

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493 "Qian and Roland (1998) argue that loss-making SOEs in China create an enormous drain on government budgets and state-owned banks, and this eventually forced the government to adopt the privatization program. Moreover, subsidizing loss making companies will likely lead to anti-competition claims by foreign governments and firms." From Firth, M., Wong, S., & Yang, Y. (2014). The double-edged sword of CEO/chairperson duality in corporatized state-owned firms: evidence from top management turnover in China. Journal of Management and Governance, 18(1). doi: 10.1007/s10997-012-9225-6.

494 Pistor, K., & Xu, C. (2005). Governing stock markets in transition economies: Lessons from China. American Law and Economic Review, 7(1), 184–210.

495 SOEs' aversion to the occurrence of financial losses is supported in several empirical studies on the corporate governance of these firms. See Firth, M., Wong, S., & Yang, Y. (2014). The double-edged sword of CEO/chairperson duality in corporatized state-owned firms: evidence from top management turnover in China. Journal of Management and Governance, 18(1). doi: 10.1007/s10997-012-9225-6.

496 "A survey indicates that Chinese managers view the state regulatory regime as the most influential and complex fact or affecting firm performance (Tanand Litschert, 1994)…" From Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147.

In fact, a dominating shareholder is able to mitigate a collective action problem through effective monitoring of the management. Ownership concentration creates more power in hands of a controlling shareholder, which in turn leads to better monitoring. In addition, concentrated ownership mitigates a managerial agency problem. To protect his or her interests, the larger shareholder may put more pressure on the firm to have better governance standards. See Yves Bozec, Richard Bozec, Ownership Concentration and Corporate Governance Practices: Substitution or Expropriation Effects? Canadian Journal of Administrative Sciences, Vol. 24, Issue 3 (September, 2007), pp. 182-195.

As evidence, "[s]ome recent studies of Chinese listed companies have found that in general, corporate performance seems to be positively correlated with concentrated ownership by institutional shareholders other than state agencies and negatively associated with dispersed ownership…" From Clarke, D. C. (2003). Corporate governance in China: An overview. China Economic Review, 14, 494–507.

497 The absence of comprehensive regulation brought about the case when privatization of small and medium-sized Chinese SOEs led to the layoff of millions of workers, who were unable to receive adequate compensation or find

regard, the government allocates state financing for purposes that often might be in conflict with the traditional concept of profit maximization.[498] SOE performance, therefore, needs to be evaluated against state-set goals and established policy objectives.[499]

At the same time, the Chinese government has shown a desire to improve SOE management and accounting standards.[500] Initially, corporatization of SOEs was designed to enable SOEs' management to "…operate and develop enterprises independently and assume responsibility for their own profits and losses on the basis of law (. . .), with a view to pushing SOEs to enter the market, to strengthen the vitality of enterprises, and to improve their economic efficiency."[501] In other words, the concept of corporatization has been grounded in market principles aimed to increase the financial independence of SOEs and, as a consequence, to produce better economic returns. Today, many SOEs in China have been

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stable jobs again. Moreover, some studies reported the misuse of state assets by the new managers. See Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

498 Firth, M., Wong, S., & Yang, Y. (2014). The double-edged sword of CEO/chairperson duality in corporatized state-owned firms: evidence from top management turnover in China. Journal of Management and Governance, 18(1). doi: 10.1007/s10997-012-9225-6.

499 Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147.

500 "The Code of corporate governance for listed companies in China (CSRCa, 2001), based on guidelines issued by the Shanghai Stock Exchange at the 2000 International Conference on Corporate Governance, stipulates requirements for shareholders and their meetings, directors and boards, and the supervisors and supervisory board for listed companies. ''The Code'' also specifies rules for establishing performance assessment, incentive and disciplinary systems, disclosing information and maintaining transparency, and cumulative voting for listed companies with more than 30 percent shares owned by controlling shareholders. The Guidelines for introducing independent directors to the board of directors of listed companies (CSRCb, 2001) require that boards of directors appoint independent outside directors. In 2003, China created the State-owned Assets Supervision and Administration Commission (SASAC) to represent its 189 major SOEs (China's SOE reform focuses on corporate governance, 2004). Among its measures to improve corporate governance was implementing an evaluation method that assesses SOE management performance using financial indicators and rewards managers accordingly. It will also appoint SOE directors who better represent the state. Also in 2003, The Third Plenum of the Sixteenth Party Congress issued the ''Decision of the CCP Central Committee on Several Issues in Perfecting the Socialist Market Economy'' that assured the government's intent to emphasize market principles, govern financial markets according to law, improve public and private administration, and strengthen legal interpretations (Fewsmith, 2004)." From Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

501 Li, C. (1995). The reform of state-owned enterprises: Smoothing out property rights relations and converting the operational mechanism. Social Science in China, 16(4), 47-58.

converted from political entities to "market entrepreneurs."[502] This means that China's policymakers have made an attempt to achieve a balance between market orientation and socio-economic policies in terms of state ownership structures.[503] By providing SOEs with the opportunity to access the international capital markets, the government has partly assured the SOEs' market orientation. Operating in the world's capital market, SOEs have been forced to optimize their capital and corporate structures and to achieve greater transparency.[504] Today, many Chinese SOEs operate under domestic and international market conditions. International listing requirements compel SOEs to review their corporate governance and spending towards the traditional concept of profitability. For the majority of them, foreign markets have become one of the major disciplining forces. As a consequence, Chinese large SOEs are widely represented in the Fortune "Global 500" list of 2013. A substantial part of the country's largest corporations includes SOEs, which are expected to become "national champions" and successfully compete in the global market.[505]

Summing up, China has followed the course of reforms toward a socialist market economy with gradual privatization of very limited state assets in terms of an existing command system and central planning. Even though, the Chinese government demonstrates its favor to the private sector, it has never agreed on a substantial or complete transfer of state assets into private hands. Instead, many SOEs have been transformed into shareholding companies that seek to apply the best standards of corporate governance. China's market and institutional failures have become solid justifications for gradualism. With no sufficient capital markets and formal governance mechanisms, private firms have a few options

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[502] Francis, C-B. (2001). Quasi-public, Quasi-private trends in emerging market economies: The case of China. Comparative Politics, 33(3), 275-294.

[503] "While not unique to China, this transformation has taken extreme and colorful forms there. Chinese state agencies and public institutions have engaged directly in commercial activities, becoming, rather than simply regulating, market actors. While remaining structurally embedded in the formal state structure, individual agencies of the Chinese state have been transformed into relatively autonomous, profit-seeking market actors…" Francis, C-B. (2001). Quasi-public, Quasi-private trends in emerging market economies: The case of China. Comparative Politics, 33(3), 275-294.

