

# The Role of Business Groups in China's Transition

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**Abstract:** One prominent feature of China's economic reform has been the persistent promotion of business groups. The origin, structure and the economic impacts of business groups are of keen relevance to understand China's transition. Questions like "what is a business group in China?", "why are they formed", "What are the similarities and differences between Chinese business groups and their counterparts in other countries?" and "what kind of functions they perform in China's transition" are all central to our understanding of the Chinese economy and its transition. This paper addresses these questions by reviewing the literature on Chinese business groups and government publications concerning business groups. The authors suggest an agenda for future research.

**Keywords:** Role, Business groups, China, Transition

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## **1. Introduction**

Organization is the important constitution of industry economy. Understanding organization is fundamental to understand industrial and economic transition (Guthrie 1997). As a special organizational form, business groups are prevalent and have significant economic impact on emerging economies (e.g. China and India, Brazil and Chile, and many more). The role of business groups may well depend on the institutional contexts in which they are embedded (Khanna & Rivkin 2001). In line with Khanna and Rivkin (2001), Khanna and Yafeh (2007) argue that in some countries business groups are paragons, whereas in other countries they are parasites.

Although studies on business groups has been well documented in other countries, it is odd that academics have paid so little attention to Chinese business groups given China's large economic scale, and business groups' economic significance in China. One prominent feature of China's economic reform has been the persistent promotion of business groups, which stands in stark contrast to that adopted in Central Eastern Europe and the former Soviet Union where the downsizing and privatization of large state-owned enterprise were advocated (Smyth 2000).

Questions like "what is a business group in China?", "why are they formed", "What are the similarities and differences between Chinese business groups and their counterparts in other countries?" and "what kind of functions they perform in China's transition" are all central to our understanding of the Chinese economy and its transition.

With these questions in mind, we have four aims in writing this paper. The first is to review the literature on business groups in China and to summarize the existing evidence on the role that business groups have played in Chinese economy. The second objective is to present a comparison of Chinese business groups and other countries, especially business groups in Japan and Korea as it is believed that China has taken the model of business groups from these two countries. The third objective is to describe the historical background and present situation of Chinese business groups. The fourth and final objective is to discuss opportunities for future research.

The rest of the paper is structured as follows. Section 2 investigates the information on Chinese business groups including the definition, the economic power, the origin and evolution, and a comparison of business groups in other countries. Section 3 survey the literature on the role of business groups in China's transition. Section 4 explores the direction of future research on Chinese business groups. Section 5 concludes.

## **2. What we know about business groups in China**

### **2.1 Defining a business group**

Defining a business group is a non-trivial task since group definition varies substantially across countries (Khanna 2000). In most countries, group membership is typically informal<sup>1</sup>. Therefore, it is not easy to define the boundaries and members of business groups across countries. Leff

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<sup>1</sup> Chile is one of the few countries in which group are legally defined entities (Khanna and Palepu 1999).

(1978) refers to a business groups as “ a group of companies that does business in different markets under a common administrative or financial control” and states that group members are “linked by relations of interpersonal trust, on the basis of a similar personal, ethnic or commercial background”. Granovetter (1994) defines a business group as “a collection of firms bound together in some formal and/or informal ways”. Khanna and Rivkin (2001) propose that a business group is a “set of firms which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action.” There are still some other definitions of business group in country-specific studies. <sup>2</sup>

Business groups are known in many countries under various names: the old *Zaibatsu* and their modern successors, the *Keiretsu*, in Japan; the *Chaebol* in Korea; the business house in India; and so on. In China, business groups are called *Qiyejituan*. As early as in 1987, the concept of business groups appeared in one file of the State Council of China (SCC) where they are defined as a kind of organizational form with multiple tier organizational structures and legally independent firms as core companies (SCC 1987). According to the National Bureau of Statistics of China (NBSC), a business group is an association with parent-filiale system as the main body combining other firms through financial or operational ways (NBSC 2001) . The State Administration for Industry and Commerce (SAIC) offers another definition of Chinese business groups: with financially connected parent-filiale system as the main body and group constitution

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<sup>2</sup> The Korean Fair Trade Commission defines group affiliation as those that are owned at least 30% by other firms in the same group. A firm is identified as a group affiliation when the controlling family is the largest shareholder in the firm for Indonesian and Thai business groups (Claessens et al 2005).

**Table 1 top 20 business groups excluding financial ones in China**

<b>business groups</b>	<b>Sales, in billion RMB (%of sample)</b>	<b>Assets, in Billion RMB (%of sample)</b>	<b>Employment, In thousands (%of sample)</b>	<b>Main Business</b>
Sinopec	663.76(5.25%)	620.25(3.19%)	779.56(2.92%)	Petroleum/ chemicals
CNPC	591.51(4.68%)	913.69(4.69%)	1039.20(3.89%)	Petroleum /gas
SGCC	590.06(4.67%)	1111.54(5.71%)	684.92(2.56%)	Electric power
China Mobile	198.29(1.57%)	469.56(2.41%)	254.39(0.95%)	Communications
China Telecom	182.30(1.44%)	540.73(2.78%)	259.72(0.97%)	Communications
Sinochem	168.83(1.34%)	54.56(0.28%)	15.47(0.06%)	Trade
Baosteel	165.37(1.31%)	193.84(1.00%)	94.23(0.35%)	Steel
CSPG	156.98(1.24%)	246.05(1.26%)	122.30(0.46%)	Electric power
China FAW	125.23(0.99%)	102.88(0.53%)	115.14(0.43%)	Car
COFCO	117.83(0.93%)	59.76(0.31%)	23.66(0.09%)	Trade
China Minmetals	109.21(0.86%)	45.80(0.24%)	33.71(0.13%)	Mining
Haier	101.63(0.80%)	32.88(0.17%)	51.00(0.19%)	electric apparatus
SAIC	100.48(0.80%)	106.87(0.55%)	80.24(0.30%)	Car
DFM	99.15(0.78%)	122.64(0.63%)	127.12(0.48%)	Car
CREC	96.30(0.76%)	82.83(0.43%)	251.88(0.94%)	construction
COSCO	95.69(0.76%)	124.10(0.64%)	45.52(0.17%)	Ocean conveyance
CSCEC	92.83(0.73%)	92.12(0.47%)	310.31(1.16%)	Construction
CRCC	92.48(0.73%)	66.08(0.34%)	202.93(0.76%)	Construction
CNC	89.51(0.71%)	276.07(1.42%)	290.99(1.09%)	Communications
China Unicom	76.12(0.60%)	226.24(1.16%)	130.74(0.49%)	Communications
<b>Total</b>	<b>3913.56 (30.96%)</b>	<b>5488.49 (28.19%)</b>	<b>4913.03 (18.39%)</b>	

