



M.A. Thesis

Reciprocal Relations: Private Small and Medium Enterprises and China's State Organs

Abstract

This thesis examines the reciprocal relations of Chinese private small and medium enterprises (SMEs) with various local state organs, in the context of "State Capitalism" and Chinese traditional values. Our study compares eight different private SMEs from different sectors and locations in China, based on various documents and interviews, including some confidential and rare information. The thesis begins with a review of the history of private firms in China, which is marked by dependency relations with state organs and strong traditional family values. The core of the thesis is the comparison of SMEs relations with local state organs in two dimensions: vertically, we examine changes over time; and horizontally, we compared the current differences of the SMEs relations with state organs. Our analysis section compares the research findings with models of Chinese "State Capitalism" that were developed for large private enterprises and state-owned enterprises, and we found that the blurred distinction between large state-owned and private-owned companies exist also among SMEs. We also examined the local governments' priorities regarding their relations with SMEs and the mechanisms that these governments use to support and cooperate with the SMEs. We found that generally the economic potential growth was the most important factor, but social stability and traditional values also played significant roles in the peripheral cities. Understanding the reciprocal relations elements and mechanisms also assist us to understand to what degree private SMEs are monitored, supervised and controlled by state organs compared with large private companies and state owned enterprises. Among other things, we found that the degree of supervision depends on the relative size of the SME in its region and/or sector, the industry (e.g. tech is more supervised), and the proximity and *guanxi* with state organs (e.g. privatized firms).

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Table of Terms and Abbreviations

ACFTU = All-China Federation of Trade Unions. A state organ.

AIB or AIB Group = A tech company with head office in Beijing.

AVL = The foreign company that is the major shareholder of HJV.

BIT or BIT Group = An IT company with head office in Beijing and a major branch in Shanghai.

B-IT = The Beijing branch of BIT.

BOC = Bank of China.

CEO = Chief Executive Officer.

CJV or EJV = Cooperative Joint Venture, or Equity Joint Venture. Two legal types of joint venture companies.

CPC = Communist Party of China.

CPS = Corporate Political Strategy.

CSR = Corporate Social Responsibility.

CTO = Chief Technical Officer.

EDZ = Economic Development Zone (in this thesis it refer to the EDZ in Ofakim city).

ESG = Environmental, Social, and Corporate Governance.

FIE = Foreign Invested Enterprise. A Chinese legal category of companies with foreign investments.

GM = General Manager.

HBB or HBB Group = A state owned enterprise, that had close relations with JMC and HJV.

ICBC = Industrial and Commercial Bank of China.

IMF = International Monetary Fund.

IoT = Internet of Things.

IPO = Initial Public Offering. The process of listing a new public company in the stock exchange.

ISP = Internet Service Provider

JMC or JMC Group = A company in the city of Ofakim with few subsidiaries

HJV = A company in the city of Ofakim that was established as a joint venture.

MNCs = multinational companies.

MOFCOM = Ministry of Commerce.

OECD = The organization of Economic Co-operation and Development.

POE = Private Owned Enterprises.

PR = Public Relations.

R&D = Research and Development.

SAIC = State Administration of Industry and Commerce.

SASAC = State-owned Assets Supervision and Administration Commission.

S-IT = The Shanghai branch of BIT.

SME = Small Medium Enterprise.

SOE = State Owned Enterprise.

SOF = State Owned Finance enterprise.

SPME = State Permeated Market Economy.

WOFE = Wholly Owned Foreign Enterprise. A specific type of legal entity in China.

WTO = World Trade Organization.

GDP = Gross Domestic Products.

Introduction

In recent years academic and business literature pay growing attention to the nature of Chinese companies; their corporate governance mechanism; ownership structure; the identity of the real and ultimate controller of their operation and/or policy; and the relations - sometimes intricate, and sometimes blunt – between Chinese companies and state organs.

One of the most important distinctions, which various bilateral agreements, trade bodies and regulatory organs use, in order to evaluate the relations between a company and the state, is the distinction between government owned companies, which in China are usually called State Owned Enterprises (SOEs, *guoying qiye* 国营企业), and Private Owned Enterprises (POEs, *siying qiye* 私营企业).¹ For example, the World Trade Organization (WTO) differentiates between State Trade Enterprises (STE) and Private Trade Enterprises (PTE), and creates a mechanism that puts additional burden on STE operation. The rationale for such differentiation is to “remove the potential for trade distortion offered by government involvement in an enterprise's decisions and activities”.²

In recent years there is growing perception that the current WTO rules are not effective in tackling institutional forms of trade such as China's SOEs and other State Capitalism tools. Thus, states have adopted new trade rules to regulate the SOEs' behavior through bilateral and regional free trade agreements (FTAs). In contrast to earlier FTAs, a separate and extensive SOE chapter, is featured in almost all new-generation mega-regional FTAs, such as the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), United States-Mexico-Canada Agreement (USMCA), the EU-Canada Comprehensive Economic and Trade Agreement (CETA) and the EU-China Comprehensive Investment Agreement (CAI).³

Academic and business literature on this topic received strong tailwinds from the recent developments of the world's trade and geopolitical situation. The China-US trade war, the Corona “blame game”, the Hong Kong crisis and the Russia-Ukraine war, only accelerated this debate. The case of Huawei (华为) illustrates this point and the designation of Huawei as SOE,⁴ had significant implications for the treatment and sanctions that were imposed on it by the US and its allies.⁵ The wide-spread fear of Chinese companies is also reflected in the European Commission position, which in just three years, revised its opinion from defining the economic activity of Chinese firms in the west as “reciprocal benefit” to view it as a major security liability.⁶

Most of the academic literature on this topic is concerned with, and based on, case studies of big SOEs and public companies of the high-tech sectors (e.g. Huawei, ZTE, DJI, Lenovo), and their relations with the Chinese

¹ For discussion of different definitions see: Ines Willemyns, “Disciplines on State-Owned Enterprises in International Economic Law: Are we Moving in the Right Direction?”, *Journal of International Economic Law*, Vol. 19, Issue 3 (2016). pp. 657–680.

² Article 17 of the GATT Agreement 1994, regarding the definition and limitations on “State Trade Enterprise”.
https://www.wto.org/english/tratop_e/statra_e/statra_info_e.htm

³ Ming Du, “Unpacking the Black Box of China's State Capitalism”, *German Law Journal*, Vol. 24, No. 1 (2023), p. 128.

⁴ Christopher Balding and Donald Clarke, “Who Owns Huawei?” (17 April 2019).
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3372669

⁵ By allies I mean the “Five Eyes” alliance and also other Western states. See for example: Christian Edwards, “Trump's Pushback Against China is Catching on Globally as European Negotiator Declares an End to the Region's Naivety”, *Business Insider Online* (24 Nov' 2018). <https://www.businessinsider.com/china-pushback-goes-global-european-union-trump-administration-2018-11>

⁶ Margaret Pearson, Meg Rithmire and Kellee Tsai, “China's Party-State Capitalism and International Backlash: From Inter Dependence to Insecurity”, *International Security*, Vol. 47, No. 2 (Fall 2022), p. 135.

central government.⁷ Recently concerns in the west focused on Chinese electric car companies.⁸ However, much less attention, if at all, is given to the small and medium private enterprises (SMEs) and their relations with local state organs at the provincial level (*sheng* 省), prefectural-level (*diji shi* 地级市) and the county level (*xian* 县), which usually do not involve cutting edge sensitive technologies and geopolitical considerations.

My research intended originally to analyze a group of small private companies in a peripheral city in one of the China's central provinces, and their relations with the local government and other state organs, such as labor unions, state owned banks and other SOEs in the prefecture. Due to confidential reasons I shall call this city Ofakim and the province Zhong. However, while doing the research I realized that considering the huge size and diversity of China, it will be much more useful and empirically valid if I analyze companies from other regions and various sectors of the economy. So in total I compared five local companies in Ofakim, which are mainly industrial companies, one medium size high-tech company in Beijing (with subsidiaries in many provinces) and one IT service company with two main branches in Shanghai and Beijing (with two additional small branches in Guangzhou and Chengdu).