[504] Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

[505] For example, Sinopec Group, China National Petroleum, State Grid, Bank of China, China Railway Construction, and China Life Insurance. http://money.cnn.com/magazines/fortune/global500/ Accessed on November 1, 2013.

for raising capital and protecting their property rights. Foreign investors demonstrate quite narrow and, typically, short-term interests. Additionally, China has quite monopolistic product markets and a very small market for managerial talents. In this situation, state financing and investments become crucial for further economic development and almost the only option for private firms since major banks in China are state-owned. Also, SOEs become the important instruments of state development programs, employment, social services, and social security to the population.[506] Furthermore, the government employs SOEs to carry out industrial and infrastructural projects bypassed by private investors. At the same time, SOEs generate a large share of state revenue that the government can reinvest in the country's further socio-economic development, technology transfer and research.

At the same time, China's SOEs and SWFs face similar challenges as their Kazakhstani counterparts, namely, political considerations and multitasking. In this regard, China's policymakers conducted a set of reforms to improve SOE management. The government introduced the concept of corporatization and the application of market principles to SOE operations that tend to find the balance between state socio-economic agendas and profit orientation and to a certain extent fulfill institutional gaps.

[506] In this context, many economists and policymakers believe that privatization may cause mass layoffs and thus have an adverse social impact. "Privatization can cause job losses in two ways. One is direct and takes place at the firms being privatized. As state-owned enterprises are privatized, the newly- privatized enterprises often eliminate redundant workers in order to cut costs and improve efficiency and profits. The other source of job loss is due to the secondary effects of the increased efficiency that privatization brings about (Kikeri 1998). The remaining SOEs in an industry will face increased competition from the growing and increasingly more efficient private sector, and they, too, may thus be forced to lay off workers and cut wage costs in order to survive…" From Chang, G. H., & Brada J. C. (2011). A model of the macroeconomic effects of privatization on employment in transition and developing countries with an application to China. Transition Studied Review, 18, 310–327. doi 10.1007/s11300-011-0206-2.

CHAPTER 4

STATE OWNERSHIP IN TERMS OF TRANSITION: CURSE OR BLESSING

China and Kazakhstan, the system of SOEs in China and Kazakhstan and the path of corporate governance both countries have chosen offer a good opportunity to analyze the corporate governance and efficiency of SOEs from different perspectives. This chapter is a summary of my theoretical arguments based on the institutional development as well as the costs and benefits of state ownership in terms of transition.

The Role of Institutions in Transition

In light of institutional conditions inherent in both countries, the traditional economic approach emphasizes the high costs of state ownership in Kazakhstan and China. In particular, typical external governance mechanisms, including debt, takeover threats, and legal protection of investors, have not been effectively developed in either country. As a consequence, while relying on markets, both countries also rely on the power of the state to direct the economy and to control strategic economic resources of production. Accordingly, corporate boards in large SOEs consist mainly, or even entirely, of state officials or managers of parent SOEs, whose incentives are largely driven by political and socio-economic considerations of the government and not just by profit maximization.

The largest financial institutions, as a potential force to discipline managers and increase the pursuit of profits, are also state-owned and, therefore, carry out strategic state policies. State commercial banks hold a dominating position in the banking sectors of both countries. Since profit maximization has become just one of the objectives of state-owned banks, there is the common practice of subsidized loans, rescheduled debt payments, and the extension of credit upon government requests, especially in the case of SOE lending. This practice, in turn, increases the costs of monitoring and management discipline particularly in the situation where there is no effective market for private non-bank debt and active merger or takeover activities.

Finally, foreign institutional investors have not been keen on paying a premium for good corporate governance in Chinese and Kazakhstani companies. Even though foreign investments in economic development in China and Kazakhstan are important,[507] this type of investment is very volatile, that is, the dynamic of FDI has been changeable and unstable.[508] Nonetheless, the prospect of high return can outweigh the risks. In other words, considerable uncertainty in the financial and legal environment of both countries has been compensated by the rich natural resources of Kazakhstan and the huge size of China's market. In any event, foreign investors are unlikely to have strong incentives to monitor domestic firms since, while they will bear a big fraction of the costs, the large shareholder (in the case of SOEs, the government) will internalize the benefits.[509]

The question then is the extent to which product market competition can be a sufficient commitment device for SOEs in Kazakhstan and China. Competition in product markets is an important corporate governance tool, which works well in many countries.[510] An important factor for competition is

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[507] Sušjan, A., & Redek, T. (2008). Uncertainty and growth in transition economies. Review of Social Economy, 66(2), 209-234.

[508] Carkovic and Levine (2005) have studied extensively the relationship between foreign direct investment and economic growth and have come to a very interesting conclusion, that "after resolving many statistical problems plaguing past macroeconomic studies (...), foreign direct investments do not exert an independent influence on economic growth, (...), while sound economic policy may spur both growth and FDI." Carkovic, M., & Levine, R. (2005). Does foreign direct investment accelerate economic growth? In T. Moran, M. Graham & M. Blomstrom (Eds.), The Impact of Foreign Direct Investment on Development: New Measurements, New Outcomes, New Policy Approaches. Washington, D.C.: Institute for International Economics.

[509] Shleifer, A. and Vishny, R. W. (1986). 'Large shareholders and corporate control', Journal of Political Economy, 94, pp. 461–88; Xu, L. C., Zhu, T., & Lin, Y-M. (2005). Politician control, agency problems and ownership reform. Evidence from China. Economics of Transition, 13(1), 1–24.

[510] Allen, F., Qian, J. "QJ," Qian, M., & Zhao, M. (2009). A review of China's financial system and initiatives for the future. China's Emerging Financial Markets, Edited by James A. Barth, John A. Tatom and Glenn Yago, The Milken Institute Series on Financial Innovation and Economic Growth, 2009.

administrative barriers for new firms entering the market.[511] In the case of China and Kazakhstan, these barriers are quite high. They are grounded on the policy of building "national champions" in strategic industries that both governments have pursued. In their desire to structure the market, the governments of China and Kazakhstan have favored particular state companies, the failure of which would impose enormous social costs. As a result, the so-called "national champions" enjoy many privileges including cheap and abundant state financing. This privileged position, in terms of capital and information, has eventually affected the ability of other domestic firms to enter the market. Moreover, many SOEs in China and Kazakhstan are natural monopolies. That essentially excludes any competition in their industries.[512] As a "by-product" of the "national champions" policy, the markets in China and Kazakhstan are quite monopolistic. Therefore, competition in the domestic markets of China and Kazakhstan does not seem to be very influential in terms of corporate governance of the SOEs.[513] In contrast, when large SOEs decide to operate in the international market, market competition becomes a powerful disciplining force. The signals provided by the international market about the value of a SOE's securities are able to induce the state shareholder and SOE management to arrange corporate processes based on those signals.[514]

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[511] Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2002) examine entry barriers across 85 countries, and find that countries with heavier (lighter) regulation of entry have higher government corruption (more democratic and limited governments) and larger unofficial economies. See Djankov, S., La Porta, R., Lopez-de-Silanes, F., Shleifer, A., 2002. "The Regulation of Entry," Quarterly Journal of Economics 117, 1-37.