Source: Information on sales revenue, asset size, and employment comes from Large Corporations of China (2004), and other information comes from the firms' websites. The total sample is 2764. the business groups are ranked by sales.

as the common rules, a business group is an association of legally entities consisting of a parent firm, filiale, firms in which parent firm has minority shares and other member firms or institutions (SAIC 1998). The SAIC also provides the criterion to become a business group in China: the core firm should have the register capital of over 50 million Yuan and at least 5

affiliated companies, and the total register capital of the core and other affiliated firms should be over 100 million Yuan (SAIC 1998). In China, business groups are not legal entities, however, they are required to register in the State Administration for Industry and Commerce (SAIC), and state clearly who their members are. Researches on Chinese business groups have used a variety of measures to identify group members (Lee & Woo 2001; Ma et al 2006; Lu & Yao 2006). Table 1 presents a list of China's top 20 business groups according to the Large Corporations of China in 2004(NBSC,2005).

## **2.2. Business Groups and Their Economic Power in China**

According to the largest corporation in China in 2004 and the definition of business groups defined by National Bureau of Statistics of China, there are 2764 large business groups in China in 2004. The columns of Table 1 show total sales revenue, asset, employment and main business of the top 20 business groups in China. It also shows in parentheses the share of sales, asset and employment of each group in the sample. All business groups in Table 1 are state-owned except Haier group. It shows that the top 20 business groups has sales revenue of RMB 3913.56 billion in 2004, which accounts for nearly one third of that of all business groups. Three groups have sales revenue in excess of RMB 500 billion, which is ranked about 50<sup>th</sup> in terms of sales revenue around the world according to *Fortune 500* in 2004. We can see that most of these business groups lie in capital intensive and technique intensive industries. Business groups play an important role in China's economy. Table 2 shows that the sales revenue of business groups account for more than 50 percent (nearly 80 percent in 2004 ) of China's GDP from 2000 to

**Table 2 the economic power of business groups in China**

	2000	2001	2002	2003	2004
GDP(billion RMB)	9921.46	10965.52	12033.27	13582.28	15987.83
Group Sales(billion RMB)	5325.99	6562.28	7712.00	10009.49	12638.70
Group Sales/GDP	53.68%	59.84%	64.09%	73.70%	79.05%
State-owned group sales/GDP	47.87%	52.94%	55.75%	62.47%	64.83%

Source: the National Bureau of Statistics of China, *China's Annual Book of Large Business Groups (2004)*, the Press of Chinese Statistics, Beijing.

2004. It also shows that the state-owned business groups contribute to the majority of the ratio. Taking business groups as engine for economic growth, the Chinese government has consistently encouraged the development of business groups. Hence, it is not strange to see that business groups contribute a lot to China's GDP. As the largest emerging market and a transitional economy, firms of different ownership types coexist and the government of China and its state-owned enterprises still play a critical role in the economy. According to the large business groups in China in 2004, there are 2764 large business groups in China in which 1546 are state owned and state controlled.

Table 3 presents the breakdown of ownership of the business groups collected in the large business groups in China in 2004. It shows that the state-owned business groups control more than 80 percent of the sample in terms of asset, sales or employment. Although in recent years, the Chinese government has encouraged the development of private sectors, they still do not have

**Table 3 breakdown of sample by ownership categories (% of total sample)**

	Number	Asset	Sales	Employment
State-owned	55.93%	88.46%	82.01%	82.44%
Non-state owned	44.07%	11.54%	17.99%	17.56%

Source: the National Bureau of Statistics of China, *China's Annual Book of Large Business Groups (2004)*, the Press of Chinese Statistics, Beijing.

much power. The number of non-state owned business groups accounts for nearly one half of the whole largest business groups in 2004. However, their sales revenue, asset and employment are less than one fifth.

Business groups controls assets in multiple provinces of China and even other countries, and in several industries. Mostly, the business groups are diversified. For example, Baosteel Group, whose main business is steel, has extended its business into 8 industries including trade and finance. Figure 3(see appendix 2) shows an industrial structure of Baosteel Group.

According to the above description, it seems that China's state-owned business groups have excessive market power.<sup>3</sup> Some are not only large by Chinese standards but also economic giant by global standards. Some state-owned business groups are important global players in their industries such as China National Petroleum Corporation which ranks 46 in Fortune 500 in 2004.

Table 4 presents the ranking of Chinese largest business groups in *Fortune 500* in 2004. It shows that all of the Chinese business groups that show up in *Fortune 500* are state-owned business

<sup>3</sup> We try to analyze the market power of business groups by industry sector. However, the data on this aspect is not available. Although data on this aspect is available for listed firms, they are not representative of the market power of the whole business group.

