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The Local Government in Corporate Restructuring: Case Studies in Fractured Bargaining Relations

LIN Kun-Chin and CHEN Shaofeng

Abstract: Through two illustrative case studies of enterprise reform in Henan Province, we examine the underlying political contentions behind the changing roles of local government in the process of the corporatization and asset restructuring of state-owned enterprises (SOE) starting in the late 1990s. As SOEs lose their ability to meet the multitude of resource demands from central and local officials, they become sites of inter-governmental contentions resulting in fiscal and social uncertainties for affected communities exiting the socialist economy. Our first case study is Puyang municipal government, which leveraged its regulatory authority to exact heavy side-payments in return for not obstructing the corporatization of Zhongyuan Oilfield; the second case involves Zhengzhou city officials colluding with provincial bureaucrats and the state-appointed managers of the Yutong Bus Company in an insider privatization that effectively circumvented a specific Ministry of Finance prohibition.

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Introduction

Chinese state-appointed enterprise managers have conducted property rights experimentation since the late 1980s when central policies encouraged state-owned enterprises (SOE) to develop a "tertiary sector" (第三产业, *di san chanye*). These early efforts largely failed for the reasons of limited economic opportunities in local markets, endemic exploitation of the soft-budget constraints of the parent SOE by the subsidiaries or affiliated companies, and typical managerial opportunism in achieving policy objectives without creating viable new businesses. Over time, the value of the state-owned assets and the productivity of the workforce declined in a prolonged process of asset-stripping through ineffective spin-offs (Ding 2000). Renewed efforts towards privatization in the late 1990s, combined with a clearer delineation of property rights and hardened financial constraints, attempted to address some of the earlier pitfalls. While Beijing and local officials, in principle, share an understanding that the overarching objective of privatization should be the sustainability of the newly restructured companies, in the hope of avoiding the relentless social and political pressures of layoffs, their operational paths often deviate. This central-local contention over the implementation of restructuring is at the root of the mixed record of enterprise reform in the past decade.

The fundamental dynamics of this contention changed in the mid-1990s, producing an associated shift toward irreconcilable differences between central planners and local officials. SOEs as socio-political organizations could no longer resource the "particularistic contracting" (Shirk 1993) required to help both sides meet their core objectives. This is not primarily a matter of the ruthless efficiency logic of the market. Instead, we argue that policy factors centred on fiscal and organizational recentralization have undermined this institutionalized equilibrium since the first two decades of reform. As a result, the structural conflict of interest between central and local government inherent in enterprise reforms began to be played out as a zero-sum game. Starting in the late 1990s, local officials began to make demands on the outcome of restructuring which effectively undermined Beijing's objectives. While the nominal purpose of local government action was the preservation of the stability of the local economy, the real agenda invariably addressed local governments' inability to resolve deep resource dependency on the dominant enterprises in their jurisdictions for the provision of a wide-range of public and private goods and services for officials.

We provide two illustrative case studies[1] from Henan Province. The first case involves a municipal government exacting excessive side-payments in return for not obstructing the ownership transformation of the dominant, centrally-owned enterprise in the locality. Having had its influence in the Zhongyuan Oilfield (中原油田, *Zhongyuan youtian*) greatly reduced through a corporatization process engineered from Beijing, the Puyang municipal government (濮阳市人民政府, *Puyangshi renmin zhengfu*) increased tax and non-tax extraction as a means of making adjustments in its favour in local government-business relations. The second case examines provincial and municipal officials going beyond defensible positions to facilitate an insider privatization of a major transport equipment manufacturer that most likely lined the private pockets of rent-seeking managers. Specifically, Henan provincial (河南省) and Zhengzhou municipal (郑州市) officials sponsored a creative legal process to circumvent a Ministry of Finance prohibition on the management buy-out (管理层收购, *guanliceng shougou*, MBO) of Yutong Bus (宇通客车, *Yutong keche*). In both cases, the central government in Beijing and the local governments resorted to increasingly coercive means in order to deny the other party's claim over SOE resources with the result that the target enterprise was pulled in different directions, thus diverting capital from productive uses or even redistributing it to the broader local constituency. Thus, the inter-governmental zero-sum game produced a no-win situation for the SOE and greater uncertainties for the community exiting the socialist economy.

Local Government and Corporate Restructuring

Research on the role of the state in economic development typically revolves around the question of "what kind", not "how much" (Evans

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1995: 10). Public and policy debates often take on a dichotomous characterization. On the one side are those who argue for a developmental image, stressing that the local governments of China play a constructive role in promoting economic growth (Segal and Thun 2001; Zweig 1994). Given China's paucity of natural resource endowments and underdevelopment in capital accumulation and technical innovation capability, both of which are requisite factors for economic growth, Cheung (2009) underscored the importance of inter-government competition at the subnational level in propelling economic growth. Jean Oi (1999) stressed that local governments acted in an entrepreneurial manner and were proactive in supporting local collective enterprises. Subsequent scholarship has identified regional variations corresponding to increasing disparities in the pathways toward marketization and state functions in welfare provisions (Hurst 2004; Tian and Tian 2009). Cautioning against taking a deductive approach to predict the incentives or commitment of local officials to support marketization, several studies emphasize the structural variables of the local political economy and the learning process of officials in shaping local state responses to fiscal and administrative decentralization (Chung 2000; Treisman 2006; Treisman and Cai 2006).