[512] "Elements of China's experience, notably the remaining power of comprehensive agencies, the desire to foster national champions, limit competition in favor of incumbent firms, resemble core elements of the developmental model. Still other elements of China's experience – especially the continuing and powerful role of state ownership and of the party, and hence the absence of political independence – mirror neither system…" From Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

[513] In this context, it is legitimate to mention that the impact of the market has become greater in China after its joining the WTO and entering multinationals. In case of Kazakhstan, the membership in the Custom Union with Russia and Belarus has also raised competition with Russian and Belarusian firms in terms of the Kazakhstani market. Nevertheless, while being substantial for private companies, in case of SOEs in China and Kazakhstan the effect of competition also have increased but still remains quite modest and often insignificant.

[514] "A newer interpretation is today emerging that cross-listing may also be a bonding mechanism by which firms incorporated in a jurisdiction with weak protection of minority rights or poor enforcement mechanisms can voluntarily subject themselves to higher disclosure standards and stricter enforcement in order to attract investors who would otherwise be reluctant to invest (or who would discount such stocks to reflect the risk of minority

The experiences of Kazakhstan and China suggest that the corporate governance approach depends on a country's stage of institutional and economic development. Institutional context and the lack of liquid capital and labor markets, in particular, call for the state sector to address market failures and undertake a leading role in industrial development. Underdeveloped capital markets are not able to manage risks associated with large-scale projects. Therefore, the government needs to mobilize its financial resources in order to provide the economy with the sufficient inflow of investments. In the absence of a sufficient marketplace, such benchmarks as the welfare that SOEs produce including their net profit, taxes collected from these entities, social and development programs and other long-term socio-economic goods granted to the population and business community, may provide the most relevant and convincing ground for the analysis of corporate efficiency and the value of SOEs in transitional Kazakhstan and China.

The model of "public good" tolerates substantial government intervention in order to structure the market and to design a country's industrial policy, often in favor of particular socio-economic programs.[515] In this regard, both Kazakhstani and Chinese governments endeavor to allocate and utilize state funds according to their agendas. In his study of China's long-run performance, Angus Maddison claims that transition economies in the "situation of relative backwardness and distance from the technological frontier have a capacity for fast growth if they mobilize and allocate physical and human capital effectively, adapt foreign technology to their factor proportions and utilize the opportunity for specialization which come from integration into the world economy."[516] The reality today is that private actors in Kazakhstan and China have quite limited capital resources and, therefore, the state acts as their

expropriation)." Coffee, John C. (2002). Racing toward the top?: The impact of cross-listings and stock market competition on international corporate governance. Columbia Law Review, 102(7), 1757-1831. doi: 10.2307/1123661.

[515] Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

[516] Cited in Jefferson, G. H., Hu, A. G. Z., & Su, J. (2006). The sources and sustainability of China's economic growth. Brookings Papers on Economic Activity, 2006(2), 1-47.

substitute in the national economy for the purpose of further industrial development and social stability.[517] The burden of economic diversification and social welfare has been imposed upon SOEs.[518] That, in turn, has determined corporate governance and investment strategies of state ownership in China and Kazakhstan.

Tradeoff of State Ownership in China and Kazakhstan

In the case of the market economy, public and private actors have to equally confront high-return, high-risk tradeoffs and compete for capital and sophisticated production technologies. Private competitors usually have better expertise than their state counterparts, and decisions about developing new products or sectors are largely left to private firms. In this situation, government subsidy support can create an unfair balance, where SOEs benefit more than private companies. Hence, the role of government tends to be more indirect by regulating and supporting projects through private financial markets and incentives for private financing.[519] This indirect approach provides the government with the opportunity to share risks between the state and private sectors. In fact, the government can utilize the private sector's deeper knowledge in selecting potential winners. Moreover, it can minimize the problem of soft budget constraints. With indirect industrial policy, private financial institutions can withdraw their financing, if

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[517] Russia can also illustrate this argument. In fact, one of the studies revealed that "… Russian businesses were reluctant to invest in new technologies. According to a survey by the Higher School of Economics, in 2010, the natural resource extraction remained the most active area of investment. Most disturbingly, the survey revealed the tendency to put new investments not into buying new technologies but in repairing and maintenance of the old obsolete equipment." From Busygina, I., & Filippov, M. (2011). Benefits and risks of political modernization in Russia. SSRN Electronic Journal, 01. doi: 10.2139/ssrn.1736483.

[518] In particular, one of Kazakhstan's state programs aims to encourage bank financing through the allocation of state funds in commercial banks for lending to SMEs. As of January 1st, 2012, 11,886 borrowers were financed in the amount of more than US$4 billion (603.4 billion tenge). In fact, for the last 4 years one fifth of the total financing of SMEs has been obtained under state programs.

[519] Felipe, J., & Rhee, C. (2013). Report to the Government of Kazakhstan. Policies for industrial and service diversification in Asia in the 21st Century, Asian Development Bank, October.

they find necessary. In these circumstances, the success of a company depends on its market strength.

However, the indirect approach requires clear and comprehensive formal regulations and liquid capital markets, which allow the government to fairly apply its indirect influence through different means. This is not the case of Kazakhstan and China, where many domestic enterprises, including financial institutions, are dependent on state support, and their competitive position is far from perfect. Accordingly, entrepreneurs attempt to secure their business or reduce regulatory uncertainty by committing to the socio-economic policy of the state. The demand for state funds motivates private actors to assume social responsibility. In other words, the government can provide private entrepreneurs with incentives to do social good and handle social and environmental challenges through granting access to less expensive state financing.[520] Hence, state interference is inhibited by the inadequacy of traditional funding sources and the absence of up-to-date technologies.[521]

Another important assignment faced by both governments is the maintenance of a stable and predictable environment for further economic growth.[522] The process of institutional transformation has led to the situation in which market actors lack crucial information about possible risks. Current integration with the world economy has increased the vulnerability of the domestic economies of Kazakhstan and China to external shocks.[523] To achieve socio-economic stability when there is no strong

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[520] Zhao, M. (2012). CSR-based political legitimacy strategy: Managing the state by doing good in China and Russia. Journal of Business Ethics, 111, 439–460.