My research is located within the framework of "State Capitalism" and it relies significantly on the seminal work methodology offered by Milhaupt and Zheng.⁹ This methodology was developed and implemented on large Chinese companies, which often operate in the international arena. By focusing on SMEs which are smaller and less researched, I hope that I can contribute to this important question and shed more light on the intricate web of relations between state organs and private businesses. Although, the world's media tend to give most of its attention to the big and famous POEs (e.g. Baidu, DJI, BYD, Tencent, Alibaba), in fact, the stark majority of POEs are SMEs and the SMEs share in GDP is often larger than that of the big POEs (as elaborated in Chapter I.).

Although the topic of State Capitalism belongs formally to the field of political economy, my research include observations from other disciplines, including the social and cultural context of China. In this respect, I shall discuss the Chinese holistic worldview of a unified hierarchical structure of society, and values such as harmonious society, priority of the family, collective society, and Chinese political philosophy. These traditional values are important part of the Chinese DNA and its governance system and thus belong to the unique model of Chinese State Capitalism. These values incorporate Confucian concepts and to lesser extent Legalist philosophy. These values, which were suppressed until 1976, re-emerged in recent years and went through a rejuvenation campaign by Hu Jintao and Xi Jinping. In order to emphasize the importance of these values, the Communist Party of China (CPC) added some of them to its concept of "Core Socialist Values". Later on, in 2018, the Chinese constitution added the Socialist Core Values and also Harmony as integral part of China's long term goals.¹⁰ Thus, traditional values have become also a part of the updated CPC policy and terminology.

⁷ For example, see: Curtis Milhaupt and Wentong Zheng, "Beyond Ownership: State Capitalism and the Chinese Firm", *Georgetown Law Journal*, Vol. 103, Issue 3 (2015).

⁸ For example: "Chinese Electric-Car Invasion Prompts Security Warning - Report", *Drive* (23 August, 2023).
<https://www.drive.com.au/news/chinese-electric-car-invasion-prompts-security-warning/>

⁹ For example: Milhaupt and Zheng, and Pearson et al.

¹⁰ The 2018 Chinese constitution includes Socialist Core Values in Article 39 and Harmony in Articles 32, 34, and 38.

When the term “State Capitalism” is used in regard to China, it often concerns big SOEs and big public companies (private or partly-private). These companies are called sometimes “National Champions”.¹¹ As we shall elaborate later, in section 2 of this introduction, the concept of “State Capitalism” is quite debated among the scholars and is hard to define. In fact it is a vague term that includes many other economic, social and cultural concepts, and among them we can also find the traditional Chinese values.

The holistic Chinese worldview sees the society as a unified (monist) hierarchal and comprehensive net of social relations that span every object in it. Within this holistic view the relations between the state and the companies are similar to the Confucian relations between emperor and subjects (or parents and children). Thus, there is not much difference between private and state-owned companies, since both are subjects of the state. Professor Li Daokui, of Tsinghua University, and a former central bank adviser, seems to have this traditional worldview, when in May 2023 he proposed to set up a regulatory body to oversee the private sector, with responsibilities and powers similar to those that the State-owned Assets Supervision and Administration Commission (hereinafter SASAC), is using to supervise the Chinese SOEs.¹²

Finally, while SMEs usually interact with local state organs (but sometime also with the central government), I hope that some of the research observations can assist in analyzing the real nature of bigger Chinese companies, including those that invest and/or operate in Israel.

1. The Research Scope, Questions and Hypothesis

The main goal of this research is to understand and clarify the nature of the relations between Chinese private SMEs and the various state organs, which they interact with. This understanding would allow me to shed light on the important questions discussed in the introduction; namely, what is the level and mechanisms of “control” that the Party-State, and especially local governments, impose on private SMEs, and thus, where and how we should draw the line, or should we, between SOEs and POEs?

The practical importance of the above questions can be demonstrated by the attempt of the Organization for Economic Co-operation and Development (OECD) to distinguish SOEs from POEs. In 2005 the OECD original criteria were based on rather narrow economic and legal angle, which emphasized the shareholding structure.¹³ However, in 2015 the definition of SOEs became much more realistic, wider and flexible.¹⁴ Yet, such definition became much harder to implement, in a way, that practically requires significant financial and research efforts (including detective work) to verify the status of a specific company.¹⁵

¹¹ For example: Li-Wen Lin and Curtis Milhaupt, “We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China”, *Stanford Law Review*, Vol. 65, Issue 4 (April 2013). And also: Mary Gallagher, “The Social Relations of Chinese State Capitalism”, In: *Regulating the Visible Hand the Institutional Implications of Chinese State Capitalism*, Eds. Benjamin Liebman & Curtis Milhaupt, New York: Oxford University Press, 2015.

¹² “China’s Private Sector Should be on a Par With State-Owned Industry, Leading Economist Tells High-Profile Beijing Forum”, *South China Morning Post* (7 May, 2023). <https://www.scmp.com/news/china/article/3219634/chinas-private-sector-should-be-par-state-owned-industry-leading-economist-tells-high-profile>

¹³ See the definition the OECD 2005, “Guidelines on Corporate Governance of State-Owned Enterprises”, p.11, which defines SOEs as: “enterprises where the State has significant control, through full, majority, or significant minority [...] but also when the State has a small stake in a company, but should nevertheless act as a responsible and informed shareholder”. <https://www.oecd.org/daf/ca/oecd-guidelines-corporate-governance-soes-2005.htm>

¹⁴ See the definition in OECD, 2015, “Guidelines on Corporate Governance of State-Owned Enterprises”, p.14. <https://www.oecd.org/corporate/guidelines-corporate-governance-soes.htm>

¹⁵ For example, such is the case and the debate to decode the “real nature” of Huawei. See: Balding and Clarke.

However, focusing solely on the “control” of Chinese SMEs by the state organs loses the context and misses some important observations. First, the research reveals that the results vary significantly and depend on many factors such as location, scale and the SMEs economic sector; Second, as shall be elaborated later, the relations are a two-way street, and the companies also effect the state organs. Milhaupt and Zheng call this phenomenon “State Capture”.¹⁶ Thirdly, by focusing on the direct players who control the SMEs, one ignores the institutional, social and cultural environment in which the players need to engage and deliver. This is especially true when we consider the holistic concept of Chinese society, in which politics, law, business, family and society are intertwined. In certain cases, such as companies with international elements, the international environment also influences the nature and decisions of the SME or the state organs. This is why the conclusions and observation of my research are much wider than the two important questions that I began my research with. In addition to the two important questions mentioned above, my research also raised the following sub-questions, which helped me to understand the full picture:

- What are the motives of the CPC and local governments (including its subordinates) to cooperate with, assist, and/or co-opt private SMEs? Which motives are dominant?
- To what extent state organs (central / local / party) intervene in the private SMEs affairs (e.g. production plan, technology research, financial issues, political indoctrination, etc.)?
- How and what mechanisms the CPC and state organs use to assist and/or co-opt private companies?
- What are the reasons of private SMEs to seek the assistance, cooperation, and relations with, local state organs and/or the CPC? What are the dominant motives?
- What are the non-economic obligations of Chinese private SMEs towards state organs? (for example: social stability, socialism, national security, employment, R&D and innovation)
- How do private SMEs in China attract the attention and assistance of local governments and the CPC? How do personal relations (*guanxi*), political affiliation and Chinese culture interact in such cases?
- What is the role of traditional values in the relations between SMEs and the state organs?

2. Literature Review:

According to Political Economy, the relations between POEs and the Chinese state organs, as well as the degree that POEs (including SMEs) are “controlled” or “manipulated” by the state, fall under the concept of State Capitalism. State Capitalism, is regarded as one variant of Capitalism, but its definition is hotly debated and criticized by many scholars. Alami & Dixon (2020) explain their criticism as follow: “Hence, the term [State Capitalism] not only lacks a unified definition, it refers to an extremely wide array of practices, policy instruments and vehicles, institutional forms, relations and networks that involve the state to different degrees and at a variety of levels, time frames, and scales.”¹⁷

Considering the wide spectrum that the term is used, the literature and the tools used in this debate, comes from a wide range of academic disciplines including; law; sociology and anthropology; economics; finance,

¹⁶ Milhaupt and Zheng, pp. 694-695.

¹⁷ Ilias Alami and Adam Dixon, "State Capitalism (s) Redux? Theories, Tensions, Controversies", *Competition & Change*, Vol. 24, No. 1 (2020), p. 71.

business; political science, etc. Thus, and depending on the specific question we ask, we may look upon it from different angles, use different disciplines, and each discipline shall emphasize different aspects.