On the other side is the image of the predatory local state that extracts economic rent from local capital and preys on its own constituents (Lu 2000; Pei 2006). In reform-era China, the insider control problem prevalent in local SOEs largely resulted from the tacit collusions between local supervising bodies and the SOE managements (Zhang and Yao 2002; Xu and Wang 2005). Zeng, Huang and Huang (2008) argued that China's periodic macroeconomic overheating derives from the excessive investments of certain sectors that are susceptible to local governmental influences. The resulting inflation, capital misallocation, and loss of value of state assets have undermined the productivity of the state sector and the livelihood of those who depend on it. In the literature on peasant burden, the lagging development of inland, rural regions is blamed on the multitude of legitimate and illicit extractive activities of the government at different levels (Lu 1997). In both scenarios of over- and under-investment, localities make decisions on capital formation that run counter to the general public interest while pursuing leading cadres' self-interests. Even with recent drives to institutionalize regulatory capacities and the public-service orientation of local governments, especially in urban areas, it is likely that officials will not become "neutral" (Burns 2000) toward the thorny task of the property rights transformation of enterprises under their jurisdiction.

Clearly, the dichotomous images of the developmental and predatory state are inadequate for capturing the crucial dynamics of give-and-take between central and local government as they struggle to divide up and assert proprietary rights over resources in the state sector (Shue 1988). Confronting an administrative space of fragmented lines of monitoring, supervision and accountability, vague policy guidelines, and an inherent balancing act in setting developmental and social stability priorities, local officials have parlayed their microeconomic directives in the past into leverages in the course of policy implementation and regulatory enforcement. While achieving nominal compliance to central mandates, local governments may seek to obtain from the enterprises informal arrangements to protect their fiscal standing and local business interests, or they may collude with the enterprises in formulating a legitimate counteraction to the central regulators' pressures.

We are mindful that there exists a broad range of possible strategic interactions among the central government, local states, and state-owned enterprises (Hannan 1998; Steinfeld 1998; Jefferson and Singh 1999; Jefferson and Rawski 2002; Jefferson and Su 2007). We argue that since 1990s these interactions have taken on a zero-sum game dynamic as SOEs became defunct as a site of interest mediation and were streamlined into an organizational vehicle for channelling capital to proprietary stakeholders. Underlying this process is the degeneration of two forms of contracting that have been well studied by scholars: "particularistic" (Shirk 1993) and "relational" (Solinger 1998) contracting. Until the mid-1990s, it may be generalized that state-owned enterprises offered unique benefits to local officials in the forms of economic rent, bribery and a safety net for local development, which was made possible by the institutional framework of the managerial responsibility system (MRS) and the inter-firm networks that established resource exchange to meet various official demands for extra-production, discretionary capital (Lin 2011b). In short, the complex political economic phenomenon known as the "soft-budge constraint" (Kornai 1992) of SOEs had underpinned local government autonomy in setting developmental priorities and counteracting Beijing's demands for policy implementation. However, former premier Zhu Rongji's campaign of privatization of SOEs and market consolidation of pillar industries in the late 1990s effectively ended the MRS as a universal incentive structure tied to limited enterprise autonomy from central planning and severely disrupted the local inter-firm and government-business networks (Lin 2006, 2011b). Consequently, intergovernmental bargaining dynamics have undergone a wholesale change.

Specifically, by the end of the decade, the power struggle over SOE reform had ended rather badly for local officials. In the early 1990s, they had controlled the reform policy agenda and implementation process as the chief beneficiaries, along with the SOE managers, of a decentralized approach to restructuring that allowed localities to take advantage of "recombinant property forms" (Stark 1996) and lax availability of bank loans (Lardy 1998) to expand their overall assets and tap the vast market demand, but they faced radically different constraints in the late 1990s. By the time of the Asian financial crisis of 1997–1998, both local governments' deficits and the scale of SOEs' indebtedness had reached crisis levels. Premier Zhu's *sannian tuokun* (三年脱困) or "Three Years Out of Trouble" campaign, which gave enterprises three years to get out of their financial predicament, aimed to recapitalize SOEs and indirectly shore up banks' balance sheets. In effect, it pushed most SOEs toward outright privatization and prepared select SOEs in strategic industries for restructuring and public listing. For the select SOEs, Beijing imposed an internal governance structure that installed centralized financial controls over subsidiaries and managers. Priority listing in the booming stock markets at home and abroad, and state-protected monopolies or oligopolies represented the material reward to the SOEs, as well as the basis of a new form of their privileged dependency on the central state in Beijing, as opposed to their previous interdependence on both sets of central and local political patrons. The improved state exercise of property rights has paid dividends in the past decade as monopolistic SOEs have reaped the benefits of a consolidated market and enhanced clout in political and regulatory realms (Nolan 2001; Ning and Sutherland 2010; Guest and Sutherland 2010).

Zhu's enterprise reforms denigrated the local state's role as the key broker of SOE capitalization. Centralized corporate governance entailed centralized lending, accounting, and subsidization practices. This shift in relative power was deliberate on the part of the central planners, who aimed to reverse two decades of the erosion of their control over state assets due to decentralization and marketization. The recentralization of property rights followed on from and was supported by concurrent fiscal and administrative reforms. Since the 1994 tax reform, local governments have shouldered the lion's share of major public goods provision within their jurisdictions without gaining substantial revenue autonomy (Shen, Jin and Zou 2012). At the same time, the cadre evaluation system, despite the incorporation of energy intensity, pollution targets and other criteria into this system, remains growth-centred. To achieve the output growth targets, local officials face escalating pressures to extract and hoard financial resources to help build up their performance (政绩, *zheng-ji*) (Cheng, Zheng and Chan 2012: 136; Zhou 2005; Zhou 2007). At the same time, Beijing has attempted to strengthen cadre management by beefing up its "vertical administration" (Yang 2004: 65–109).

Nevertheless, while local governments saw the reduction of their formal stakeholder role in the SOEs, they often situated themselves in a more advantageous position in manoeuvring the bargaining game for reform vis-à-vis Beijing and the SOEs. As reform drove up the failure rate of SOEs and the number of unemployed and temporary workers, the welfare functions of the local government gained importance. The mandatory transfer of non-production units such as hospitals and schools to local government became bargaining chips for officials to exact compensation from the SOEs. New regulatory issues such as environment, and health and safety also played into local officials' hands in terms of selective enforcement based on a mutual understanding. In short, local officials took advantage of the continued "embeddedness" of the restructured firms in the local market and regulatory contexts to exact reform outcomes that were protective of their interests (Lin 2006).