[521] In transitional Kazakhstan and China "the state must necessarily play the role of the key promoter of economic modernization and technological innovations." See Busygina, I., & Filippov, M. (2011). Benefits and risks of political modernization in Russia. SSRN Electronic Journal, 01. doi: 10.2139/ssrn.1736483.

[522] Analyzing autocratic regimes in Singapore and China, Victor Shin (2009) concluded that if a national leader was quite certain of gaining power over crucial state assets and was less concerned about his political survival, he might largely focus more on maximization of long-term profit and economic growth. This means that the stability of a political regime matters in the context of the efficiency of state ownership. With respect to the Singaporean experience, Shih (2009) argues that "[t]he long time horizon and unchallenged political dominance afford Singaporean rulers the luxury of focusing on long-term returns on their investment because they can expect to reap the bulk of the benefits." See Shih, V. (2009). Sovereign wealth funds in Singapore and China. Geopolitics, 14, 328–344. In this regard, Kazakhstan reminds Singapore to a large extent because of highly influential role of the country's leader, his family and close allies.

[523] Prasad, E. S., & Rajan, R. G. (2006). Modernizing China's growth paradigm. The American Economic Review, 96(2), 331-336.

system of institutional checks and balances, Kazakhstan and China have made use of strong political leadership and a vertically integrated structure of state asset management. From the perspective of efficiency, a weak government can be under pressure to spend resources in return for political support. In contrast, strong political leadership tends to have less incentive to spend resources for political gain and can commit to a country's economic development and better governance of state assets.[524] Having a proxy from the population and a long history of being in power, the political leadership in China and Kazakhstan is likely less concerned with its political survival today. To maintain a decent level of credibility, they have been focused on issues of economic development and social welfare.[525] Furthermore, international integration and SOEs' listing on international stock exchanges induce the governments in China and Kazakhstan to proceed with further institutional reforms and improve SOEs' performance.

Given the fact that the existing social security and pension systems in China and Kazakhstan are still developing, the risks inherent in a market economy are especially critical for the population in both countries.[526] To mitigate those risks, both governments have assumed social responsibility through state

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[524] See Gilson, R. J., & Milhaupt, C. J. (2010). Economically benevolent dictators: Lessons for developing democracies. Columbia Law and Economics Working Paper No. 371. Available at SSRN: http://ssrn.com/abstract=1564925.

[525] However, it is worth mentioning that scholars warn that strong political leadership can ultimately produce a higher concentration of power over state resources. With the lack of external oversight, policymakers have wide discretion in using state assets for their personal interests and political agendas. In this situation, a reputational effect can perform the role of a commitment instrument. This means that for the political elites in China and Kazakhstan the question of self-enrichment has been replaced by the necessity to capture a higher portion of foreign investments and obtain access to international financing. In particular, in 2009 Standard & Poor's conducted the study of transparency of Kazakhstan's largest public companies. According to the results, public national companies of the Group demonstrated a higher level of transparency compared with their private counterparts. The national oil company "KazMunaiGas Exploration and Production" was estimated to be the most transparent. Non-public companies of the Group received only 25 percent largely because of the low formal requirements to corporate disclosure.

[526] In particular, the course of the state sector's total replacement initially applied by the Kazakhstani political leadership led to extreme social insecurity among a large part of the population that could not adjust to newly established market conditions. Moreover, the Kazakhstani state gave up responsibility for social insurance and pension payments for the majority of citizens. As a consequence, for a quite long period of time, the state sector's guarantees were eliminated and the private sector did not demonstrate prudency and accountability in complying

ownership and state social and pension programs.[527] Social spending implemented through state ownership structures seems to be less costly for the political leadership than the establishment of new institutional and political arrangements. At the same time, to secure the stable implementation of social programs, the political leadership in Kazakhstan and China seeks to improve SOE performance through transformation of traditional SOEs into effectively-run shareholding companies governed in accordance with the best standards.

Consequently, the systems of state ownership in Kazakhstan and China are deemed to be a response to the existing institutional environment. They serve to guarantee lower prices for basic goods and services and, therefore, to maintain an essential level of social stability and market predictability.[528]

The positive effect of government commitments can also be supported by the presence of minority shareholders in SOEs. In particular, one study of controlling shareholders in Chinese listed firms indicates that minority shareholders place a higher value on firms where the controlling shareholder is a local government. In the opposite situation, firms controlled by individuals are less valuable to minority shareholders. Furthermore, individually-controlled firms, where the local government is the second largest shareholder, have a higher value than other individual controlled firms.[529] One of the explanations

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with its social obligations. Recently, this situation resulted in the nationalization of the pension system in Kazakhstan.

[527] For example, the telecommunication industries in both countries bear the costs of the telephony lines' contraction in rural areas. In its Tenth Five-Year Plan (2001-2005) for Information Industry, the Chinese government committed unambiguously to a universal services obligation, with the goals of providing all citizens and regions equal access to telephony. See Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

Similarly, the electricity sector has been responsible for providing lower electricity prices to the population.

[528] "The Chinese legal system itself, like the society of which it is a part, does not function on the basis of what it lacks; it functions on the basis of what it has… [T]he question should be not whether China possesses or lacks courts that enforce rights, but simply whether investors and others engaged in business in China have adequate predictability for their needs." From Clarke, D. C. (2003). Economic development and the rights hypothesis: The China problem. The American Journal of Comparative Law, 51(1), 89-111. Also see Dimitrova-Grajzl, V., Grajzl, P., & Guse, A. J. (2012). Trust, perceptions of corruption, and demand for regulation: Evidence from post-socialist countries. The Journal of Socio-Economics, 41, 292–303.