**Table 4: The ranking of Chinese largest business groups in the Fortune 500 in 2004**

Corporation	World ranking (2004)	Revenue (us\$ 100m 2004)	Ownership type
Sinopec Group	54	750.77	state-owned
State Grid Corporation of China(SGCC)	46	712.90	State-owned
China National Petroleum Corporation	52	677.24	State-owned
China Life Insurance Company	241	249.81	State-owned
China Mobile Communications Corporation	242	239.58	State-owned
Industry and Commercial Bank of China	243	234.45	State-owned
China Telecom	257	215.62	State-owned
Sinochem Corporation	270	203.81	State-owned
Baosteel Group	372	195.43	State-owned
China Construction Bank	331	190.48	State-owned
Bank of China	358	179.60	State-owned
Agricultural Bank of China	412	152.85	State-owned
China National Cereals, Oils and Foodstuffs Corp	415	141.89	State-owned

Source: Large Corporations of China (2004), in Chinese. Beijing: China Statistics Press, 2005 and each firm's website.

Notes: here "state-owned" means wholly owned or more than 50 per cent shares are hold by the government.

groups. It signals that the state-owned business groups are still dominant market power in China.

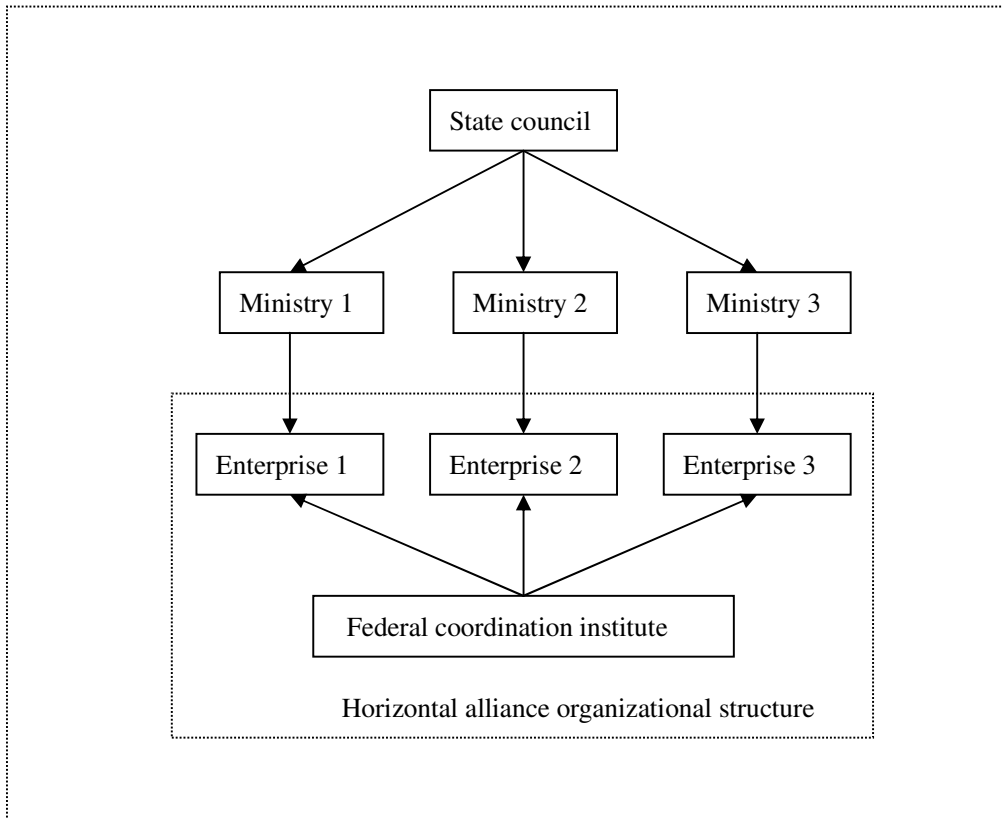
The enactment of antitrust law in China in 2007 may limit possible monopoly power of these economic giants.

### **2.3 The Origins and Evolution of Business Groups in China**

The origin of Chinese business groups can be traced back to the so-called "horizontal economic alliance of enterprises" that has emerged since the late 1970s (Lee and Hahn 1999). Starting from

1978, China began its economic reform. China's transition to market economy can be divided into two stages, where the first stage is between 1978 and 1993 and the second stage began in 1994 (Qian & Wu 2000). Chinese government took many ways to reform towards a market economy such as the development of the household contract responsibility system, the price reform and opening policy. However, the central part of China's economic reform was to transform formerly state-owned enterprises into modern corporations. Under the central planning system before the reform, enterprises tended to be "under-specialized". In 1978, there are about 0.35 million state-owned enterprises belonging to different ministries and different local governments (Xiao 2004). As the market system is under-developed and the supply distribution channels are uncertain, every enterprise wanted to produce as diverse outputs as possible which cannot meet the requirement of modern production on a large scale. According to Xiao (2004), the reform of SOEs is along two lines. The first one is to expand enterprise autonomy and increase profit incentives. The second one is to promote the restructuring and association of SOEs. As to the first line, the reform of SOEs underwent the profit retention and profit contract systems (1979 to the early 1980s), the tax-for-profit system (1983 to 1985), and the contracted management system since 1986 (Lee & Mark 1991). As to the other line, the industry restructuring was taken in Beijing, Tianjin, Liaoning and some other places in 1978. In 1980, the State Council promulgates the "Provisional regulations regarding the promotion of horizontal economic alliance". As it is not possible to break the administration-based system at that moment, the decree aims at encouraging the formation of all kinds of economic alliance to break the old system of market partition and local government blockage. At that time, a horizontal alliance of