A great deal of scholarship has documented local statist pressures on SOEs to sustain the existing workforce and workplace-centred welfare regimes (Gold, Hurst, and Won 2009; Kuruvilla, Lee and Gallagher 2011). Much less has been written about the local political pressures on managers' choice of a particular pathway or vehicle for enterprise restructuring. While Beijing seeks to defend the value of state-owned assets by imposing a standard template for shareholding conversion and centrally-monitored procedures for public listing, local states pursue their own conception of value-added reform by introducing a coalition of managers and outside board members amenable to insider privatization. The next sections address these strategic choices and divergent outcomes through the case studies of the Zhongyuan Oilfield (中原油田) and Zhengzhou Yutong Bus Corp. (郑州宇通汽车公司) in Henan Province.

Holding Central Enterprises Hostage: Puyang Municipal Government's Demand on the Zhongyuan Oilfield

In the fall of 1998, the then Chinese premier Zhu Rongji directed the Chinese oil and petrochemical sectors to reconsolidate all assets and operations under three integrated and territorially protected national oil corporations (NOC) in which the state held the controlling shares (Lin 2006). The restructuring of oilfields and petrochemical industries in the period 1998 to 2000 was not only the largest asset reallocation event in the reform era, but also the most successful one, when measured in terms of the scope and speed of reform implementation and subsequent financial returns and international expansion (Lin 2011a). The restructuring of the NOCs for public listing could have become a highly contentious process, given the organizational complexity and the large numbers of work units and employees concerned. Thus, Beijing insisted on corporate reform taking place at a lightening pace that would shock the local managers and officials into immediate compliance (*Jingji Ribao* 1998).

Nearly all state-owned oilfields, refineries, and petrochemical plants were incorporated into one of two onshore NOCs: Sinopec (中石化, *Zhongshihua*) and CNPC (中石油, *Zhongshiyou*); henceforth, the NOCs' corporate headquarters in Beijing managed these subsidiaries under a highly centralized multidivisional form of corporate governance (Lin 2008b). At the microeconomic level, Beijing imposed strict financial controls that aimed to generate profitability for the core subsidiaries by concentrating the most valuable assets and creating a relatively lean workforce drawn from the former petroleum administrative bureau. The bulk of the unprofitable assets and workforce, including those work units involved in production and technical services and the provision of social services and local public goods, were lumped together under the noncore companies. As independent legal persons, the core subsidiaries obtain technical and production services from the noncore companies through contracts at variable rates of payment for a fixed amount of work, thus ensuring the financial success of the former.

The most significant non-participant in the new contractual relations redefining the corporatized SOEs was the local government. It no longer had a formal, regular, or socio-politically legitimate role in the production and investment decisions of the firm. Under the tight financial rein of the corporate headquarters, Sinopec and CNPC oilfields and refineries reduced their bartering and supply relations with local firms and borrowing from local banks, hence drastically reducing the intermediating role of local officials (Lin 2011b). In annexing an ex-CNPC unit into its asset profile, Sinopec emphatically disregarded previous downstream, distribution, and marketing relations that had been assiduously cultivated by Zhongyuan managers to expand the oilfield's extra-plan businesses. Instead, new regional networks established by the corporate headquarters in Beijing took over these functions, deflating the Zhongyuan Petroleum Bureau (中原石油管理局, *Zhongyuan shiyou guanli ju*) into a supplier within the Sinopec conglomerate.

At the same time, however, the local state was expected to shoulder the responsibility of providing employment opportunities for an increasing number of laid-off workers, to which the restructuring SOEs contributed a sizeable pool (Wong and Flynn 2001; Chow 2000; Chow and Xu 2001). This deliberate abdication from welfare and public goods provision by large, centrally-controlled firms has prompted local officials to leverage their fiscal and regulatory authority in exacting additional side-payments in return for cooperating with the restructuring of SOEs. In doing so, local governments wield authority over land use and real estate, key personnel appointments of managers and Party secretaries, local taxation, personnel files and residential permits, and select targets on aggregate industrial profit, environmental protection, layoff quotas and labour regulations. In effect, the local officials are able to hold captive the noncore managers who have no recourse but to make concessions if they want to hold onto any hope of success in restructuring.

In effect, the local officials offer cooperation at a high and undefined cost to the managers. The logic tacitly accepted by Beijing is that local transition mechanisms are needed to extricate the SOEs from their historical function of supporting various productive and bureaucratic resource needs, otherwise certain mass discontent and moral economic disruption would ensue. While it is necessary and often in the interests of both parties to work together for a welfare-enhancing solution for the local community, local governments frequently adopted more insidious options. Facing the decline of the main industry in the locality and a lack of viable alternatives for tax-base diversification (many of the oilfields and petrochemical plants were located in a one-factory town with few commercial links to the outside), local governments reacted out of an impending sense of fiscal crisis and a sense of their underdeveloped welfare functions. Two frequent outcomes were the continuation of enterprise provisions contrary to the restructuring guidelines, and local government's *ad hoc* requests for tax and nontax payments (Lin 2008a).