[529] Zhan, W., & Turner, J. D. (2012). Crossing the river by touching stones? The reform of corporate ownership in China. Asia-Pacific Financial Markets, 19, 233–258.

might be that minority shareholders in SOEs favor the state-controlling shareholder as a powerful monitoring force. The centralized group structures, within which SOEs operate, make it easier for the government as a large shareholder to monitor SOE management using political connections.[530] These groups include different actors such as central and local authorities, parent SOEs, state-owned banks and SWFs that often have distinct incentives.[531] Multiple parties involved in SOE decision-making deliver an opportunity to debate major policy issues and SOE spending.[532]

Therefore, as opposed to the image of SOEs as moribund, strategic industries in China and Kazakhstan include productive or potentially productive SOEs capable of competing in the international markets.[533] These SOEs are gathered into a pyramidal holding company structure with a state asset management company running SOEs across different industries on the top. Within the group, its members enjoy access to internal capital and information markets as well as the advantage of risk sharing and stability regarding market fluctuations. At the same time, the governments utilize the opportunity to diversify and more effectively allocate resources. This means that the governments have a chance to allocate and channel assets across industries.[534]

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530 Recent studies "has extended its basic concepts by studying the identities of principals and agents, such as when looking at the role of state shareholders in emerging economies to explore the lack of incentives of state ownership to monitor a firm's management." They conclude that "legal person shareholders, as a complementary form of identity to state shareholders, can have the incentive and abilities to monitor a firm's management..." See Delios, A., & Wu, Z. J. (2005). Legal person ownership, diversification strategy and firm profitability in China. Journal of Management and Governance, 9, 151–169. Also see Chang, H-J. (2007). State-owned enterprise reform. Policy Notes, Department for Economic and Social Affairs (UNDESA).

531 Chen, G., Firth, M., Xin, Y., & Xu, L. (2008). Control transfers, privatization, and corporate performance: Efficiency gains in China's listed companies. The Journal of Financial and Quantitative Analysis, 43(1), 161-190.

532 Boix, C., & Svolik, M. W. (2013). The foundations of limited authoritarian government: Institutions, commitment, and power-sharing in dictatorships. The Journal of Politics, 75(2), 300–316. doi:10.1017/S0022381613000029.

533 As Ho Ching, the CEO of Temasek, put it: "We don't intend to raid the larder, nor sell the family jewels. We will jealously guard our interest, and invest, rationalize, consolidate or divest where it makes sense, and where we can achieve clear sustainable value." Cited in Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

534 One function often attributed to such groups is that they enable member firms to share risks by smoothing income flows and reallocating money from one affiliate to another. Samphantharak, K. (2007). Internal capital markets in business groups. SSRN Working Paper Series, March. Available at: http://ssrn.com/abstract=975562. Also see

Thus, the presence of policy interests in management may guarantee an investment return in markets, in which there is the lack of liquid instruments for investment. Since large SOEs are often the leaders in their industries that enjoy access to state capital, the chance of their bankruptcy is minimal. That, in turn, assures minority shareholders that their money will not be lost.

However, the systems of state ownership and management in China and Kazakhstan have the costs of political considerations, poor profit motivation and multitasking.[535] A political component is one of the major sources of costs in SOEs. For example, Su (2005) provides evidence that corporate boards in China's publicly-listed firms are largely selected through political and administrative processes rather than endogenously chosen in competitive managerial labor markets, and hence are less likely to monitor management.[536] In Kazakhstan, current or former government officials constitute the majority of corporate directors in the NFK, Samruk-Kazyna and the Group. Kazakhstani policymakers consider this board composition as taking advantage of the solid work experience of government officials. Indeed, many of them have important managerial skills and a deep knowledge of particular industries that may be beneficial for the SOEs they manage. However, this also raises a huge concern that some of the commercial interests of SOEs are sacrificed to the political or career considerations of bureaucrats, when major corporate decisions are subject to bargaining between "the bureaucracies of the central ministries in charge of big state firms."[537]

Notwithstanding that some of the SOEs are among the largest corporate entities in their

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Khanna, Tarun, and Rivkin, Jan W. "Estimating the Performance Effects of Business Groups in Emerging Markets." Strategic Management Journal 22 (2001): 45-74; Khanna, T., & Yafeh, Y. (2005). Business groups and risk sharing around the World. The Journal of Business, 78(1), 301-340.

[535] Scholars emphasize the existing tension between two models as well tensions "between the economic and political systems." See Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[536] Su, D., & He, X. (2012). Ownership structure, corporate governance and productive efficiency in China. Journal of Productivity Analysis, 38, 303–318; Su, D. (2005). Corporate finance and state enterprise reform in China. China Economic Review, 16, 118-148.

[537] Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

industries, their position is often attributed to extensive state support, not their efficiency. As Chan (2009) puts it, there is a "concerted bureaucratic efforts" to make SOEs strong but "they are not as competitive i.e. market performing, as we would like them to be." SOEs in China and Kazakhstan are subject to soft budget constraints. This means that SOEs can secure additional finances to be rescued from bankruptcy, if they make losses. Thus, the possibility of the bailout for SOEs can cause moral hazard.[538]

Also, the institutional context of both countries casts significant doubt on whether both governments have fully separated their capacities as a regulator and as a shareholder.[539] SOE managers and government officials routinely circulate within the systems of state governance and ownership. That reinforces a cozy relationship between the incumbent SOE managers, the government and the political leadership.[540] For instance, top executives of China's public enterprises are appointed by the SASAC to monitor their performance. Chen et al. (2009) conclude that around 14.0 percent of listed firms are affiliated with the central government, and around 66.0 percent of listed firms are affiliated with provincial governments in China.[541] Fan et al. (2007) show that 27.0 percent of the CEOs of newly partially privatized firms in China are former or current government bureaucrats.[542] Therefore, we may conclude that politics persists to be an issue for state ownership in Kazakhstan and China.

Furthermore, it might be that the market will become too dependent on the state policies of financing and subsidizing. In other words, private companies will not be able to solve their financial problems without state support and the market will shrink with the termination of government programs. In addition, SOEs and quasi-state entities enjoying a privileged position in terms of state funding and may

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[538] Chang, H-J. (2007). State-owned enterprise reform. Policy Notes, Department for Economic and Social Affairs (UNDESA).

[539] Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

[540] Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

[541] Chen, G., Firth, M., & Xu, L. (2009). Does the type of ownership control matter? Evidence from China's listed companies. Journal of Banking & Finance, 33, 171–181.

[542] Fan, J., Wong, T., & Zhang T. (2007). Politically connected COEs, corporate governance, and post-IPO performance of China's newly partially privatized firms. Journal of Financial Economics, 84, 330–357.

crowd out less sustainable private companies, which in turn will reduce economic diversification and competition and lead to an even more monopolistic market. For example, one of the negative consequences of the recently increased role of the state in Kazakhstan is the possible decline of entrepreneurial initiative.[543] The essence of relationships in the state and quasi-state sectors do not create equal conditions for all actors and for private business, in particular. That may cause a situation when entrepreneurs are not able to compete with their state counterparts and prefer to leave the market or choose free riding when the state bears large expenses.