The academic literature regarding State Capitalism in modern China (after 1980) extends for almost 45 years and we can see how the literature and the models evolved with the actual changes of the economy and the governance of China. Thus, we see that during the first period (roughly 1980-1994), when SOEs dominated the economy, scholars differentiated less between Chinese State Capitalism and other nations. During the second period (roughly 1995-2007), Chinese economy went through privatization and internationalization process, which created a hybrid economy with very high growth rate that transformed China to be the second biggest economy in the world. These changes encouraged new theoretical models of China's State Capitalism and many scholars began to see China as a unique case of State Capitalism. The current period, which began during the 2007 economic crisis, shifted back the power and resources to the state sector and SOEs. Then, from 2012 onward, when Xi Jinping took control, further measures were taken to support the state sector, while the state "penetration" and control of the private sector become deeper.¹⁸

In analyzing the "control" nature and whether a company is SOE or POE, the work of Milhaupt and Zheng emphasizes the perspective of corporate governance, and their main argument is that in China (and also in some other countries), you cannot simply use shareholding data to determine the actual control of the company. Moreover, they reject the dichotomist division between SOEs and POEs and believe that the nature of a company can be defined along a spectrum between "pure" POE and "pure" SOE. In order to determine this nature and the POE relations with state organs, Milhaupt and Zheng provide a list of parameters that can help in such determination. Among them, the corporate structure and shareholding data; management identity and its proximity to state power; alignment with the State's developmental and industrial policy objectives; access to state finance, subsidies, tax benefits; and access to other state privileges (e.g. real-estate, licenses and technology).¹⁹ The rejection of the simplistic division between POEs and SOEs is also supported by the theory of May, Nölke and Ten-Brink, according to which "Economic activity [i.e. in emerging economies like China] rests on a close relationship between various state and domestic business actors leading to growth alliances at the national and sub-national level".²⁰

Instead of using the vague term of State Capitalism, May, Nölke and Ten-Brink prefer to use the term State Permeated Market Economy (SPME), which they identify as one of five major types of Capitalism (along with Liberal, Coordinated, Dependent and Hierarchical Capitalism).²¹ Other scholars, like Allen, Wood and Keller, prefer to define State Capitalism based on the typical components that are often stipulated in the literature. Thus, they identify three major components of State Capitalism: The "purpose"; the "means" that the state is using to achieve its purpose; and the "networks of state-business interactions".²² Another approach is

¹⁸ For summary of the changes see: Gal Furer, "Economy and Control: State-Owned and Private Corporations", In: *The Red Book, A Guide for Contemporary China*, Ed. Eyal Propper, Tel Aviv: INSS & Yediot Acharonot, 2022, pp. 171-175 (in Hebrew).

¹⁹ Milhaupt and Zheng, pp. 683-688.

²⁰ Christian May, Andreas Nölke, and Tobias Ten Brink, "Public-Private Coordination in Large Emerging Economies: The Case of Brazil, India and China", *Contemporary Politics*, Vol. 25, No. 3 (2019), pp. 277-278.

²¹ Tobias Ten Brink, "China's State-Permeated Capitalism: a Global Political Economy Perspective." In: *State Capitalism and Development in East Asia since 1945*, Leiden: Brill, 2023, p. 182.

²² Matthew Allen, Geoffrey Wood and Matthew Keller, "State Capitalism: Means and Dimensions", In: *The Oxford Handbook of State Capitalism and the Firm*, Eds. Mike Wright et al, (Oxford Handbooks Online ed), Oxford: Oxford University Press, 2022, pp. 81-83. <https://doi.org/10.1093/oxfordhb/9780198837367.013.4>

taken by McNally, who prefers a special definition of Sino-Capitalism, and I think we can classify his approach as a special variant of SPME.²³

McNally distinguishes his Sino-Capitalism from other State Capitalism as follows:

Sino-Capitalism is much more complex than pure conceptions of State Capitalism. It incorporates various liberal economic tenets and the creative use of market forces, while encompassing vibrant, highly networked, and globally integrated entrepreneurial firms often with hybrid or purely private ownership. Many state firms are also frequently profit driven, seeking markets or resources for commercial reasons rather than purely to fulfil political goals.²⁴

McNally's description emphasizes the *guanxi* aspect and before he coined the term "Guanxi Capitalism".²⁵ Pearson, Rithmire and Tsai, who focus on the contemporary situation, had shared with McNally the uniqueness of Chinese State Capitalism, but they argue that since 2013, the Chinese model was transformed into a new version that they name as Party-State Capitalism. They explain this as follows:

Recent changes in China's model, however, make it less comparable to state capitalist systems because the tools of state intervention and its underlying logic are different [...] contemporary China is better understood as a sui generis form of political economy in which the party-state's political survival trumps developmental goals.²⁶

Pearson, Rithmire and Tsai, argue that this Party-State Capitalism includes three main features: "Further encroachment by the party-state on the economy; blurring of state and private sectors; and demands for political fealty from firms."²⁷

It is also interesting to note that the SPME approach and the Sino-Capitalism description of McNally, can fit in or at least have a lot in common, with the much older model of "encompassing organization" which Mancur Olson defined in his seminal book *The Rise and Decline of Nations* (1982).²⁸ Olson claims to explain the differences in macroeconomic growth of nations. One of his observations is that in some nations there are "encompassing organizations", which often help society to be more productive. He explains it as follows: "The members of highly encompassing organizations own so much of the society that they have an important incentive to be actively concerned about how productive it is; they are in the same position as a partner in a firm that has only a few partners."²⁹

In 1984 Olson gave examples for nations with encompassing organizations, such as Sweden and USA and did not refer to China (maybe because in 1984 China was just "waking up"),³⁰ but I argue that the CPC, which

²³ Christopher McNally, "Sino-Capitalism: China's Reemergence and the International Political Economy", *World Politics*, Vol. 64, No. 4 (2012), p. 747. McNally recognizes the division of three types of Capitalism, the liberal, coordinated and dependent, and he adds his Sino-Capitalism as a fourth type. May, Nolke and Ten-Bricks defined SPME only in 2013 and they would probably define the Sino-Capitalism of McNally, as a specific variant of their SPME general type.

²⁴ McNally, *Ibid*, p. 766.

²⁵ Christopher McNally, "China's Changing Guanxi Capitalism: Private Entrepreneurs between Leninist Control and Relentless Accumulation", *Business and Politics*, Vol. 13, No. 2 (2011), p. 4.

²⁶ Margaret Pearson, Meg Rithmire, and Kellee Tsai, "Party-State Capitalism in China." *Current History*, Vol. 120, No. 827 (2021), p. 207.

²⁷ *Ibid*, p. 209.

²⁸ Mancur Olson, *The Rise and Decline of Nations*, New Haven: Yale University Press, 1982, p. 48.

²⁹ Olson, *Ibid*

³⁰ Mancur Olson, "Why Nations Rise and Fall", *Challenge*, Vol. 27, No. 1 (1984), pp. 16, 23.

has almost 100 million members, is a better example for “encompassing organization” than Sweden and USA. What Olson adds to the State Capitalism concept and SPME is that if certain conditions are fulfilled (e.g. organization size and identity of the leaders) Sino-Capitalism or SPME can create a very productive economy.