Zhongyuan Oilfield, the second largest oilfield by output in the restructured Sinopec Group, was unable to meet the reform directive to divest noncore businesses, due to compromises with the Puyang municipal government. For example, in transferring education and healthcare operations to the local government, the Zhongyuan Oilfield should have been able to reduce its workforce by 4,800 and 2,200 workers, respectively. As part of the restructuring agenda and general administrative reform in the late 1990s, Beijing had been calling for the transfer of these functions from the work unit to the local government. However, the local government insisted that it would have to charge 100 million CNY in subsidies from the oilfield for taking over these units, a substantially larger sum than the around 90 million CNY per year that Zhongyuan had been spending in the early 2000s to run these units. Meanwhile, the central state and the corporate headquarters had essentially washed their hands of any responsibility to participate in the negotiation of the prices for providing these non-production related functions. Facing proximate sociopolitical pressures and weak support from Beijing in the bilateral negotiation with local officials, Zhongyuan hesitated to force Puyang municipal government to accept these assets (Anonymous 1).

This haggling over the financial implications of reform was also evident in the post-restructuring arrangements for local-enterprise tax relations. In the early 2000s, the Zhongyuan Oilfield contributed between 700 million and 800 million CNY in tax per year, or about 95 per cent of the locality's total income from taxation (Anonymous 1). Additionally, it provided subsidies to the Puyang municipal government for pension funds and financing for education and medical facilities. Somewhat surprisingly, taxation on the oilfield escalated after the 1998–2000 restructuring. Puyang continued to charge turnover tax based on the quantity of oil processed, while introducing new taxes on the service contracts between the core company and the noncore companies. Ironically, the conversion of previously internal transactions into legal contracts facilitated documentation, monitoring and auditing, and therefore taxation by the local officials. In fact this was not the first time that Puyang had creatively taxed intra-firm transactions. In the mid-1990s, when Zhongyuan experimented with "internal marketization" through a system of competitive contracts between pseudo-legal entities within the petroleum administrative bureau, the local government sought to impose a tax bill of some 50 million CNY on these new transactions. At the time, the enterprise managers negotiated a reduction in the official demand with blanket promises of added local political economic contributions once the gains from the reforms were forthcoming. The shared expectation of dividing the spoils of enterprise prosperity was not in evidence in the early 2000s, however, prompting local officials to take a predatory stance toward managers.

The Puyang municipal government also played hardball with Zhongyuan Oilfield in increased non-tax and irregular extractions. Understandably fearing that the Beijing corporate headquarters would be inclined to end the common practice of allowing local firms to access SOEs' energy supply, Puyang blackmailed Zhongyuan into selling natural gas to local enterprises at ridiculously below-cost prices. While the unit cost of natural gas was about 0.50 CNY and was sold internally within the Sinopec group for around 1.40 to 1.60 CNY per unit, Puyang obtained the supply of gas from Zhongyuan for over 100 local enterprises at just 0.40 CNY per unit. To obtain this deal, the municipal government threatened retaliation for price increases by sending teams to investigate the enterprise's "violations" of workplace safety and environmental protection standards. Being rational economic actors, SOE managers eventually figured that it was more economical to provide gas at sub-cost than to endure constant harassment and uncertain cost proliferation from levies and penalties. One Zhongyuan manager sardonically observed:

> In the past, local enterprises used to just *steal* gas by tapping the pipeline. Now, they can legitimately *buy* it at sub-cost prices through their official patrons (italics added).

Many of these local enterprises were town and village enterprises that sought to boost their profitability through input subsidies, which in turn lined the pockets of local officials (Anonymous 1).

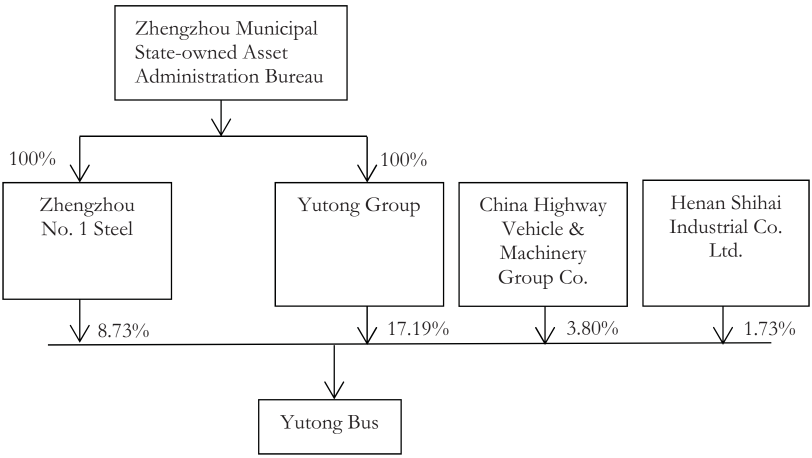
Land use frequently becomes a prime area of regulatory intervention and bargaining between localities and restructured enterprises. In the case examined, Zhongyuan had intended to build a Commerce and Trade Centre on a site formerly designated for the Geology Museum, which was never constructed due to its obvious lack of commercial value. The local government seized this chance to threaten the oilfield with a penalty fine of 50 million CNY for violating the zoning code. A heated haggling process ensued, out of which the penalty was reduced to 15 million CNY and then waived by the local officials on the condition that Zhongyuan build a luxury hotel on behalf of the local government as the property owner. In addition, Zhongyuan would manage the hotel and bear the entire operational cost for the first ten years, during which time local officials would enjoy the use of the hotel for free. At the end of the first ten years, the hotel would revert to local government management. Predictably, the hotel was sited in a secluded part of the town and incurred an operational loss of 500,000 CNY per year in the early 2000s. To prevent the enterprise from defecting from the bargaining game, the local government stipulated that if Zhongyuan were to abandon management of the hotel, it would have to pay 1 million CNY per year as a penalty, until the ten year period had ended. Rationally, Zhongyuan continued the operation of the hotel to the detriment of its commercial and reform objectives.