Nonetheless, the system of SOEs functioning in China and Kazakhstan has been apparently less expensive and has provided both national economies with benefits that seem to outweigh their costs.[544] This system broadens the conceptual and empirical boundaries between the state and the market and exhibits many quasi-public, quasi-private features.[545] As a result, China and Kazakhstan do not fall neatly into either the free-market category or the planned-market category. Both countries have relied sufficiently on markets and competition while retaining the power of the state in settling the economic course of development.[546]

Summing up, the governments in both countries have become a real force capable to deal with market frictions and transaction costs of ownership through a dual governance model, where the shareholder supremacy approach grounded on traditional governance theories exists within a state-centered economic system. The latter is designed to keep control over strategic industries and also to avoid the potential social danger of unemployment and other negative outcomes, which might be the

[543] Amalbayev, A. (2012). Adam Smith v Astane. Expert Kazakhstan, 50(391). In Russian.

[544] "[T]he existence of transaction costs means that it is often much less costly to set up an SOE and deal with unexpected contingencies through internal government directives than to set up some contract-based regime – regulation and/or taxes/subsidies – to address such concerns." Chang, H-J. (2007). State-owned enterprise reform. Policy Notes, Department for Economic and Social Affairs (UNDESA).

[545] Francis, C-B. (2001). Quasi-public, Quasi-private trends in emerging market economies: The case of China. Comparative Politics, 33(3), 275-294.

[546] Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

results of economic transition. Therefore, one may assume that policymakers in China and Kazakhstan act as a rational individuals, who weight their concerns for market failure against the government failure.[547]

CONCLUSION

The view that poor-quality institutions impede a country's economic development is widespread among economists. Accordingly, the IMF and the World Bank have started to impose many governance-related covenants, which require borrowing countries to adopt "better" institutions.[548] Typically, they are institutions that are found in Anglo-American systems. These systems are based on a liberal market approach grounded in the strong protection of property rights, a liquid stock market, a shareholder-oriented corporate governance structure, and a flexible labor market. These institutions are considered helpful in promoting investments and sustained economic growth.[549]

In this regard, transitional countries have been strongly encouraged to adopt institutions that call for deregulation, significant privatization, and capital market liquidity. The IMF, the World Bank and other international organizations have evaluated corporate governance in transition economies from the perspective of their formal compliance with best standards with little attention to whether these arrangements would effectively operate and carry out their anticipated functions in terms of transition. The main obstacle with the application of such best standards in transition economies is the lack of a

[547] See Dimitrova-Grajzl, V., Grajzl, P., & Guse, A. J. (2012). Trust, perceptions of corruption, and demand for regulation: Evidence from post-socialist countries. The Journal of Socio-Economics, 41, 292–303. Zingales (2009) similarly conjectures that the lack of trust could explain why demand for regulation increases after every major crisis.

[548] Chang, H-J. (2011). Institutions and economic development: Theory, policy and history. Journal of Institutional Economics, 7(4), 473–498.

[549] La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (2008). The economic consequences of legal origins. Journal of Economic Literature, 46(2), 285-332.

liquid capital market, an efficient market for corporate control or a transparent labor market. The examples of Kazakhstan and China show that state equityholding can, and in fact does, create market systems but largely based on state, not private, ownership.[550] These market structures do not necessarily lead to weak protection and discrimination of private property rights.[551] For instance, SOEs can benefit and enhance private initiatives through state investments, subsidies and informational support. In China and Kazakhstan, the government and SOEs have been the key actors substantially responsible for industrial upgrading.[552] They have been able to provide long-term investments that are crucial for economic diversification and the creation of capital and infrastructural conditions for the further growth of private activities (the so-called "crowding in" effect).[553] This means that SOEs have become important

[550] The findings from an examination of the tobacco-market dynamics during China's economic reform era suggest that market-building in transitional economies does not necessarily require or entail the decline of the state's role in market activities as in the ''shock therapy'' approach. See Wang, J. (2006). State-building as market-building in China. European Journal of Sociology, 47(2), 209- 240.

[551] For example, the Singaporean state is well known as a strong state that protects private property rights very well. "However, the very strength of the Singaporean state that enables it to offer such protection is founded upon a very high degree of state ownership. First, the Singaporean state's strength owes a great deal to its strong fiscal position thanks to highly efficient SOEs, which collectively produce over 20 percent of the country's GDP. Second, an important basis for the Singaporean state's high political legitimacy is its ability to supply high-quality affordable housing, which in turn is possible because it owns all the land in the country and operates a giant public housing corporation that supplies 85 percent of the country's housing. In other words, a high degree of state ownership may in some cases be exactly what enables the country to offer strong protection of private property rights." See Chang, H-J. (2011). Institutions and economic development: Theory, policy and history. Journal of Institutional Economics, 7(4), 473–498.

[552] In Kazakhstan, as the result of state strategies of industrialization GDP rose to 27.3 trillion tenge (over US$180 billion) in 2011, which was 107.5 percent more than in 2010. More importantly, the GDP growth in 2011 was achieved thanks to sustainable expansion of the manufacturing and the services sector. The growth of industrial production reached 3.8 percent. In general, 237 start-ups with the total amount of 1 trillion tenge (almost US$6.7 billion) were initiated in 2011, which allowed the creation of 20 thousand new jobs. Summing up, the overall effect of the industrialization program in 2011 was 2 percent of GDP, which could be a solid evidence of the efficiency of state asset management. From the address of the Prime-Minister of the Republic of Kazakhstan Karim Massimov. Samruk-Kazyna's Annual report of 2011.

[553] "Over the last two decades, there has been a tendency to presume that all public investment "crowds out" private investment. However, "crowding out" becomes a significant possibility only when the economy is near full employment. In most countries with underutilized resources or increased resources obtained through aid, we can expect public investment to "crowd in" private investment. Public investment can further enhance economic development especially if they are made in areas that complement private sector investment (e.g., road facilities for major export crop region, investment in the training of engineers for a newly-expanding industry, investment in the basic inputs industries that are too risky for the private sector)." From Chang, H-J. (2007). State-owned enterprise

market players.