Professor Yang Yao, using this concept, albeit with a different terminology and with some distinctions, attempts to prove that this is what actually happened in China during the reform period.³¹

Although there are many academic definitions to the Chinese economic system, most scholars can agree that Chinese sort of Capitalism includes the special component that Allen, Wood and Keller named “networks of state-business interactions”,³² and which McNally describes as follow:

Sino-Capitalism relies on informal business networks rather than on legal codes and transparent rules [...] For the most part private capital accumulation in China has exhibited highly networked formal and informal institutional characteristics that have enabled entrepreneurs to overcome initial hostility from the state and forge cooperative relations at the local level, where the two processes of state-led development from above and network-based development from below tend to meet.³³

This “networks of state-business interactions”, which is the focus of my research, further blurring the dichotomist definition of SOEs vs. POEs, which is also the observations of Milhaupt and Zheng as well as Pearson et al. Cheng and Wu add to that, and explain that; in countries like China, where formal institutions are weak (e.g. legal system, protection of private property rights; enforcement of contracts; frequent change of government policies; and discrimination against private firms), there is a tendency of POEs’ owners, and executives, to look for non-formal institutions as a substitute to formal institutions. Thus, close relations with state organs is a major tool in business development.³⁴ Empirical evidence by Dickson, shows that such close relations are sought after by owners and managers of POEs, which explains why so many businessmen join the CPC and various public and state institutions.³⁵ This phenomenon reflects the reciprocal nature and growing alliance between the private sector and the state, as suggested by the SPME theory of Nölke et al. Other studies that validate the benefits of these reciprocal relations were conducted by Li et al. (2008), and also Xu et al. (2014) and they show that leaders of POEs with CPC membership had positive effect on the firm’s performance and helped them to obtain loans from state banks and/or other state institutions, as well as affords them more confidence in the legal system.³⁶ Lin and Milhaupt also list additional studies:

Political connections are important to private-firm growth in China and serve as a form of protection for large Chinese firms in a weak rule of-law environment (Milhaupt and Zheng 2015). Prior studies

³¹ Yang Yao, “The Disinterested Government: An Interpretation of China's Economic Success in the Reform Era”, In: *Achieving Development Success: Strategies and Lessons from the Developing World*, Ed. Augustin K. Fosu, USA: Oxford University Press, 2013. Yao recognizes that China regime is “Encompassing Organization” but he prefer using the term “Disinterested Government”, which he thinks is better suited to describe the phenomenon in China, and in other places. pp. 153, 162.

³² Pearson, Rithmire and Tsai, p. 207.

³³ McNally, p. 744.

³⁴ Wenli Cheng and Yongzheng Wu, “Bank Finance for Private Firms in China: Does Political Capital Still Pay Off?”, *World Economy*, Vol. 42, No. 1 (January 2019), p. 245.

³⁵ Bruce Dickson, *Red Capitalists in China: the Party, Private Entrepreneurs, and Prospects for Political Change*, New York: Cambridge University Press, 2003, pp. 159-160.

³⁶ Hongbin Li, Lingsheng Meng, Qian Wang and Li-An Zhou, “Political Connections, Financing and Firm Performance: Evidence from Chinese Private Firms.” *Journal of Development Economics*, Vol. 87, No. 2 (2008), p. 296.
Xu, Chenggang, Di Guo, Kun Jiang, and Byung-Yeon Kim, “The Political Economy of Private Firms in China”, *Journal of Comparative Economic*, Vol. 42, Issue 2 (May 2014), pp. 294-295

document the link between political connections and the likelihood of listing shares on Chinese stock exchanges in initial public offerings (Lee, Qu, and Shen 2019), that POE with political connections being favored by domestic courts in commercial lawsuits (Lu, Pan, and Zhang 2015), and assist in gaining access to external finance (Firth et al. 2009; Li et al. 2008; Berkowitz, Lin, and Ma 2015).³⁷

As mentioned earlier, the model of Milhaupt and Zheng, which try to distinguish between POEs and SOEs, is part of the debate on State Capitalism, and what the many scholars we introduced are trying to achieve is to place the Chinese capitalistic version within a wider theoretical model that fit all the emerging markets and preferably build a blueprint that encompass all versions of Capitalism. In this regard, May, Nölke and Ten-Brink seems to introduce the most inclusive theory of Comparative Capitalism, which include five (5) major types (Liberal, Coordinated, SPME, Depended and Hierarchical Capitalism), and among them, the SPME version of Capitalism fits best the emerging markets like China.³⁸

The work of Milhaupt and Zheng is focused on big Chinese multinational companies (MNCs), such as Huawei, ZTE and Lenovo, which are exposed to scrutiny by the media, due to their status as “National Champions”; international operation; and legal disclosure obligations as public companies (excluding Huawei, which is a “private” company). However, Milhaupt and Zheng methodology ignores the Chinese SMEs, which operate in a more opaque environment, cooperating with local state organs, under regional priorities and various sub-cultures. This gap we plan to fill in our research.

The theoretical model of Nölke et al. is founded on various disciplines, including anthropology (in other words sociology and culture),³⁹ but it lacks empirical data and they themselves suggest that “future research would need to further specify the specific conditions under which intensive collusion between state actors and businesses does or does not prove to be economically harmful”.⁴⁰ In this respect, our research can provide some empirical data that will clarify the above specifics.

In Chapter I. we shall see that a certain form of State Capitalism was actually common in China in previous periods, such as the late Qing, and especially during the nationalistic government (1929-1949). We shall also see that “networks of state-business interactions”, which are an essential component of State Capitalism, was common in the past. It reveals itself in the traditional networks of family businesses, Kin and state *guanxi*, and it has remained until today. These networks contain the traditional values, many of them Confucian, that are deeply embedded in the Chinese psyche in general, and the Chinese business culture in particular. These traditional values re-emerged, by a bottom-up process after Deng Xiaoping’s reforms (grassroot process),⁴¹ and they were further promoted in a top-down process by the CPC since Hu Jintao took office.⁴² One of the

³⁷ Lauren Yu-Hsin Lin and Curtis Milhaupt, "Party Building or Noisy Signaling? The Contours of Political Conformity in Chinese Corporate Governance", *The Journal of Legal Studies*, Vol. 50, No. 1 (2021), p. 196.

³⁸ May, Nölke and Ten Brink, p. 276.

³⁹ Ibid, p. 279. Anthropology actually contain also sociology and culture

⁴⁰ Ibid, p. 287.

⁴¹ Sébastien Billioud, "Confucianism in Chinese Society in the First Two Decades of the 21st Century", In: *The Cambridge History of Confucianism*, Ed. Kiri Paramore, Cambridge: Cambridge University Press, 2021, pp. 2-5.

⁴² Billioud, Ibid, pp. 10-13. See also: Aleksandra Kubat, "Morality as Legitimacy under Xi Jinping: The Political Functionality of Traditional Culture for the Chinese Communist Party", *Journal of Current Chinese Affairs*, Vol. 47, No. 3 (2018), p. 48.

better examples is Hu Jintao's promotion of the slogan "harmonious society" that most people will immediately associate with Confucianism.⁴³

These historical and present facts lead us to the conclusion that the traditional values are a part of the Chinese form of Capitalism. The CPC itself is using the slogan "Chinese Characteristics", as a suffix to their description of the economy ("Market Economy with Chinese Characteristics") and the political system ("Socialism with Chinese Characteristics"), and it is interpreted to include also the traditional values of Confucianism,⁴⁴ and to lesser extent also Legalism (mainly since Xi Jinping ascended the throne).⁴⁵

The literature on the role of Confucian and traditional values in the Chinese economy is diverse. The famous Max Weber, argued that Confucianism inhibit the development of Capitalism and market economy in China.⁴⁶ Professor Lam believes that Confucian values fit better with Socialism and thus in 1919-1949 Sun Yat-Sen and his followers implemented economic policy, which used Confucian ideas to pursue a form of socialism that nationalized most of the economy and left very small part of it for the private sector.⁴⁷ Poznanski argues that Chinese people have a built-in psyche that he calls "Confucian Economics", which contain the ancient Confucian philosophy, and it is transferred mainly through family, from parents to children. These economic principles are ethical in nature, and Confucian economics favors a type of market that he calls a "familial market" based on moral principles. In this market the basic institution is the family, rather than the individual, and as a result Chinese prefer long-term goals over short term profits. Poznanski believes that these Confucian moral economic principles fits better with socialism but also helped with the capitalistic reforms of the last few decades.⁴⁸

Others, such as Lee Kuan Yew, the former legendary prime minister of Singapore, believed that Confucian values are key ingredient in capitalist modernization, and similar opinions are shared by many contemporary scholars.⁴⁹ For example, Rarick, argues that Confucian Work Ethics are very helpful in capitalist economy, especially by maintaining social interconnection, which enables family based networks. Such informal, worldwide networking (*guanxi*) has helped fuel an explosion of Chinese Capitalism. This networking can be seen now in China as well as other Chinese communities around the world, and it is facilitating economic success.⁵⁰ Rarick claims that "fostering a work ethic consistent with Confucian values has been shown to be fruitful", because Confucian tradition not only emphasizes a holistic concern for the welfare of employees, group harmony, teamwork, and self-sacrifice, but it also promote frugal managers, and loyalty and dedication to the organization. Thus, employees work tirelessly for the good of the group, the organization, and the nation, while managers tend to be autocratic and maintain tight control over the organization.⁵¹

⁴³ Billioud, Ibid, p. 12.