Getting around Beijing's Prohibition: Zhengzhou Government's Support of the Management Buyout of Yutong Bus

The second case study, which pertains to the management buyout (MBO, a form of acquisition where a company's existing managers acquire a large part or all of the company) of a SOE, aims to show how local governments, under the strong lobbying activities of a coalition of state-appointed managers, connived to circumvent central government policies and regulations. The local governments in this case refer to Henan provincial government (河南省政府, *Henan sheng zhengfu*) and Zhengzhou municipal government (郑州市政府, *Zhengzhou shi zhengfu*), and the SOE concerned is Zhengzhou Yutong Group Co., Ltd. (郑州宇通集团公司, *Zhengzhou Yutong Jituan Gongsi*, hereinafter referred to as Yutong Group) and its listed part Zhengzhou Yutong Bus Co., Ltd. (Yutong Bus, 郑州宇通客车股份有限公司, *Zhengzhou Yutong Keche Gufen Youxian Gongsi*).

As a local SOE in Zhengzhou city, Henan Province, the Yutong Group is one of China's top 500 enterprises. Yutong Bus, with a daily capacity of over 170 finished buses, has become China's largest bus manufacturer with an annual sales volume ranked second worldwide to that of Mercedes-Benz. In 1993, Yutong Bus was corporatized and in 1997 it launched its initial public offering on the Shanghai Stock Exchange, becoming the first listed company in China's bus manufacturing sector. Its largest shareholder became the Yutong Group after the Henan provincial government approved a share transfer from the Zhengzhou Municipal State-owned Asset Administration Bureau (郑州市国有资产管理局, *Zhengzhoushi Guoyou Zichan Guanliju*, ZMSAAB) in September 1999. Before the launch of Yutong Bus's MBO in 2001, the Yutong Group held 17.19 per cent of company equities, as shown in Figure 1.

Figure 1: The Equity Structure of Yutong Bus Prior to the MBO (at 31 December 2001)



Source: Zhu, Chen and Yu 2006: 115–129.

The Yutong Group expanded and diversified rapidly in various vehicle manufacturing and engineering services. Concurrently, its financial and managerial core gained cohesion and concentration. March 2001 saw the establishment of Shanghai Yutong Venture & Investment Co. (上海宇通风险投资公司, *Shanghai Yutong Fengxian Touzi Gongsi*, Shanghai Yutong), in which Tang Yuxiang, the CEO of Yutong Bus, joined the 20 other members of the Yutong Bus management to hold 73.26 per cent of Shanghai Yutong's shares.

Between March and October 2001, Yutong Bus submitted its application for a MBO to the Ministry of Finance (财政部, *Caizhengbu*, MoF). The Ministry deferred approval of this application despite intense lobbying by the Henan provincial and Zhengzhou municipal governments. By the end of 2001, it had become clear that the Ministry was anticipating a general shift of policy direction on MBOs, as central policy-makers in Beijing expressed grave concerns for emerging evidence that MBO did not lead to significant improvement in operational efficiency and profitability in the majority of MBO cases. In the typical scenario, the management took advantage of such opportunities to rake in enormous profits for themselves as the new shareholders. In essence, the state was rapidly losing value on its assets as MBOs turned into a massive asset-stripping bonanza.

Progressively from 2002 to 2005, central regulators issued further prohibitions on managers taking on shareholder positions. In October 2002, the MoF publicized a notice stipulating that any change of state-owned equities of a listed company must be sanctioned first by the MoF before the company's board would be allowed to apply for a revision of registration at the securities registration and settlement companies. After the State-owned Assets Supervision and Administration Commission of the State Council (国有资产监督与管理委员会, *Guoyou Zichan Jiandu yu Guanli Weiyuanhui*, SASAC) was established in 2003, the above regulatory functions were transferred from the MoF to the SASAC. As the nominal owner of state assets, the SASAC has direct responsibility for preserving the value of these assets. In 2003, SASAC issued statements prohibiting the management of a company targeted for management buyout from intervening in matters directly affecting the transfer of state-owned property rights, such as audits, asset evaluation, and base price determination, etc. In the process of fundraising, the management is prohibited from borrowing money from state-owned and state-holding enterprises including their own enterprises, or from using these enterprises' state-owned properties or physical assets for the purposes of guarantee, mortgage, collateral, discount, and so on (*Xinhua* 2003).

Sensing an unfavourable wind of change, the management of Yutong Bus decided to proceed with the MBO despite the withholding of approval by the MoF. On 15 June 2001, Shanghai Yutong signed an agreement on transferring the equities of Zhengzhou Yutong Group Co. Ltd. with ZMSAAB, in which the municipal bureau transferred 89.8 per cent of the Yutong Group's equities to Shanghai Yutong at a price of 96.87 million CNY, with the remaining 10.2 per cent equities being allocated to Henan Construction Investment Management Co. Ltd. All three parties agreed that as soon as they received permission for this equity transfer from the MoF, they would file the change of registration procedures at the Zhengzhou City Industrial and Commercial Bureau (郑州市工商行政管理局, *Zhengzhoushi Gongshang Xingzheng Guanliju*). On 6 August 2001, Shanghai Yutong made its payments to ZMSAAB for the acquired shares. This meant that ZMSAAB had entrusted Shanghai Yutong to manage the equities of the Yutong Group and allowed it to make profits from the management. To all practical senses and purposes, the Yutong Group was treated as a private enterprise by local government. However, as the MoF continued to refuse to issue its approval of Yutong Bus's MBO application, by the end of 2003, the trilateral deal fell into stagnation.

With the aim of downsizing the asset value of the target of the management buyout, the management of Yutong Bus cooked up false bookkeeping accounts and bank statements to show a significant reduction in the company's assets and liabilities (Liu 2003). This was discovered by the China Securities Regulatory Commission (证监会, *Zhengjianhui*, CSRC). In October 2002, the CSRC imposed a penalty on Yutong Bus for falsifying financial statements in 1999. On 3 December 2003, with the prospect for the approval of the MBO dimmed by the investigation, Shanghai Yutong decided to sue the Zhengzhou City Bureau of Finance (which merged the functions of ZWSAAB later) for the latter's failure to complete the equity transfer from ZWSAAB, and to seek a refund of payment for its share of 89.8 per cent of the Yutong Group's equities.