**Figure 1 the organizational structure of horizontal economic alliance of enterprises**



enterprises were formed by enterprises of more or less equal status in the same sector or different sectors of business based on cooperation agreement (Lee and Hahn 1999). According to the State Council's (1980) decree, a federal coordination institute was required to set up to coordinate the business in the alliance. However, the enterprises in an alliance cannot change their affiliation to different ministries, which mean that the federal coordination institute does not have authority over the member enterprises. Figure 1 shows the structure of a horizontal alliance of enterprises. With the development of horizontal alliance, the resource were used more efficiently by reallocation, the uncertainty of supply and distribution was reduced and the enterprises can focus on their main industries in an economic scale. After observing the advantages of horizontal

economic alliance, in 1986, the State Council issued “Regulations regarding a few problems related to the further promotion of horizontal economic alliance” in which the word “business group” first appeared in the state council’s official documents. With the progression towards a market economy in China, it appeared costly for some enterprises in the same alliance to continue executing the alliance agreement as some alternative resources of supplying and marketing had emerged. In order to resolve this problem, they built hierarchy structure turning themselves into business groups (Lee and Hahn 1999). The government detected the emergence of new organizational form, and issued decrees to encourage the formation of business groups. In 1987, the State Commission for Economic System Reform (SCESR) et al. promulgated “Several opinions regarding the establishment and development of business groups” to encourage the formation of business groups.<sup>4</sup> As a result, there were more than 7,000 known business groups in China by the early 1990s (Keister 1998). After observing the advantages and problems of the new organizational form, the Chinese government decided to promote and regulate the development of business groups. In 1991, the government issued “Information about selecting a patch of largest business groups as experimental units” and formed 57 business groups as the experimental ones for special promotion. The experimental business groups are required to form based on a core firm, and to develop shareholding relationship between firms.

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<sup>4</sup> The concept of “business group” first appeared in this state council’s official document .The decree stipulated that the organizational structure of business groups should have several tiers with a core company at first tier, closely related companies at the second, semi-closely companies at the third tier and loosely related companies at the bottom.

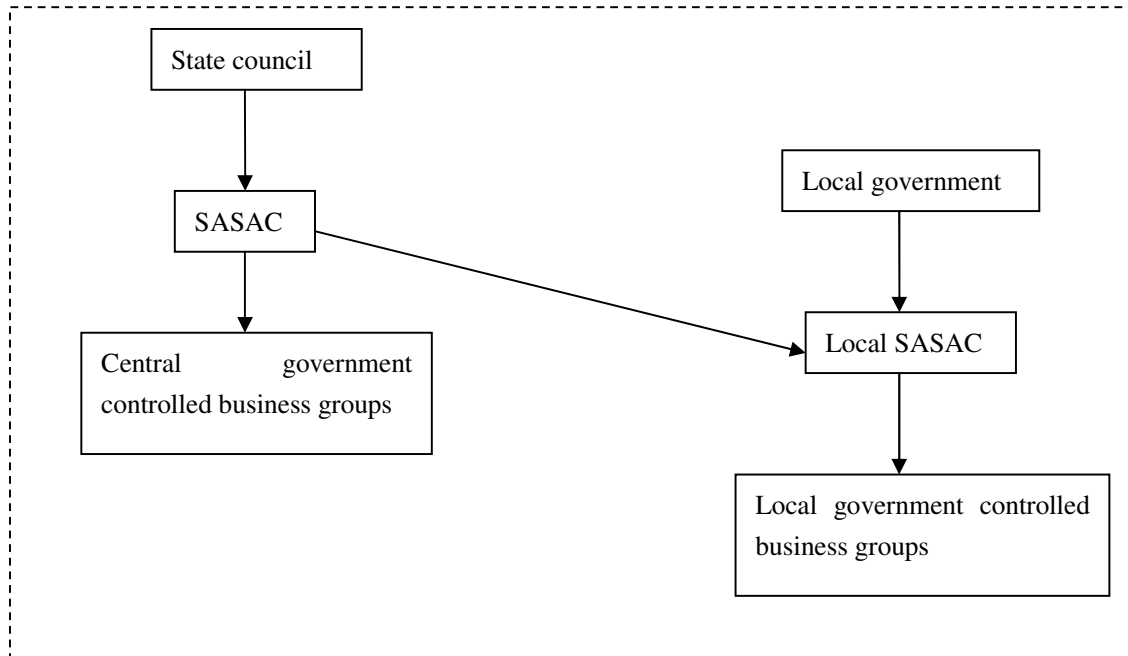
Starting from 1994, China's economic reform enters into the second stage. In November 1993, the Third Plenum of the Fourteenth Party Congress adopted the "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure". The essence of the November 1993 decision is to replace China's centrally planned system with a modern market system. After the decision was made, a series of reforms was launched according to the decision, mainly in five areas:(1) foreign exchange and external sector reform;(2) tax and fiscal reform;(3) financial reform;(4) SOE reform; and (5) establishment of a social safety net (Qian and Wu 2000). From 1978 to 1993, the privatization of SOEs in China was absent. After 1993, small and medium sized SOEs were allowed to be privatized, especially after the 15<sup>th</sup> Party Congress in 1997 on which the Chinese government adopted the landmark strategy of "holding on to the large and letting go of the small" to restructure and improve the performance of the SOEs. By letting go of the small, over 80% of the small and medium sized enterprises had completed their transformation through forming joint-stock company, restructuring, merger, leasing, contracting, outright selling, and bankruptcy by 2000 (Chen et al 2003).<sup>5</sup> By holding to the large, from 1997 to 2001, the government issued several decrees to promote the development of largest business groups in order that they can play the pillar role in national economy and can compete with foreign firms. The State Council promulgated "Opinions on deepening the experimentation of the largest business groups" in 1997. The decree required the experimental business groups to build up parent-filiale system based on shareholding relationship in the light of Corporation Law.<sup>6</sup> In

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<sup>5</sup> According to Ma et al. (2005), the private business groups began to form and develop after 1993.

<sup>6</sup> In 1993, the Chinese Corporation Law was issued.