⁴⁴ Yi-Huah Jiang, "Confucian Political Theory in Contemporary China", *Annual Review of Political Science*, Vol. 21 (2018), p. 171.

⁴⁵ Billioud, p. 13.

⁴⁶ Sophie Pezzutto, "Confucianism and Capitalist Development: From Max Weber and Orientalism to Lee Kuan Yew and New Confucianism", *Asian Studies Review*, Vol. 43, No. 2 (2019), p. 224. See also: Baomin Dong, "Capitalism and Confucianism: Was Weber Right?", *Journal of Economic Issues*, Vol. 57, No. 1 (2023), pp. 103-104.

⁴⁷ Kit-Chun Joanna Lam, "Confucian Business Ethics and the Economy", *Journal of Business Ethics*, Vol. 43 (2003), pp. 157-158.

⁴⁸ Kazimierz Poznanski, "Confucian Economics: How is Chinese Thinking Different?", *China Economic Journal*, Vol. 10, No. 3 (2017), pp. 363-364 and 372-374.

⁴⁹ Pezzutto, pp. 224-225.

⁵⁰ Charles Rarick, "Confucius on management: Understanding Chinese Cultural Values and Managerial Practices." *Journal of International Management Studies*, Vol. 2, No. 2 (2007), pp. 2, 6.

⁵¹ Rarick, Ibid, p. 8.

In contrast to the previous scholars, Pezzutto believes that Confucian cultural explanations for socioeconomic development is inadequate, and she argues that: “Confucianism has all too often been presented as a monolithic fixture offering a convenient, culturally deterministic explanation for either economic growth or stagnation, without sufficiently taking into account the complex social, political, historical, geographic and economic processes that shape and determine capitalist development.”⁵²

Most of the above arguments are rather theoretical, but there are also new empirical evidence that Confucian and traditional values support successful economic activity (i.e. Capitalism). In a rather big-data empirical research, Dong shows that places where historically Confucian influence was more pronounced, business activities, measured by the amount of capital, were more flourishing today. Thus, he concludes that Confucian values are conducive to the development of better informal institutions, which positively impact informal finance. These results offer support to the argument that it is pro-capitalist in contrast with the Weberian theory.⁵³ Without taking a decisive opinion on the benefits or drawbacks of Confucianism to Capitalism, our research findings (Chapters III, IV) shows that in many cases traditional values do influence the SMEs operation, as well as the local state organs that interact with the SMEs.

To summarize this Chapter; there are various theories that try to define the Chinese State Capitalism. Among them I find the SPME and McNally theories to be the most useful. I also concur that the “networks of state-business interactions” is a special component that exist in most versions of Chinese Capitalism. And, finally, I acknowledge that Chinese traditional values, many of them Confucian, influence the nature and scale of the “networks of state-business interactions” in China.

3. Hypothesis and Methodology:

Based on the literature and my personal experience of living and working in China, my original hypothesis was, that the dominant motives of local governments and state organs to assist private SMEs, are to promote economic development, while keeping social stability.

This hypothesis fits well within the “State Capitalism” paradigm, but it doesn’t exclude other motives of the state organs, such as political control, scientific development, traditional values of the culture (such as harmonious society, local patriotism, etc.), personal relations (*guanxi*), local prestige and personal benefits. However, I hypothesized that non-dominant motives can play a role in some cases, although they are not a necessary element. Moreover, I assumed that *guanxi* is a major reason for a specific company to acquire the attention of the state organs, and in a competition or public tender situation, when everything else is equal, there is a good chance that state organs shall prefer the company with *guanxi* over its competitors.

My analysis is based on different academic discipline including law, sociology, economics, business management and political science. Thus different viewpoints will not always be consistent. For example, business management scholars examine the Corporate Political Strategy (CPS) of POEs. Facilitating *guanxi*, which is studied mainly by sociologist and anthropologist, is an important part of CPS, but CPS and *guanxi*

⁵² Pezzutto, p. 225.

⁵³ Dong, pp. 119-120.

only partly overlap.⁵⁴ On the other hand, political science, and political / developmental economy are more interested in the state organs viewpoint, and the actual influence on the economic output of the state / region, or other political targets of the regime. Thus, they may focus on issues of employment, social stability, and political control, as well as economic performance of the region. Political scientists and anthropologists may combine the above viewpoints into one holistic view that emphasizes the reciprocity between POEs and the state organs, and view the two sides as complementary parts of one structure. In this respect they will examine how the system contributes to the social cohesion and people's happiness and not concentrate only on economic parameters. In this respect they may examine how career promotions of state officials and personal benefits influence the reciprocal relations.⁵⁵

Considering all this, my thesis tend to take the holistic approach, focusing on reciprocal relations, and view both sides as complementary components of society. I think that this holistic approach match the traditional Chinese worldview, which is still common today in China, and thus it captures reality better. This approach also matches McNally's description that the POEs and state organs "Forge cooperative relations at the local level, where the two processes of state-led development from above and network-based development from below tend to meet".⁵⁶

The research was designed and based on my personal experience, gathered during 30 years of engagement as a lawyer and manager in China, including 15 years living and working in Beijing and seven years of working with SMEs and State organs in Zhong province. This experience includes private meetings with officials, and SMEs managers; exposure to common practices that are not always strictly legal; and access to confidential documents and information that are rarely open to academic research. In addition, in order to gain a complete and updated picture of the SMEs that are the subject of this research, in summer 2023 I conducted field research, which includes interviews the SMEs' management and officials from Ofakim government.

My field research has two axis of comparison: Vertically I compared the development of the SMEs in Zhong province, between the 2003-2013 period and the recent period (2013-2023). Horizontally I compared the current situation among eight SMEs of different nature and size in Zhong province, Beijing and Shanghai.⁵⁷ The horizontal axis helped me to identify which factors and motives work at which environment, and the vertical axis, allows me to see, which factors and motives gain or lose dominance and importance along time. Below it the table of the researched SMEs. In Chapter II, we will provide more details on each company:⁵⁸

Groups	JMC Holding (JMC)				HJV	BIT Group		AIB
SME	JMC Glass	JMC Packing	JMC Caps	JMC Farm	HJV	B-IT	S-IT	(16 branches)
Location	Ofakim	Ofakim	Ofakim	Ofakim	Ofakim	Beijing	Shanghai	Beijing

⁵⁴ CPS activities are wider than *guanxi*, but CPS miss the reciprocity and social aspects of *guanxi*. See : Xinming Deng, Zilong Tian, and Muhammad Abrar, "The Corporate Political Strategy and its Integration with Market Strategy in Transitional China", *Journal of Public Affairs*, Vol. 10, No. 4 (2010) p. 377. See: McNally, p. 4. See more in Chapter III (3.5)

⁵⁵ See: Hongbin Li and Li-An Zhou, "Political Turnover and Economic Performance: The Incentive Role of Personnel Control in China", *Journal of Public Economics*, Vol. 89, No. 9-10 (September 2005), pp. 1743, 1744.

⁵⁶ McNally, p. 744.

⁵⁷ Some of the bigger companies also have branches and subsidiaries in other cities and provinces.

⁵⁸ The real names and details of these companies are stipulated in the confidential Annex B.

List of Collected Raw Materials:

- Materials and real-life experiences collected in the years 2008-2013 while I represented HJV as a lawyer. In this capacity I was also exposed to state organs relations with HJV and JMC group of companies, as well as the relations within JMC group and JMC relations with other companies (mainly loans and debts). Written materials include legal contracts, memos, letters, emails, etc.
- Formal documents of the relevant companies from the Chinese relevant departments (SAIC, MOFCOM, Labor Bureau, etc.), including business licenses, annual audits, etc.
- Interviews with key people in the relevant companies (in Ofakim, Shanghai and Beijing).
- Interviews with key officials of various state organs in Ofakim.
- Work experience of 15 years in China (1998-2012), as a Lawyer, Manager and Entrepreneur.