A few days later, the Zhengzhou Municipal Court issued a judicial verdict that froze all the Yutong Group equities held by the Zhengzhou City Bureau of Finance and entrusted an auction agency to conduct a public auction of those equities. On 29 December 2003, Shanghai Yutong won 90 per cent of the Yutong Group's equities for the price of 148.5 million CNY at the auction held by Zhengzhou Auction Co., with the remaining 10 per cent of the equities going to Zhengzhou Yutong Development Co. Ltd. (郑州宇通发展有限公司, *Zhengzhou Yutong Fazhan Youxian Gongsi*). The very next day saw the Zhengzhou City Industrial and Commercial Bureau complete the paperwork for the registration changes at the People's Court of the Erqi District of Zhengzhou (郑州市二七区人民法院, *Zhengzhoushi Erqiqu Renmin Fayuan*), making official Shanghai Yutong's new ownership of 90 per cent of the equities of Yutong Group in Yutong Bus. As a result, the ownership of the Yutong Group was transformed from state to private through legal channels (Zhang and Yang 2004). On 5 January 2004, the Shanghai Branch of the China Stock Registration and Settlement Co. Ltd. changed the nature of

23.5 million shares in Yutong Bus originally held by the Yutong Group from state-owned corporate shares to privately-owned ones. The board of Yutong Bus issued a report concerning this acquisition to its shareholders on 15 January 2004, bringing the MBO process to an end.

However, the auction process described above was highly suspicious for a number of reasons: firstly, the board of directors of the Yutong Group defied CSRC regulations by not conducting the timely disclosure of information about important matters such as the lawsuit launched by Shanghai Yutong against the Yutong Group, the fact that the Yutong Group's equities were frozen by the court, the court's intention to auction off the frozen equities of Yutong Group, and so on. Secondly, the Zhengzhou City Auction Company (郑州市拍卖总行, *Zhengzhoushi Paimai Zonghang*) announced the public auction in a small local newspaper, the *Henan Daily* (河南日报, *Henan Ribao*), rather than in a large national newspaper designated by the CSRC, such as *China Securities* (中国证券报, *Zhongguo Zhengquan Bao*), the *Securities Times* (证券时报, *Zhengquan Shibao*), or *Shanghai Securities* (上海证券报, *Shanghai Zhengquan Bao*). Thirdly, only two bidders participated in the public auction: Shanghai Yutong and Zhengzhou Yutong Development (see Qing 2004; Zhang Chunzi 2004).

It is clear that the primary beneficiary of the MBO was the coalition of managers at Yutong Bus, particularly the CEO Tang Yuxiang, whose rise to CEO position in July 2001 enabled him to concentrate various political and financial powers and to set the stage for the MBO. Under Tang, a group of managers established insider control of Yutong Bus. The board of directors of Yutong Bus was composed of nine people. Aside from three independent directors and Meng Xuanxin, representing the China Highway Vehicle & Machinery Group Co. (中国公路车辆机械总公司, *Zhongguo Gonglu Cheliang Jixie Zonggongsi*), the other five board members were concurrently high-ranking managerial staff in Yutong Bus and major investors in Shanghai Yutong. Furthermore, Tang acted as the CEO and corporate representative in person at Shanghai Yutong. Of the 23 nominal shareholders in Shanghai Yutong, 21 were from the management of Yutong Bus. Tang held a 24.29 per cent stake in Shanghai Yutong which translated into a 3.84 per cent holding in Yutong Bus (Li 2006). In the two years leading up to the MBO, Tang lifted the salary cap on senior managers and allocated handsome profit-sharing and dividend payouts to them to build up a war-chest for the MBO (Li 2006). In order to raise money for the MBO, Yutong Bus decided to pay cash dividends of 6 CNY for every ten shares to its shareholders in July 2001 and April

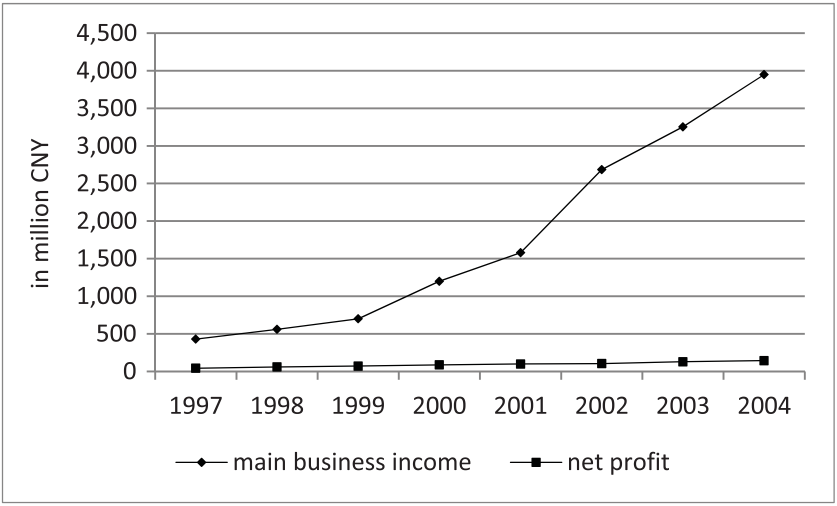
2002, respectively, even though the company's earnings per share in 2001 was only 0.72 CNY. After the two payouts, the management had received a minimum of 28.2 million CNY, accounting for 20 per cent of the costs of the subsequent MBO (Jiang 2009). Through these preparatory steps, the Henan and Zhengzhou governments offered their blanket political support to Tang and the company.