**Figure 2: the management structure of state-owned business groups after the SASAC was founded**



1998, the State Council of China promulgated “Guidance on building up parent-filiale system in business groups” in which the function and liabilities of parent firm are stipulated and who can be the member of business groups are also clearly stated. The final form in the course of the development of business groups should be the establishment of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) in 2003. The SASAC took the role of claiming property rights on behalf of the state, which announced a list of 189 large state-owned enterprises/business groups under its supervision. The SASAC has the power to appoint and remove the directors and managers and send supervision board to the large state-owned enterprises/business groups. Local state-owned enterprises/business groups are under management of local SASAC correspondingly. Figure 2 shows the management structure of

**Table 5 The percentage of business groups using bank credit for new project      unit: %**

year	2002	2003	2004
ratio	60.9	89.1	89.5

Source: the National Bureau of Statistics of China, *China's Annual Book of Large Business Groups (2004)*, the Press of Chinese Statistics, Beijing.

state-owned business groups after the SASAC was founded.

## **2.4 Business groups in China and elsewhere: a comparison**

This section compares business groups with groups in other countries, especially in Japan and Korea. Some studies argue that the Chinese government had observed the success of *Keiretsu* and *Chaebol* in Japan's and Korea's economic development. Consequently, they formed the network-based groups in parallel with their counterparts in Japan and Korea (Keister 1998; Ma et al. 2005).

With regards to the relationship between commercial banks and business groups, unlike in Japan, Chinese business groups do not set up with a main bank at the core. The commercial banks in China are not allowed to become shareholder of firms according to the Commercial Bank Law in China. Banking credit is the main resource for Chinese firms to finance their programs.<sup>7</sup> In 1996, the Central Bank of China (CBC) promulgated the decree named "the temporal way to manage

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<sup>7</sup> In 2003, the amount financed by stock and security accounts for only 4.27% of bank credit (shanghai zhengquanbao, 03/07/04). In 2004, there are 89.5% business groups using bank credit to finance their new project (NSBC 2004).

the main banks” to support the reform of state-owned enterprises.<sup>8</sup> However, unlike the main banks in Japanese business groups, Chinese “main banks” have no power and incentive to monitor the enterprises that get credit from them since both banks and enterprises are state-owned. Although the Chinese government encouraged the founding of financial firms inside the business groups, they are not comparable to the main banks in Japanese *Keiretsu*, as pointed out by Marukawa (2002). Table 5 shows the rate of business groups using bank credit to finance their new projects. We find that in 2004, there are 89.5% business groups using bank credit to finance their new project. Although using internal capital is taken as a benefit for affiliations, Table 5 reflects that the internal capital market in Chinese business groups is not very important in financing new project. This is different from the India business groups where the most important role of the group’s internal capital market for Indian business groups is to launch new ventures (Khanna 2000).

Regarding the control system inside business groups, there are differences between Chinese business groups and those in other countries. For example, there is no common control in Japanese *Keiretsu* because of the absence of a centralized decision making mechanism (Yafeh 2002).<sup>9</sup> However, in China, the pyramid structure guarantees centralized control. According to the NBSC’s statistics in 2004, 92.1% of parent firms of all Chinese business groups have the

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<sup>8</sup> The decree requires the commercial banks in China to build up stable relationship with 300 specified state-owned enterprises and large state-owned enterprises in seven cities (CBC 1996).

<sup>9</sup> Holding companies are legally banned in Japan and other formal joint control mechanisms are unavailable (Yafeh 2002).

decision-making power. The decision-making power of parent firms is authorized by the State Commission for Economic System Reform (SCESR) in 1998. In Korea, the *Chaebols* are controlled by founder families (Chung 2004).

In terms of ownership pattern within group, Lee & Woo (2001) argue that Chinese business groups are characterized by a simple hierarchy structure with a parent company at the top and the affiliates at the next tier most of which 100% or more than 50% are owned by the parent firm. However, the within-group ownership pattern in Korean *Chaebols* are more complicated, with owner family at the top, several core companies at the next tier playing the role of holding companies, and other affiliates at the bottom( Lee & Woo 2001). The founder families in Korea and managerial elites in Japan usually hold or control relatively insignificant ownership shares of their affiliated companies (Chung 2004).

Regarding ownership types of business groups, unlike most other countries where private business groups dominate, the state-owned business groups are the main body of Chinese business groups in terms of total asset and sales revenue.

Regarding the evolution of business groups, as the main body of business groups in China is state-owned business groups, the evolution of business groups in China is under the guidance and support of Chinese government. However, in most other countries, the private business groups evolved as a response to institutional surroundings.

As regards the size of business groups, as Marukawa (2002) points out, they are not comparable to Japanese business groups. In 2004, the 2764 business groups owned 26487 affiliations. On average, one group only has about 9.58 affiliations. In Japan, even a large firm-not a group-may has more subsidiaries: in 2000, the 2722 listed companies in Japan on average had 11.8 subsidiaries. Two Japanese airlines, JAL and ANA, have 143 and 113 subsidiaries respectively. The largest Chinese business group in 2004, Sinopec, has about 80 subsidiaries.<sup>10</sup>

In term of the weight of the business groups in national economy, the share of the top 20 business groups in China is not comparable to that of Korean *Chaebols*. The ratio of the aggregate sales revenue of the top 20 groups to the Chinese GDP in 2004 is about 28.59%(NBSC 2004), whereas the similar ratio in Korea is 70.8% in 1987(Lee and Woo 2001).

Through the above analysis, we find that there are considerable differences between Chinese business groups and business groups in other countries. Although it is believed that Chinese business groups model these in Japan and Korea, we also find that there are big differences between Chinese business groups and their counterpart in Japan and Korea.

### **3. The Role of Business Groups in China's Transition<sup>11</sup>**

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<sup>10</sup> Information was got from Sinopec's website <http://www.sinopec.com.cn/>.

<sup>11</sup> Some other studies focus on the economic logic of the Chinese government in promoting the formation

There is yet no verdict on the economic roles played by business groups around the world (Khanna and Yafeh 2007). The value and the role of business groups may well depend on the institutional contexts in which they are embedded (Khanna & Rivkin 2001). Only a handful of published papers examine the role of the business groups in China's transition. In this section, we briefly summarize the existing papers on Chinese business groups and then develop our own arguments on the role of business groups in China's transition.