Other Methodological Issues:

- **Interviewees identity:** Due to the sensitivity of some materials and requests by some of the interviewees The identity and other details of the interviewees are confined to the confidential Annex B of this thesis.
- **Interviews methodology:** We used pre-made unstructured questionnaires with mostly open-ended questions. Most interviews where in informal settings (except the interview with the official). Most interviews where one-on-one, so people could talk freely. With most interviewees I had previous friendly relations. The advantage is that that they were more honest and exposed some sensitive materials (not the least because they knew that I know). On the other hand, there is a risk that my analysis could be biased due to these friendly relations. I also made complementary phone interviews with most interviewees during the writing process.
- **Analysis of Research Findings:** Most analyses in this research are qualitative, but the comparison between the eight SMEs has some a quantitative dimensions. In addition I compared the research results with the current literature about Chinese POEs.

Chapter I. Private Chinese Companies: Historical Background

In order to give a wider context, I review first the rather unique phenomenon of private companies in China. It is unique, because through much of Chinese history, what is normally called “private company” in the west, was quite different in China, due to the holistic worldview of a unified, hierarchic, and centralized governance system. This system never adopted the “separation of powers” concept. Thus, during most of Chinese history, private firms had significant dependency relationships (formal and informal) with the state and local governance organs. For our purpose it is sufficient to begin our observation in the 18th century, when production and commerce were increasingly privatized. However, the central government, mainly via its finance ministry, kept tight control of the private sector by licensed brokers for trade,⁵⁹ and licensed monopolies, which existed mainly in the manufacturing fields of salt, copper, ginseng, Imperial textile and porcelain.⁶⁰

Another unique feature of the Chinese private firms at that period is that they were mainly in the form of family household businesses. Yet, many of them where pretty large, with a network of branches and intercity

⁵⁹ Richard Lufrano, "Minding the Minders: Overseeing the Brokerage System in Qing China", *Late Imperial China*, Vol. 34, No. 1 (2013), pp. 67-68.

⁶⁰ Philip Richardson, *Economic Change in China, c. 1800-1950*, Cambridge: Cambridge University Press, 1999. p. 86.

cooperation. During the 19th century, private firms included, among others, big trading houses and the salt business, and mining (e.g. the Zigong Merchants in Sichuan). However, due to the centralized and unified governance structure of the Qing Dynasty, many of the large and successful private firms relied upon some form of state sponsorship. Goetzmann and Köll describe it as follow:

Private household businesses, many of them of substantial size and scope, were the central institutions for domestic private economic activities in imperial China during the Ming (1368–1644) and Qing (1644–1911) dynasties. Family businesses have a long tradition in China and have been highly successful in the production and/or distribution of commercial goods, including long-distance trade. [...] However, as these merchant businesses were dependent upon government patronage, they were forced to stay in good favor by contributing large sums to the state's military campaigns and making huge donations to various public and imperial projects.⁶¹

The unique nature of the Chinese (private) family firms in the late Qing period did not include the limited liability concept, and it is summarized in the following paragraphs: "Chinese family firms are generally perceived to have been organized as simple partnerships, relying on household capital and the resources of kin and friends, demonstrating little separation of ownership and control, and providing neither clear separation between the claims of business and personal creditors, nor protections for the firm against claims by individual creditors against individual partners."⁶² William Kirby, quoting John Fairbank, explains that:

There was no idea of the corporation as a legal individual. Big firms were family affairs. Business relations were not cold impersonal matters governed by the general principles of the law and of contract in a world apart from home and family. Business was a segment of the whole web of friendship, kinship obligations, and personal relations that supported Chinese life.⁶³

Taking into consideration this traditional social background, the enacting of the first Western style, Company Law in 1904, reflected an important step towards Western style structure, which enabled, for the first time, the establishment of Western style limited-liability corporations in China.⁶⁴ These legal changes did not happen in a vacuum, and they reflected the reality on the ground, in which Chinese companies cooperated and/or competed with foreign firms that operated in China for over 70 years (since the Nanjing Treaty), mainly in the extraterritorial coastal enclaves. Thus, Goetzmann & Köll explain: "The code of 1904 should not be viewed as a beginning of corporate Capitalism in China in any sense, but rather a top-down "revision" of the course that large-scale Chinese business enterprise had taken over the previous three decades - a course that had already freely interacted with, and been adapted from, Western-style business models."⁶⁵

⁶¹ William Goetzmann and Elisabeth Köll, "The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control", In: *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, Ed. Randall K. Morck, Chicago: University of Chicago Press; 2005, p. 152.

⁶² McWatters, Cheryl Susan, et al, "Family Business Development in Mainland China from 1872 to 1949", *Business History*, Vol. 58, No.3 (2016), p. 408.

⁶³ William Kirby, "China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China", *The Journal of Asian Studies*, Vol. 54 No. 1 (1995), p. 46.

⁶⁴ Goetzmann and Köll, p. 150.

⁶⁵ Goetzmann and Köll, p. 162.

Goetzmann and Köll also add that "the newly incorporated companies combined traditional business practices and institutions rooted in Chinese family business with modern corporate structures to successfully gain and maintain control."⁶⁶

In other words, the legal and structural revisions that followed the adoption of a Western legal and business values, assisted to the expansion of the private sector of China, but the traditional culture values of family business, kin networks, etc., have still been kept within the new legal structure.

The next phase of development, took place during the turmoil period of 1911-1929. This period saw rapid changes in many dimensions. First, and most important, it was a period of strong economic growth combined with major social changes that came after the fall of the Qing Dynasty and the end of "Chinese Feudalism".⁶⁷ International and interregional transactions between "strangers" grew fast,⁶⁸ as well as competition with, and imitation of, foreign firms by the Chinese private companies (mainly in the coastal area of China). Second, the development of civil law enabled and facilitated contracts and enforcement of contracts via litigation, so it was easier for companies and individuals to establish business relation between parties with no previous acquaintance.⁶⁹ And third, many new laws were enacted and elaborated the corporate structure of companies, such as the 1914 Ordinance Concerning Commercial Association. Also, in this same period, the structure of the traditional guilds was replaced by Chambers of Commerce and "street associations".⁷⁰

However, in spite of all the changes, the actual operation nature of most firms continue to reflect the traditional "family values", which relies on family control, traditional networks, and family financing. Kirby described it as follow: "What we may call a 'Capitalism with Chinese characteristics' resisted the corporate structure (a.k.a. western style incorporation) even in the period of its most dynamic and unencumbered growth."⁷¹

During the 1929-1949 period, the Nationalist Government, that controlled most of the industrialized regions, pushed for a different policy of strengthening state control of the economy, by transferring the private sector, including foreign companies, into SOEs, or public-private partnerships (with 51% of ownership to the government). The process was gradual and included a blitz of new civil and commercial laws, including the Company Law of 1929 and the Company Law of 1946. In 1935 the government also nationalized the leading commercial banks, and after the war with Japan broke in 1937 the government became even more aggressive and nationalized industrial, mining, and electricity enterprises, as well as appointed the management of firms that failed to "effect measures of technical or administrative reforms as ordered by the government".⁷² Thus, by 1943 the SOEs accounted for 70% of the total paid-up capital of all enterprises in the areas controlled by the Nationalist Government.⁷³ By 1944, the state controlled share of production had reached 53.7%.⁷⁴ Kirby

⁶⁶ Goetzmann and Köll, p. 175.

⁶⁷ Feudalism is a European concept that was adopted by Chinese historians and Marxists in the early 20th century in spite of the major differences with the European situation. In essence in China the term means combination of the fiefdom system in and the idea of local self-rulers. For elaboration see: Lidong Zhao, "Feudal and Feudalism in Modern China." *Journal of Modern Chinese History*, Vol. 6, No. 2 (2012), and: pp. 198-216.

⁶⁸ Kirby, p. 49.

⁶⁹ Kirby, Ibid.

⁷⁰ Kirby, Ibid.

⁷¹ Kirby, p. 51.

⁷² Kirby, Ibid, pp. 51-53.

⁷³ Kirby, Ibid, p. 53.