Their support is best illustrated by the various honours and awards that Tang continued to receive even after the Shanghai stock regulators' investigation into the falsified accounts at his company in 1999. These included, such accolades as being named as one of "Zhengzhou's Top Ten Young Entrepreneurs", as one of "Ten Outstanding Newsworthy Individuals in the Henan Province", as a "Model Worker in the Henan Province", and receiving a First-class Merit Citation from the Zhengzhou municipal government. Tang was also elected as a delegate for the seventh Party Congress in Henan Province, as well as a delegate to the National People's Congress in 2003.

It is evident that the legally contrived MBO could not have been completed without the tacit cooperation of the local governments. The Zhengzhou municipal and Henan provincial governments were counting on Yutong's management to promote local interests. Building on its success in the competitive vehicle manufacturing industry, Yutong Bus was able to spur the growth of local related enterprises, promoted local employment and expanded local tax bases. In 2000, the second largest shareholder in Yutong Bus, the Zhengzhou No. 1 Steel Factory (郑州第一钢厂, *Zhengzhou Diyi Gangchang*), was in urgent need of capital to resolve operational difficulties and subsequently signed an agreement for a share rights transfer with a Beijing-based investment corporation. The Zhengzhou municipal government blocked the deal, and instead initiated the privatization of the state shares in the company (Zhu 2004). The local government was motivated by the prospect of several short-term gains, primarily the conversion of stock to cash and the potential use of the money to compensate laid-off workers from a local textile industry. The sales attracted over 20 domestic securities trading companies, including the Sanjiu Group, all of which wanted to acquire a majority shareholder position. However, the Zhengzhou municipal government was suspicious of these traders' lack of experience in the bus manufacturing industry, as well as their capability and willingness to further invest in Yutong Bus. It figured that only with a bus manufacturer in control would the original firm be retained in Zhengzhou and further expanded so as to generate more job opportunities and broaden the local tax base.

The management and workers of Yutong Bus shared the concerns of their political patrons; hence together they turned to a MBO as a means of securing the company's future and their job security (Hou and Yu 2001: 7). The management team of Yutong Bus had already gained credibility with the local government for turning around the chronically indebted Zhengzhou Bus Factory and making it a successful conglomerate of Yutong Bus. Headed by Tang Yuxiang and Lu Farao (Hou and Yu 2001), Yutong Bus yielded the highest financial returns in China's automobile manufacturing industry in 2003. As shown in Figure 2, Yutong's core business income and net profit rose from 430 CNY and 42.6 million CNY in 1997 to 3.25 billion and 128.3 million in 2003, respectively.

Figure 2: The Main Business Income and Net Profit of Yutong Bus



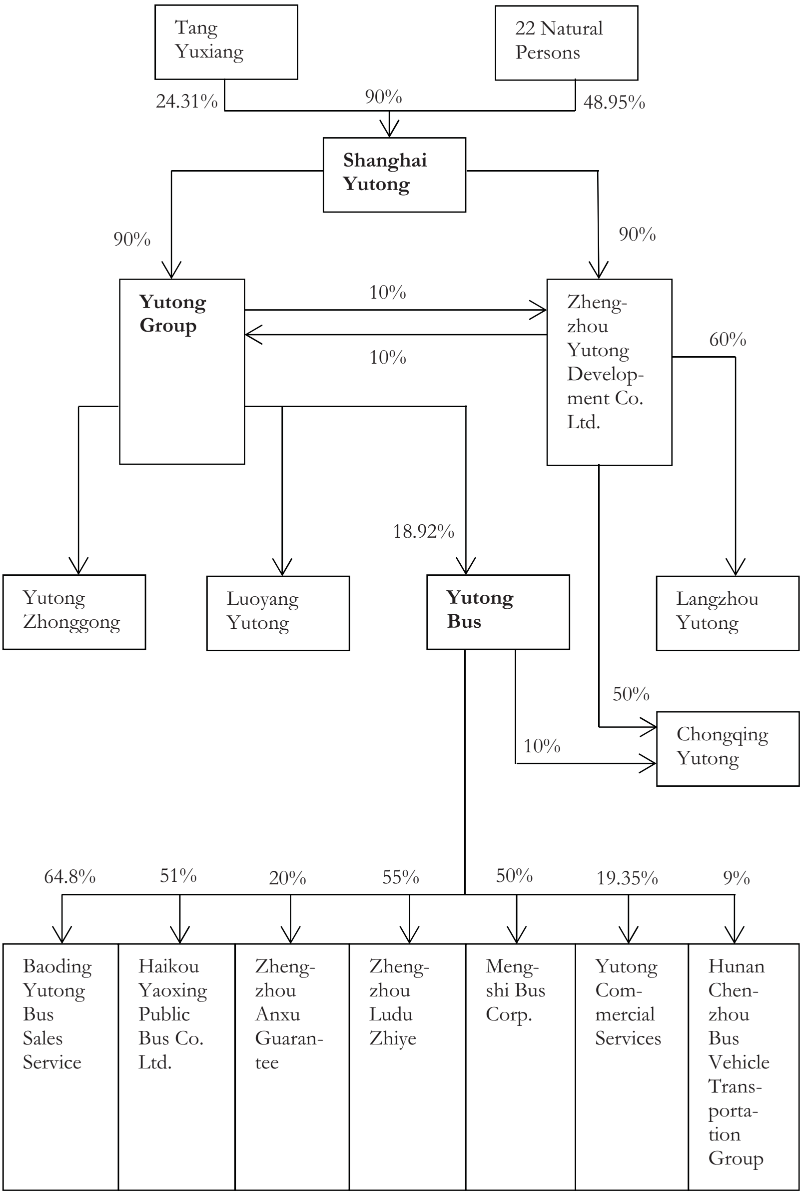
Source: Zhengzhou Yutong Bus Co., Ltd. various years.