The institutional environment in Kazakhstan and China continue to evolve. Many SOEs have been partly privatized or become the subject of privatization and currently borrow in the international debt markets. The traditional hierarchical and bureaucratic structure of SOEs has been substantially reformed, and now possesses "many, but not necessarily all, of the values found in Western market-oriented organizations."[554] The governance structures in SOEs have obtained many features of profit-oriented enterprises.[555]

However, despite the corporatization of state entities in Kazakhstan and China as well as the economic progress that both countries have achieved in the last decades, there is much work to be done to make these economies resilient to external shocks, to ensure the sustainability of their growth, and to translate this growth into corresponding improvements in the economic welfare of their citizens. In fact, the securities markets in both countries still suffer from the lack of attractive financial instruments and the low number of investors and issuers.[556] The recent financial downturn revealed that growth could sometimes mask deep underlying problems.[557] Particularly, multiple tasks in state asset management call for the establishment of clear standards and objectives for SOEs, depending on their industries. Those standards and objectives should be easily measured by independent actors and made transparent for overview, monitoring and evaluation. In this context, the system of separate accounting of both

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reform. Policy Notes, Department for Economic and Social Affairs (UNDESA).

[554] Ralston et al., 2006. Cited in Hua, J., Miesing, P., & Li, M. (2006). Empirical taxonomy of SOE governance in transitional China. Journal of Management Governance, 10, 401–433.

[555] Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

[556] In case of Kazakhstan, it is worth mentioning that investments capacities of a big number of potential investors and issuers (institutional and individual) have not been explored notwithstanding the government's efforts to make this market more attractive. According to the National Bank's statistics, by the results of 2011 the deposits of population have exceeded US$18.6 billion (2.8 trillion tenge). That money could be successfully transferred to the market. The press release No. 7 of the National Bank of the Republic of Kazakhstan as of February 14, 2012 "On Situation at the Financial Market" http://online.zakon.kz/Document/?doc_id=31124911.

[557] Some of them are mentioned in Chang, H-J. (2007). State-owned enterprise reform. *Policy Notes*, Department for Economic and Social Affairs (UNDESA).

commercial and non-commercial activities proposed by the management of Samruk-Kazyna will likely provide the Kazakhstani government and investors with clearer market indicators for the evaluation of the commercial component in the Group's operations.

To establish clear objectives, develop workable check-up mechanisms and ensure proper coordination among multiple agendas of SOEs, the governments in Kazakhstan and China should consider the following policy priorities:

First, state policies need to be coordinated, simplified and closely monitored. The number of strategic documents and reports must be downsized to focus on the actuality and feasibility of the strategic goals for the country.[558] Every strategic document for a state project should be result-oriented. This means that the document should establish long-run comprehensible outcomes of the project. In order to reach these outcomes, the document should determine a roadmap with the coherent criteria of success for every stage that corresponds with the long-run outcomes of the project. Also, it should define concrete quantitative and quality indicators to assess the achievement of short-term and long-term results. Clear and concrete criteria and indicators would improve the quality of monitoring and assessment of the project's results and would allow tracing the project's progress.

The number of state entities should also be decreased, when appropriate, through liquidation, mergers, or reorganization into shareholding companies. In order to avoid creating permanent subsidies, budget constraints should be tightened and SOEs' assets need to be cleared up.

Second—an issue emphasized by international experts—is the increase of disclosure. The lack of complete information on the actual total amount of state financing across different industries prevents an effective analysis of state industrial policies in China and Kazakhstan. The available data is usually limited by a particular sector or a group of investment projects. For instance, in Kazakhstan there is no

[558] Another illustration of an overwhelming quantity of formal documents is the legislation of the Republic of Kazakhstan. According to an analysis conducted by the National Economic Chamber of Kazakhstan "Atameken Union", 49 laws were approved, 45 of which - the laws amending the existing legislation, just for 10 months in 2012. 147 statues were adopted in 2011. This dynamic variability of the law raises questions about its effectiveness, presenting a serious challenge to conducting business activities in the country.

information on the exact amount of budget funds allocated to all the sectors through different instruments, nor is there a comprehensive study of the efficiency of such budget spending. Despite a great number of state programs, strategies and action plans issued by the Kazakhstani government, by state agencies, and by national companies on an annual basis, the data is typically limited to reporting on the implementation of these documents and putting the numbers on records, without an adequate examination of the outcomes of the entire system of state planning and spending. Therefore, with the exception of a few strategic state assets, the majority of SOEs can and should be fully transparent in terms of their investment strategy, portfolio allocation, risk management procedure, governance structure, and management reward system. For transparency and accountability, an external monitoring mechanism involving parliament, academics, and private sector representatives should also be set up.[559]

Third, decision-making in SOEs should be actually independent from politics.[560] Independent directors in corporate boards and supervisory committees may fulfill this function.[561] To guarantee their objectivity, the government shall establish a sufficient system of solid regulation. Competent corporate directors and professional managers should be appointed in accordance with their skills and work experience rather than their political affiliation and personal connections. From this viewpoint, the number of independent directors in corporate boards should be increased since management largely

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559 Felipe, J., & Rhee, C. (2013). Report to the Government of Kazakhstan. Policies for industrial and service diversification in Asia in the 21st Century, Asian Development Bank, October.

560 "To illustrate this notion of why the government has not intervened in the Temasek—Shin Corporation (of Thailand) business deal in January 2006, the Minister told Members of Parliament said that the government had not meddled with the Shin Corp-Temasek deal because it was not the government's job to do so. Temasek's board, which the government helps to appoint, has the discretion to decide how the investment arm's resources are allocated, which as Temasek's CEO Ho Ching explained, is strictly based on returns." From Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

561 The experience of SOEs around the globe demonstrates that such issues as a free-riding problem and soft budget constraints inherent in SOEs can be mitigated through independent and professional management. Indeed, there are many examples of SOEs in countries such as Singapore, France, Finland, Norway and Taiwan that are not just efficient in a narrow sense but also lead their country's economic growth through technological dynamism and export successes. see Su, D., & He, X. (2012). Ownership structure, corporate governance and productive efficiency in China. Journal of Productivity Analysis, 38, 303–318.

represented by government officials cannot be fully objective.[562] This means a qualitative expansion of the list of persons who will take over SOEs. In addition, state authorities should create the right incentives for SOE managers with respect to higher productivity of state assets through highly attractive personal benefits.

The arrangements mentioned above would ensure that there is a sufficient distance between political considerations and operational issues. It would also provide SOEs with an objective analysis of corporate performance and stronger legitimacy in the eyes of domestic and international constituencies. The separation of SOEs from politics does not preclude the governments from an opportunity to influence SOE activities and spending. The transfer of decision-making to independent directors does not constrain the government's powers as a shareholder. It does not imply that the government cannot exercise a general oversight over state assets.[563] Holding a stake in SOEs, the government is able to supervise the SOEs' operations, including the fulfillment of social programs, but through corporate governance means.