⁷⁴ Moris Bian, "State Enterprises During the First Half of the Twentieth Century", In: *The Cambridge Economic History of China*, Eds: Debin Ma & Richard Von Glahn, Cambridge: Cambridge University Press, 2022, p. 205.

summarize the situation as follow: “When the Communists took over in 1949, they would find 70% of all Chinese industry controlled by the government and over half of government enterprises already reorganized as limited (lability) companies.”⁷⁵

After the establishment of the people republic of China in 1949 the decline of the private sector in general, and private corporations in particular, accelerated in several waves; first, during the Five Antis Campaign in 1952;⁷⁶ then the “socialist high tide” of 1956;⁷⁷ which was followed by the Great Leap Forward (1958-1961); and then the Cultural Revolution (1966-1976). During this period the state nationalized and/or purchased and/or collectivized the private firms,⁷⁸ and at the end of 1958, there were practically no private corporations in China. However, some individual private businesses still existed. By 1978, China contained merely 140,000 individual private businesses (0.01% of the population) and not a single private corporation.⁷⁹

The revival of private companies in China begun in 1978 as part of the “reform and opening-up” (改革开放), policy of Deng Xiaoping. Some scholars argue that these reforms and the combination of socialism and capitalism, were inspired by the ambiguous ideas of Sun Yatsen that “to his death he retained the hope that China would find a way to harness the energy of capitalism to the justice of socialism”.⁸⁰

The reforms of Deng began, informally, within the agriculture sector; but later on, a constitutional amendment passed by the National People’s Congress authorizing, not surprisingly, family businesses, which were restricted to the employment of no more than seven non-family members.⁸¹ This piece of legislation, suggests that the social values and the traditional values of private family firms in China were still very important, despite 30 years of the CPC Marxist ideology.

Then in 1979 the novel concept of Sino-Foreign Joint Ventures was enacted, and it was the first PRC law that recognized a company with a separate legal identity. In 1982, the revised Chinese constitution acknowledged in article 11 the legitimacy of the private sector, followed in 1988 by the Tentative Stipulations on Private Enterprises (TSPE), and in 1994 it was finally replaced by the comprehensive Company Law.

Since 1978, the private sector in China expanded dramatically. But, as Lardy explains:

The state expanded the scope of businesses open to private firms only gradually. *Family businesses* were quick to take advantage of the early opening of opportunities in retail, catering and construction, but private entry into manufacturing was initially slower. And, as discussed above, key parts of the economy are still reserved for state companies.⁸² [My emphasis]

⁷⁵ Kirby, p. 56.

⁷⁶ Jonathan D. Spence, *The Search for Modern China*, New York: Norton, 1990, pp. 536-539.

⁷⁷ Robert K. Cliver, "Surviving Socialism: Private Industry and the Transition to Socialism in China, 1945-1958", *Cross-Currents: East Asian History and Culture Review*, Vol. 4, No. 2 (2015), pp. 153-154, 156.

⁷⁸ Kirby, p. 56.

⁷⁹ Guibin Zhang and Zhong Qin, “The Development of Private Businesses in China 1978-2008”, Asia-Pacific Economic and Business History Conference. Responses to Environmental Change (p.[25]). University of Melbourne: Economic History Society of Australia and New Zealand. pp.3-4. <https://ro.uow.edu.au/commpapers/1872>,

⁸⁰ Michael R. Godley, “Socialism with Chinese Characteristics: Sun Yatsen and the International Development of China”, *The Australian journal of Chinese affairs*, Vol. 18 (1987), p. 113.

⁸¹ Nicholas Lardy, "The Changing Role of the Private Sector in China", RBA Annual Conference (2016), p. 40. <https://www.rba.gov.au/publications/confs/2016/lardy.html>

⁸² Lardy, *Ibid*, p. 41.

In 2018, the number of private companies in China was 15.61 million, which comprised 84.1% of the total number of companies.⁸³ These companies employed over 80% of urban employees, and their share of the GDP was about 60%, or 70% if we include Foreign Invested Enterprises (FIE).⁸⁴ It is a bit harder to estimate what is the share of private SMEs among the POEs. In 2020 SMEs were 97% of the companies in China, they contributed over 60% of total GDP, 50% of tax income, 79% of job creation and 68% of exports.⁸⁵ However these numbers include state-owned SMEs. Assuming that the share on SMEs among POEs and SOEs is similar, than private SMEs contribute about 36% of GDP (actually the share of SMEs among POEs is probably larger). This estimation is close to the average numbers of the World Bank for emerging economies (around 40% share of GDP),⁸⁶ and it also match the numbers calculated on 2003 Chinese data (around 30%),⁸⁷ which likely increased since then.

Another feature of the Chinese private sector is that it is export oriented, and thus it usually has international operations. So some of the big private corporation are often publicly listed in China and/or foreign Jurisdictions (mainly USA and Hong Kong).⁸⁸ The international operation and public listing exposed the large Chinese POEs to deeper scrutiny and professional accounting standards, which did not always end well, this was especially evident in 2011-2012, when over 100 Chinese companies were delisted from the New-York stock exchange due to fraud and accounting scandals.⁸⁹

This brief historical review teaches us that the history of private firms in China is not so short, and all along this history, the private sector in China had two main features; first, the private firms often had tight and reciprocal relations with the local and/or central government, as well as frequent participation in guilds and other business association.⁹⁰ And second, that the traditional values that are ingrained in the concept of “family business” are central to the operation and management of the Chinese private firms.

These traditional values, which are often described as Confucian values (though there are also others), include holistic worldview of a unified (monist), centralized and hierarchical structure of society and governance, strong family ties (and filial piety), and harmonious society. The harmony of the society dictates governance based on moral values, priority to the collective over the individual, and thus, submission to authority.⁹¹

⁸³ "Over 84% Companies in China are Private", *China Daily* (28 Nov', 2019).

http://www.china.org.cn/business/2019-11/28/content_75457219.htm

⁸⁴ Chunlin Zhang, "How Much Do State-Owned Enterprises Contribute to China's GDP and Employment?", *World Bank Publication* (August 2019), pp. 1-2. <https://elibrary.worldbank.org/doi/abs/10.1596/32306>

⁸⁵ See : "The Rise of SMEs in China", *Ecovis* (24 Nov', 2021) <https://www.ecovis.com/heidelberg/en/blog/2021/11/24/the-rise-of-smes-in-china/> and also "Financing SMEs and Entrepreneurs 2022 (Chapter 33 China)", *OECD Library*. <https://www.oecd-ilibrary.org/sites/a3891ad8-en/index.html?itemId=/content/component/a3891ad8-en#:~:text=In%20China%2C%20there%20are%20over,creation%20and%2068%25%20of%20exports>

⁸⁶ "Small and Medium Enterprises (SMEs) Finance", *World Bank* (2019) <https://www.worldbank.org/en/topic/smefinance>

⁸⁷ "Private Sector Assessment, People's Republic Of China", *Asian Development Bank* (Nov' 2003)

<https://www.adb.org/sites/default/files/institutional-document/32210/prc-psa.pdf>

⁸⁸ The foreign IPOs of Chinese firms began in 1991 with mainly SOEs, and become a flood since 2000. For examples of IPO of POEs abroad: NetEase, SOHO, Sina in 2000, Ctrip in 2003, Baidu in 2005, etc.

<https://www.uscc.gov/sites/default/files/Chinese%20Companies%20on%20U.S.%20Stock%20Exchanges.pdf>

⁸⁹ David Cogman and Gordon Orr, "How They Fell: The Collapse of Chinese Cross-Border listings", *McKinsey Insights*, (2013).

<https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/how-they-fell-the-collapse-of-chinese-cross-border-listings>

⁹⁰ Goetzmann and Köll, pp. 150, 177.

⁹¹ Christopher Ford, "The Party and the Sage: Communist China's Use of Quasi-Confucian Rationalizations for One-Party Dictatorship and Imperial Ambition", *Journal of Contemporary China*, Vol. 24, No. 96 (2015), pp. 1037, 1045.