In case the MBO had failed, local officials foresaw that the management of Yutong Bus would likely lose the motivation to engineer the firm's expansion and profitability. Moreover, Tang and his company might use their insider control position to capture the interests of the listed company, and possibly shift its core assets and business operations to its affiliated companies under more direct and complete managerial control. In the worse case, the management might relocate Yutong Bus away from Zhengzhou or even Henan Province. Given that vehicle and parts manufacturing is a relatively mobile business with low asset specificity, this would be a credible threat. In fact, the rapid expansion of Shanghai Yutong through its subsidiaries Lanzhou Yutong (兰州宇通) and Chongqing Yutong (重庆宇通) (see Figure 3) rendered this prospect quite probable.

As a matter of fact, the local governments' abovementioned worries turned out to be well-founded in light of the operational changes made by Yutong Bus after the MBO, with regard to ways to control earnings and raise funds, setting up purchasing centres in various regions, increasing related cross-border transactions within the group, and so on (Zhu, Chen and Yu 2006). Hence local governments were likely to have been under duress from the management of Yutong Bus to accept their lobbying for a MBO. By engineering a legal pathway around the administrative procedures, they helped Shanghai Yutong to complete the MBO in a manner that pre-empted the adoption of prohibitive regulations from the Ministry of Finance and the CSRC.

With a novel coping strategy developed by the management and the local government, Yutong Bus successfully transformed its identity into a private firm. The central government had to accept the change of ownership of Yutong Bus; however, it eventually realized that the MBO provided leeway for the embezzlement of state assets. Thus, the SASAC subsequently proclaimed a ban on MBOs in large-sized enterprises and required prudence to be taken in MBOs in small- and medium-sized enterprises (Zhang Tianwei 2004).

Figure 3: Structure of Share Rights after the MBO of Yutong Bus



Source: Zhu, Chen and Yu 2006: 118.

Conclusion

Since the late 1990s, Beijing has stepped up enterprise restructuring with the coercive statist goal of regaining effective property rights over SOEs, thus providing the impetus for counter-strategies to preserve access to state-owned resources by local governments. In the process, enterprise managers often find themselves confronting the active leverage of the regulatory and legal capacities of local officials. In the final analysis, the central state as the highest principal has recognized these deviations, but has little in the way of resources, aside from *ad hoc* interventions, to dissuade local officials from behaviours contrary to reform directives. The underlying problem is one of a lack of institutionalized voice and compensation for local officials as the primary losers in the rollback of the earlier decentralized approach to enterprise reform, and adequate fiscal provisions for the additional welfare and regulatory functions they have been asked to take on.

Our case studies further suggest the limits of a simple principal-agent framework in understanding central-local relations in China. It is not particularly useful to characterize implementation outcomes as deviating from some definable demands and obligations in a proscribed set of principle-agent relations. Both in Puyang and in Zhengzhou, there was no direct line ministry taking a conflicting stance against local interests. In the case of the Puyang municipal government making it difficult for Zhongyuan Oilfield to achieve the reform objectives set out by the Sinopec headquarters in Beijing, Puyang had no official obligation to Sinopec, precisely because corporate restructuring had cut loose local governments' participation in enterprise management. In the second case, Zhengzhou's various courts and the city finance bureau colluded with managers to take legal action that was within their rights without MoF sanction. It is not clear who the principal would be in either of these cases, aside from the general figure of the SASAC which represents central state ownership. Even so, one could argue that in the second case, the Zhengzhou city government had actually preserved the value of Yutong Bus by facilitating the MBO.

When examining the relations between the Chinese government and business, earlier studies tend to either regard the former as a monolithic entity, or assume a categorical characterization of the local government as developmental or predatory, or obedient or resistant to central directives. By focusing on the strategic interactions of the central regulators, local officials, and enterprise managers, we highlight the range of games shaped by each party, each of which possesses a unique set of resources that confer context-specific bargaining advantages. Our cases illustrate two types of outcome of SOEs being held hostage to local government's extractive demands and collusion between local officials and self-serving executives. Common to both cases is the reality that corporate restructuring is a power game in which each party concerned will try to hold sway over the overhaul. As Robert Bates contends,

> When political actors intervene in the economy and seek to restructure economic relations, the policies they choose depend upon the incentives generated by the institutional context within which they are made. Economic forces thus generate institutions and the structure of these institutions in turn shapes the way in which governments transform their economies. Economy and polity thus interact, generating a process of change (Bates 1989: 16–17).

Our case study has further verified Zhou Xueguang's (2010) findings, which maintained that the prevalent phenomena of collusion among local governments results from three paradoxes in the institutional logic of the Chinese bureaucracy: uniformity in policy-making and flexibility in implementation, the increasing intensity of incentives in personnel management and goal displacement, and increasing bureaucratic formalization and the personalization of administrative ties. Nonetheless, the diffusion of power among different ministries at the central level contrasts with a unified leadership power at local level, where the Party secretary is the core, enhancing local government's combat effectiveness and making it easier to forge alliances with central political patrons, government agencies and SOE executives.

In conceptualizing "adaptive informal institutions", Kellee S. Tsai (2006) argued that local actors would try to devise novel informal coping strategies to evade the various constraints arising from formal institutions, and diffusion of these informal strategies may force political leaders to reform the original formal institutions. Despite repetitions of these informal coping strategies, the central government did not give a green light to local governments' unsolicited interventions or the MBO practices of Chinese SOEs. Neither has the central state reconsidered incorporating local governmental inputs into enterprise management in an institutionalized, inclusive manner. The lack of resolution to these governance dilemmas has been sidestepped while the SOEs continue to profit from their leading market and political positions, but our analysis suggests that local governments will need to develop independent resource options to enable their own functional adjustments before they might once more become the facilitators of change as they were in the mid-1980s to early 1990s.

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