Keister (1998) is the first to analyze in depth how and why Chinese business groups were formed and what impact their formation has had on economic performance. She proposed that the formation of Chinese business group was a strategy of the government to reform SOEs and she described how the government actively encouraged the formation of business groups in China and protected them from competition. She examines which firms within the group of firms that are affiliated to business groups perform better. Her study indicates that the presence and predominance of interlocking directorates and finance companies in business groups improve the financial performance and productivity of member firms. Keister (2001a) argues that Chinese firms face many problems which can be overcome by business groups, such as being a substitute for missing markets. Keister (2001b) argues that, since China is an underdeveloped market, Chinese firms can benefit from a business group affiliation by means of insider lending, selling

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of business groups. Nolan (1996) proposes that the economic reform in China has a bias towards heavy industry where economies of scale are needed. And the economic history of the advanced capitalist countries suggests that the development of large firms is essential for economic growth. Aimin Chen (2003) argues that the government, at both central and local levels, has been the primary driving force of forming enterprise groups which are taken as a tool to fostering economic development.

and purchasing of intermediate and final goods and due to internal trading networks. Keun Lee et al. (2002) suggest that business group formation in China may help to catch up the Chinese economy to Western standards. Yiu (2005) conceptualizes business groups as an instrument to facilitate organizational transformation during the institutional transition process in emerging economies. According to Yiu et al (2005), the Chinese government realized that without making systematic choices in this transition it could end with the chaos as reflected in the Russian transition. Therefore, the nation needed an intermediary institution that would facilitate the enterprise reform and thereby the economic transition .The solution was the encouragement of business groups' formation that would facilitate the movement toward the market based system. Using data collected by the National Statistics Bureau of China (NSBC) in 1998, and based on 224 largest business groups, Yiu et al. (2005) examine the resource based view in Chinese business groups. This view argues that firms affiliated to business groups can benefit from sharing scarce and strategic resources within business groups. The results indicate that most of endowed government resources do not help business groups to create a competitive power. Instead, business groups with strategic actions to develop a unique portfolio of market-oriented resources and capabilities are most likely to prosper (Yiu et al.2005). Ma et al. (2006) suggest that state-owned business groups play a more important role in the corporate governance by filling the ownership voids and they find that the negative effect of group affiliation is lower for state-owned firms than for private firms, which offers evidence for their arguments.

Based on the existing studies on Chinese business groups and the origin and evolution of Chinese

business groups, we conceptualize the formation of business groups as a step to market economy. The existing research on the role of business groups seems not directly related business groups with China's market orientated transition. Through Simon (1991)'s analysis, we see that a market economy is also an organization economy as most of the transaction are inside the organizations or among the agents of different organizations. In this sense, the development of organization is the development of market. So the development of business groups can directly contribute to the development of market. At the beginning of China's economic reform, the external market is underdeveloped, the contribution of the formation of business groups to the transition are two folds. First, the formation of business groups reduces the intervention of government. Before the formation of business groups, every state-owned firm was directly controlled by the government. After the formation of business groups, the headquarter of every group manages the affiliated firms instead of the government although the government still have administration over the headquarter of every group. In the sense that the formation of business reduces government intervention, it is a step towards market economy. Second, the formation of business groups promotes exchange among firms affiliated into the same group through so-called internal market. In the sense that the formation of business improves exchange, it is a step towards market economy. The exiting evidence more or less supports the benefits of the formation of business groups. However, it is unclear whether rapid privatization and down-sizing would achieve better results (Smyth 2000). We cannot give the answer before further evidence is given on this issue.

#### **4. Future Direction of Research on Business Groups in China**

**Table 6 ownership types and group affiliation**

	<i>Business group affiliations</i>	<i>Stand alone firms</i>
<i>State-owned</i>	<i>A</i>	<i>B</i>
<i>Non-state owned</i>	<i>C</i>	<i>D</i>

The existing studies show that business groups play a critical role in China's transition economy. In order to fully assess their impact on China's economic development, we need more systematic analyses and empirical work on the role of business groups in China's transition. Based on the existing studies and our understanding of the role of business groups in China's transition, we suggest several directions for future research on Chinese business groups.

#### **4.1. Ownership Type and Group Affiliation Effect**

In emerging markets like China, firms of different ownership types coexist and compete, and each of these types not only faces different institution and task environments but also possesses heterogeneous institutional advantages and disadvantages (Tan 2002). It seems reasonable to suggest ownership type as a key variable in analyzing the performance of Chinese business groups. We divided firms in emerging economies into four types and named these firms as A, B, C and D (see Table 6). Although business groups in other countries are usually private based on family relations, the state-owned business groups are the main body of Chinese largest business groups which do not base on family relations. Therefore, the old research topics concerning business groups like group affiliation effects and financing constraints may get different answers in China's special institutional context. For instance, Ma et al (2006)'s study shows that the effect

of group affiliation may to a large extent depend on ownership types. Their results imply that (1) private stand-alone firms perform better than private-firms affiliated to a business group; (2) state-owned stand-alone firms perform worse than private stand-alone firms; (3) the negative effect of group affiliation is lower for state-owned firms than for private firms. However, the authors have not formally tested whether group affiliation has significant effect on firm performance for state-owned firms. Hence, two further research questions would be whether group affiliation improves firm performance for state-owned firms and whether the group affiliation effect is different between state-owned firms and non-state owned firms. It is interesting to compare the benefits and costs of group affiliation in business groups of different types as suggested by Claessens et al. (2005).