Fourth, the government must clearly define the non-profit objectives of SOEs with their

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[562] For example, in his testimony before the House of Financial Services Committee in the United States on 5 March 2008, Simon Claude Israel (2008), who was then Executive Director and Member of the Board of Temasek, told the US audience that the professional management team at Temasek comprised 40percent of non-Singaporeans at its senior level. This can be seen as an attempt to profile Temasek as a commercial entity on the basis that it is less likely for non-Singaporeans to serve Singapore's political interest in the hope of moving up the state hierarchy, particularly after the government has publicly pronounced the commercial orientation of Temasek. In a similar vein, Temasek appointed 11 individuals with diverse management background and industrial experience from the US, UK, Japan, China and India to sit on the International Panel. That there exist non-Singaporeans to provide advice on how Singapore's resources are to be allocated supports the government's claim that Temasek is commercially and independently run. See Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

[563] In this regard, the government of Singapore has relied on two main monitoring agents. "First, Temasek has to answer to the Minister for Finance who is tasked to monitor the management and performance of Temasek. It is well known that an important reason for the agency problem to arise is the information asymmetry between the principals and agents where the latter have better knowledge about their ability and actions than the principals. By appointing the Minister for Finance as the key monitoring agent, the agency problem may be moderated. The Minister stands a better chance of uncovering any improper practices since they have accessed to more information than other external monitoring agents such as the general public and credit rating agencies. Second, Temasek has to seek the approval from the Elected President of Singapore on its annual budget (to ensure that past reserves are not drawn without explicit approval from the president) and appointments, reappointments and/or removal of the board members or CEO. Together, they provide the necessary checks and balances, which are deemed important because there is still much secrecy about the operations of Temasek." From Sam, C-Y. (2013). Partial privatization and the role of state owned holding companies in China. Journal of Management & Governance, 17, 767–789.

subsequent approval by corporate boards. These objectives should be defined for a concrete period and/or a project in order to improve the efficiency of SOE economic planning. Good planning leads to better governance and higher profitability of SOEs, which, in turn, increase the revenue part of the state budget.

Finally, industrial and financial policy programs need financial participation of private actors, domestic and foreign, in order to share risks between the state and private sectors. Even though existing policy documents in Kazakhstan and China establish the opportunity for private firms to invest in industrial and innovation projects, the role of the private sector needs to be expanded. Moreover, foreign private investors should get the same level of access to the projects and information as domestic investors have. In this regard, the governments have to expand the list of approachable capital sources available for the private sector along with state financing and bank loans. Hence, further development of capital markets becomes essential. The conditions offered by these markets should be at least as favorable as bank financing. This means that the governments in China and Kazakhstan should create a fair and competitive market environment for all actors.

In conclusion, institutional shifts are never simple, and the final result of any transition remains unknown. On the initial stage of institutional formation, the governments in Kazakhstan and China took the lead of economic development, blurring the line between public and private. However, that period must eventually come to the end. As long as the markets of both countries develop and integrate with the international market, many of these problems become exacerbated by the interference of the "helping hand" that causes preferential treatment, conflicts of interests, corruption and limited competition.[564] The differential approach applied by the governments deepens disparities and distortions in economic performance across regions, industries, and enterprises since it implies the creation of administrative and capital barriers and other types of entry restrictions negatively affecting competition.[565] Having a

[564] Steinfeld, E. S. (2002). Moving beyond transition in China: Financial reform and the political economy of declining growth. Comparative Politics, 34(4), 379-398.

[565] Park, S. H., Li, S., & Tse, D. K. (2006). Market liberalization and firm performance during China's economic transition. Journal of International Business Studies, 37(1), 127-147.

privileged position of monopolies, SOEs inevitably eliminate any competition in their industries and, as a consequence, crowd out less sustainable private companies. At the same time, domestic companies can become too dependent on the state policies of financing and subsidizing. They can heavily rely on state support and choose free riding or prefer to leave the market meaning that, on the one hand, the market will downsize with the termination of state programs and, on the other hand, the amount of state expenditures and the burden on the state budget will increase.

Therefore, there is a real agenda to continue developing the capital markets in Kazakhstan and China and introducing alternative capital arrangements in order to grant market actors more opportunities to obtain financing and diversify risks. The share of government financing needs to be diluted and partly replaced by other capital sources. In this case, capital will be allocated among companies depending on their market advantages and performance. This does not mean that SOEs should disappear. Rather, it means that SOEs will have to equally compete with their private counterparts in the market, which, in turn, will call for the further modernization of the state sector, as well as for the reduction the number of SOEs in order to decrease transaction costs. In this context, many SOEs, including Temasek SWF in Singapore, have been successfully managed on a professional businesslike basis. Many experts argue that the experience of Singapore has demonstrated that SOEs, in general, can be governed on a commercial ground and staffed by competent professionals regardless of their connection with the authorities.[566]

Therefore, we may assume that for such transition economies as Kazakhstan and largely China, the process of transition does not imply the application of the traditional corporate governance approach, which requires the supremacy of developed private markets as the final outcome of transition. In other words, the process of transition can involve alternative approaches to understanding good governance and corporate efficiency, where SOEs perform an active role in capitalizing national economies and sustaining

[566] "Temasek, while fully state-owned, operates out of government influence. It is supervised by an independent Board of Directors, which largely consists of top businessmen of Singapore. The dominance over the political and economic systems of Singapore, make the Lee family feel comfortable with giving Temasek certain degree of autonomy. Moreover, approximately 40 percent of senior managers of Temasek and 30 percent of its professional staff were non-Singaporeans as of March 2007." From Elson, A. (2008). The sovereign wealth funds of Singapore. World Economics, 9(3).

economic growth. From the perspective of the public good approach, the governments will still have to fulfill certain social objectives including macroeconomic sustainability, national industrial development, and social stability. Therefore, state ownership will remain a significant peculiarity of Kazakhstan and China. However, as long as the capital markets develop, SOE will continue evolving and concentrating in strategic industries, where the state has to preserve control. Consequently, we may expect the establishment of different sets of institutions depending on the role of a particular sector for the national economy.[567]

[567] For the similar assumption see Pearson, M. M. (2005). The business of governing business in China: Institutions and norms of the emerging regulatory state, World Politics, 57(2), 296-322.

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