#### **4.2. Historical and Dynamic Analyses of Business Groups**

Originated as a way to reform SOEs, the role of the business groups may change with the development of China's economy towards a market economy. We should make distinction between the original purpose of Chinese government to form business groups and roles that business groups were subsequently assumed. And the aim of Chinese government to develop business group may change with the change of institutional context. Hence, historical and dynamic analyses of business groups can enrich our understanding of the role of this organization in China's transition.

#### **4.3. Business Groups and Government's Intervention**

One of the unique characteristics of the institutional change in emerging economies is the simultaneous operation of market mechanisms and the presence of the remaining state governance mechanisms (Stark 1996). However, the general neglect of governments as contexts in organizational behavior research persists (Ring et al 2005). The nature of the relation between business groups and the state must be considered, which is often central in sorting out why business groups exhibit the form, characteristics, and behaviors that they do (Granovetter 1994). The literature suggests that the appearance of the business groups was strongly influenced by government policies (Khanna and Yafeh 2007). There is also evidence that strong linkages between business groups and government can benefit group members. Fisman (2001) provides estimates of the value of political connections enjoyed by business groups in Indonesia during the Suharto regime. The prevailing assumption that government support of groups is socially harmful should be examined more closely (Khanna and Yafeh 2007). Business groups may have helped governments realize other aims. Understanding the relationship between business groups and government require a far better understanding of business groups and their institutional context than we have thus far attained. Political economy explanation for the formation and effectiveness of groups should receive more attention than they have so far (Khanna and Yafeh 2007).

There are no systematic analyses on the government's support in the formation and development of Chinese business groups. Perkins (2002) suggested that maybe the formation of Chinese business groups is just a way for the government to realize control over the economy. As suggested by Marukawa (2002), we need to pay more attention to government policies and

interventions that influence the structure and behavior of Chinese business groups, and we need to examine whether inefficiencies and weaknesses are caused by such interventions (Marukawa 2002).<sup>12</sup>

#### **4.4. Business Groups and Monopoly Power**

Business groups may under some circumstances, drive their rivals out of markets, or prevent entry, due to their deep pocket and ties to the government. The literature on the industrial organization effects of business groups has not developed much. The general evidence on the relation between market power and business groups are weak. Encoua and Jacquemin (1982) find little evidence of monopolization by French groups. As we find in section 2 and the review of the roles of business groups in China, the general evidence on the relation between market power and business groups is weak. Some argued that business groups were formed only to shuffle around enterprises losses and to protect state-owned enterprises from competition (Lichtenstein 2001). The government can take two ways to protect state-owned enterprises form competition. One is to impose legal and regulatory constraints on indigenous private firms. As of the late 1990s, more than two dozen industries, including some of the most important and lucrative sectors of the economy-banking, telecommunication, highways and railroads were still off-limits to private local companies. These restrictions were designed not to keep Chinese enterprises from competing with foreigners but to prevent private domestic businesses from challenging China's state-owed enterprises (Huang & Khanna 2003). According to SASAC(2006), the state-owned

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<sup>12</sup> Chen et al (2003)'s case study of Liaoning province is a study in this direction.

sector were required to keep absolute control over important industry and key fields including electricity, oil and chemical, communication, coal, civil aviation and ship. The other way is to setup business groups and give them policy support which may restrict the entry of private firms into the market. We need more evidence to support this argument.

## **5. Conclusion**

The literature shows that business groups play an important role in China's transition. We find that Chinese business groups, especially state-owned business groups, do control a substantial part of the economy. The origin of business groups in China shows that the formation of business groups may itself a step towards a market economy. although it is believed that Chinese business groups model these in Japan and Korea, we find that there are considerable differences between Chinese business groups and their counterpart in Japan and Korea. We also suggest several directions for further studies on Chinese business groups. The influence of ownership type on group affiliation effect, historical and dynamic analysis of business groups, government's intervention on business groups and the relation between business groups and monopoly power are of special interest to us. In sum, little has been written on Chinese business groups and concrete evidence (positive or negative) on their economic effect is also scarce. We need more theoretical and empirical studies on the role business groups played in China's transition.

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## Appendix 1

**Table 7: Government policies on business groups (1980-2001)**

The table collects files issued by Chinese government directly related with the formation and evolution of business groups in China. Data can be found in the website of different departments.

time	Government department	decree
1980.7.	State Council, P.R.China	Provisional regulations regarding the promotion of horizontal economic alliance
1986.3	State council, P.R.China	Regulations regarding a few problems related to the further promotion of horizontal economic alliance
1986.12	State council, P.R.China	Some regulations on deepening enterprise reform and strengthen the energy of the enterprises
1987.12	State commission for economic system reform et al.	Several opinions regarding the establishment and development of business groups
1991.12	State council, P.R.China	Information about selecting a patch of largest business groups as experimental units
1991.12	the State Planning Commission et al.	Information on the way of approval of experimental business groups
1997.4	State council, P.R.China	Opinions on deepening the experimentation of the largest business groups
1998.3	State commission for economic system reform	Guidance on building up parent-filiale system in business groups
1998.12	Ministry of finance, state commission for economy and trade	Temporary regulation on the management of state-owned capital in the experimental business groups
2001.11	State council, P.R.China	Guidance on developing largest business groups as international competitive power

## Appendix 2

### **The Baosteel Group: an example<sup>1</sup>**

Shanghai Baosteel Group Corporation (referred to below as Baosteel) is a large iron and steel conglomerate set up on Nov. 17, 1998, with the former Baoshan Iron and Steel (Group) Corporation as the core, and absorbing the former Shanghai Metallurgical Holding Group Corporation and the former Shanghai Meishan Group Co., Ltd. Baosteel is under the supervision of the State-owned Assets Supervision and Administration Commission of the State Council. In order to improve the corporate governance, the parent firm of Baosteel group set up a director board in which more than half are outsider directors. Hence becomes the first one who has a normative director board in the wholly state-owned firms.

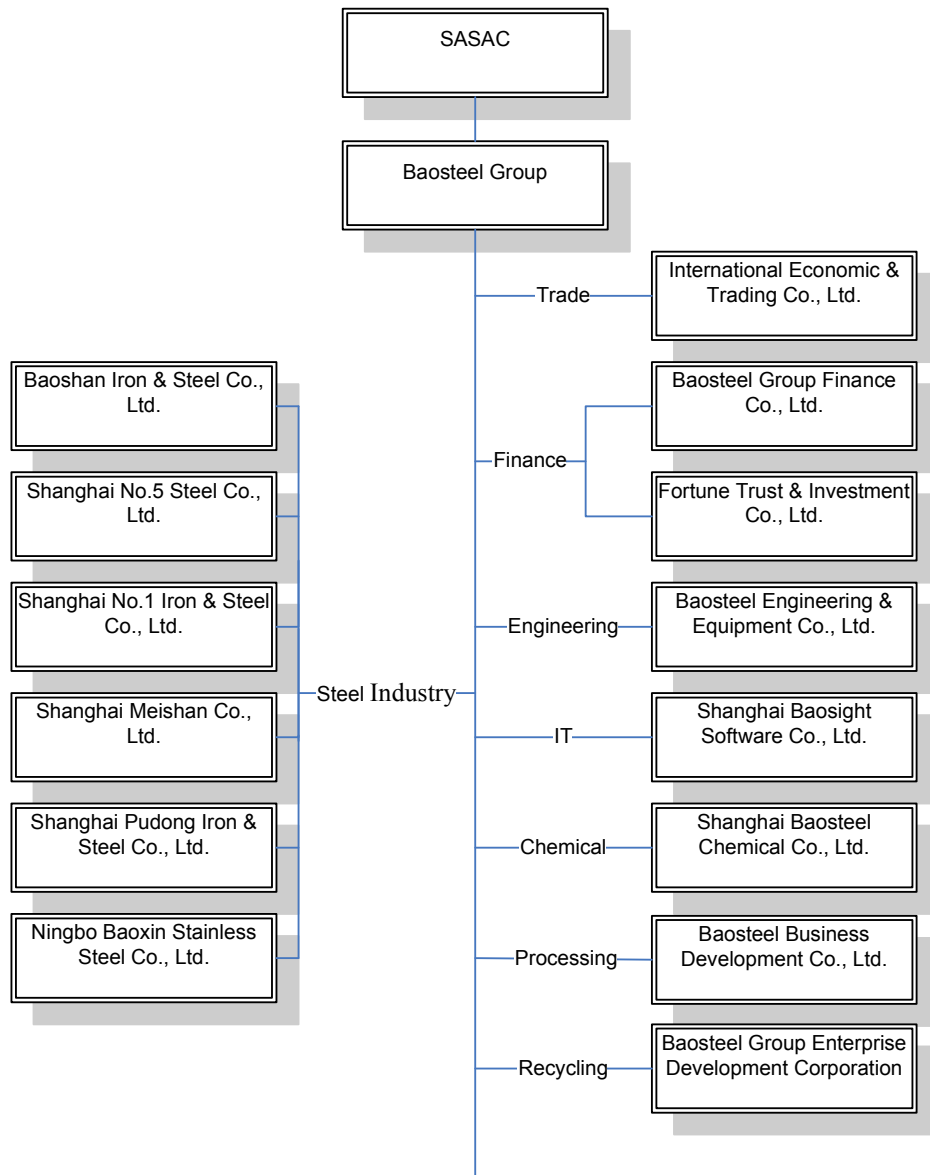
Baosteel has a registered capital of 45.8 billion Yuan. It possesses 22 wholly owned subsidiaries (including 9 overseas subsidiaries) and 14 holding companies (including 2 overseas subsidiaries) and 24 equity-sharing companies. Among the wholly owned subsidiaries and share holding companies, 11 are iron and steel companies, 2 financial companies, 8 trading companies.

Baosteel is one of the most profitable steel enterprises in the world enjoying international competence, and its annual production capacity is about 20 million tons. Baosteel produces high demand products in the domestic and international market. On Dec. 6. 2004, Standard & Poor has raised the credit rating of Shanghai Baosteel Group Corporation from BBB to BBB+ with a

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<sup>1</sup> The information in this appendix is obtained from the website of the Baosteel Group <http://www.baosteel.com/> and the website of the State-owned Assets Supervision and Administration Commission of the State Council <http://www.sasac.gov.cn/>, and shanghai information service website [www.istis.sh.cn](http://www.istis.sh.cn).

**Figure 3 the structure of the Baosteel Group**



"stable" outlook. Baosteel was ranked No. 372 on the list of 2003 Global 500 by "Fortune" magazine on July 2004, and became the first of its kind in the competitive industry and the manufacturing sector in China to enter the world's top 500 enterprises. In 2004, it had sales of RMB 165 billion and 94,000 employees.

Baosteel follows its "premium products" strategy and aims to become the prime research and

development base for new processes, new technologies and new materials in China's iron and steel industry. Baosteel's premium products include automobile steel, oil and gas exploitation and transportation steel, stainless steel, household electric appliance steel, transportation facilities steel, silicon steel, boiler and pressure vessel steel, food and beverage packing steel, metal production steel, special material steel, high-grade construction steel. Baosteel aim to become the prime research and development base for new processes, new technologies and new materials in China's iron and steel industry.

Baosteel follows a strategy of “one main industry of exceptional quality with appropriate and relevant diversified trades”. Besides its main steel business, Baosteel also engages in diversified industries such as trade, finance, engineering & equipment manufacturing, information, coal chemical industry, deep processing of steel products and recycling.

Baosteel conducts internationalized operation. The global network, including 20 overseas and domestic trading companies, has taken shape. Baosteel cooperates and establishes joint ventures with international steel giants; it has made strategic alliances worldwide to achieve win-win result on the basis of mutual benefit.