This view stands in contrast to the Anglo-American approach, which support a much more individualistic society and a governance system that is based on the separation of powers theory, and the medium of the law (“rule of law”) to balance between these powers.⁹²

The inclination to keep the traditional values of family businesses in contemporary POEs, is supported by empirical evidence, such as the situation in Taiwan, where, in 1983, some 84 of the 97 most significant business groups could be “strictly classified as family-owned business groups.”⁹³ Another research confirming the importance of traditional Chinese values in the business operation of current day private firms, was conducted by Oppen & Andersson (2018) and this research found that: “Provinces that have been entrepreneurial during the Ming and Qing dynasties tend to be also entrepreneurial in modern times, with only the form of entrepreneurship changing over time.”⁹⁴

In other words, entrepreneurship, which is a good proxy for private firms, depends on deep-rooted cultural values transmitted over generations.⁹⁵ The proposition that was validated in the research was defined as follow: “Chinese regions that have historically displayed a high concentration of entrepreneurial activities enjoy comparative advantages in the recreation of a post reform *private firm economy* [my emphasis], once the institutional constraints of the old socialist regime have been lifted and the relative payoff structure starts rewarding productive entrepreneurship.”⁹⁶

In recent years, the expansion of the private sector in China, and especially its domination of high-tech fields, such as e-commerce, social networks, drones, surveillance, and electric cars, saw the renewal of government intervention, and aggressive moves by the CPC to assert greater control over important and/or big private companies.⁹⁷ This intervention ended in some extreme cases of “nationalization”, such as Hainan Airlines,⁹⁸ and Anbang Insurance Group.⁹⁹ One of the recent and significant cases is the shareholding restructure of Alibaba and Ant Financial.¹⁰⁰

⁹² Since Xi Jinping took the helm he emphasized the concept of “Rule by Law”, but it is a very different concept from “Rule of Law”. See: Kwai Hang Ng. “Is China a Rule-by-Law Regime?” *Buffalo Law Review*, Vol. 67, No. 3 (2019).

⁹³ Kirby, p. 57.

⁹⁴ Sonja Oppen and Fredrik Andersson, “Are Entrepreneurial Cultures Stable Over Time? Historical Evidence From China”, *Asia Pacific Journal of Management*, Vol. 36 (2019), p. 1167.

⁹⁵ Oppen and Andersson, *Ibid*, p. 1167, define “entrepreneurial culture” as a culture that reward the accumulation of power and wealth. Therefore I think this is a good proxy for private firms.

⁹⁶ Oppen and Andersson, *Ibid*, p. 1170.

⁹⁷ This can be done, for example, via installing CPC Cells in the company or by other means. See for example: Alexander J. Martin, “‘Private’ Biz Xiaomi Sets Up Communist Party Exec Committee”, *The Register* (15 June, 2015). https://www.theregister.com/2015/06/29/xiaomi_sets_up_communist_party_committee/
See also: “Kweichow Moutai, China’s Biggest Listed Company, Gives 4% of Stock to Prop Up Home Province”, *Apple Daily* (25 Dec’ 2020). The Apple Daily website was deleted by the Hong-Kong government, But I have a copy of the article.

⁹⁸ “Hainan Airlines Says Govt is Controlling Shareholder Now, But Change Possible”, *Reuters* (17 May, 2018). <https://www.reuters.com/article/china-hainan-airlines/update-2-hainan-airlines-says-govt-is-controlling-shareholder-now-but-change-possible-idUSL3N1SO3E4>

⁹⁹ Lucy Hornby and Archie Zhang, “China’s Anbang Gets Rebrand After Government Takeover”, *Financial Times* (11 July, 2019). <https://www.ft.com/content/6dc0a97a-a3ab-11e9-974c-ad1c6ab5efd1>

¹⁰⁰ See: “Ant Group Says No Plan for IPO, Focusing on Business Optimisation”, *Reuters* (8 January, 2023). <https://www.reuters.com/technology/ant-group-says-no-plan-ipo-focusing-business-optimisation-2023-01-08>
See also: “Why China Jailed a Billionaire Entrepreneur and Seized His Company”, *Voice of America* (18 Nov’, 2020). https://www.voanews.com/a/east-asia-pacific_voa-news-china_why-china-jailed-billionaire-entrepreneur-and-seized-his-company/6198557.html

This recent intervention trend, is a source of fear for Western governments and commentators, which we presented in the introduction. In the following Chapters, we will examine the actual and practical influence of this intervention on the private SMEs that we researched. I shall also observe the significance of the traditional values for the relations between state organs and those private SMEs. In this respect it is interesting to keep in mind how Goetzmann and Köll described the common opinion:

China business historians have tried to capture the essence of Chinese enterprises by focusing on personal relations, in particular in family businesses. Frequently, a business organization has been more or less reduced to the interpretation of being a network, often in the context of a search for the “spirit of Chinese Capitalism”. Scholars have argued that “kinship and collegiality in China play roles analogous to those played by law and individuality in the West.”¹⁰¹

This review of the Chinese history of private firms, and the importance of the family values and social networks explains why many scholars recognize the role of traditional values in the Chinese State Capitalism theories. In Chapter V(3) we shall analyze how these traditional values express themselves in our research findings.

Chapter II. SMEs under Research

1. Introduction of the Researched Companies

The table below shows major differences among the eight SMEs that I researched. I will start by giving a brief review of each SME, or group of SMEs, but due to the sensitivity of some materials, many details and names are fictitious. The real names and data are available in the confidential Annex B.

Group	JMC Group (JMC)				HJV	BIT Group		AIB
Name	JMC Glass	JMC Packing	JMC Caps	JMC Farm		B-IT	S-IT	(16 branches)
Location	Ofakim	Ofakim	Ofakim	Ofakim	Ofakim	Beijing	Shanghai	Beijing
Started	2003	2003	2003	2015	2004	1998	2001	2006
Nature	Privatized	Privatized	Privatized	Private	Private	Private	Private	Private
Industry	Glass Production	Cardboard Production	Metal Production	Agriculture	Materials Production	IT Service	IT Software	AI logistics Data Mining
Revised	2009	----	2023	----	2005/2009	-----	-----	gradually
Current Nature	SOE	Privatized	SOE Hybrid (25% JMC)	Private	FIE-EJV Owned by AVL	Private	Private	“Mixed Ownership”
Employ	20-50	20-50	20-50	5-10	150-250	30-50	30-50	1500-2500
Value	Small	Small	Small	Tiny	Medium	M-Small	M-Small	Big Unicorn
Revenues	Small	Small	Small	Minimal	High	Medium	Medium	Very High
Profits	Loses	Profits	Profits	Loses	Profits	Profits	Profits	Loses

2. Companies Background and History

The JMC Group: (Hereinafter also “JMC”) includes a group of SMEs, which most of them were originally subsidiaries of a big SOE in Zhong province (Hereinafter “HBB”). The companies are located in Ofakim, which

¹⁰¹ Goetzmann and Köll, p. 176.

is a “Prefecture Level City” (地级市). The city is about 200km from the capital of Zhong province. Although the urban population of Ofakim is only around 400,000 people, due to China distinct administrative system, the city government controls an area of over 12,000 square km and a population of over 3,000,000 people.

Following the privatization policy of 1997, whose slogan was “grasp the large, let go the small” (抓大放小),¹⁰² HBB requested its chairman, which we will call Mr. Long, to take ownership and management of the small and unprofitable subsidiaries of HBB in order to recover them. For this purpose they offered Mr. Long all kind of financial and legal assistance and in 2003 Mr. Long established JMC as a holding company with three small subsidiaries: **JMC Glass** that mainly produces glass bottles for use by HBB; **JMC Packing** that mainly produces cardboard packing materials for various clients, including HJV and HBB; and **JMC Caps** that produces bottle caps and metal cans, mainly for HBB.

Since those companies were money losing enterprises, HBB and the local government assisted JMC to establish in 2004 a new and bigger company, which we shall call HJV. This company produces special materials and the government assumed that HJV, will be healthy and profitable, so it can sustain and support financially the whole of JMC Group. Unfortunately, the recovery process was not so successful. JMC glass was hardly profitable and it was sold to another private investor in 2009 and later he sold it back to HBB and now it is again a subsidiary of HBB (i.e. SOE). JMC Caps was also hardly profitable, so in 2023, the JMC Group sold 76% of it back to HBB, and the restructured company relocated its factory to the Economic Development Zone (EDZ) of Ofakim. This transaction enabled JMC to make a nice profit from selling the old factory’s land, which is in the middle of the city, for expensive residential construction. On the other hand, JMC Packing was reasonably profitable and JMC still keeps 100% ownership of it. JMC farm was established in 2015 and it grows mainly cherry trees that still do not give commercial yield.

HJV Company: After the establishment of HJV in 2004, JMC faced hardships in managing HJV due to lack of experience in the new industrial field of special materials. Therefore they searched and found Avalon (AVL), which is a foreign public company with experience and leadership in this industry. AVL agreed to help JMC and share the ownership of HJV in order to develop the business. AVL received originally 50% of ownership, but only the minimum management powers. However, in 2008 AVL purchased another 20% of HJV ownership, took control of management and turned the company profitable. Due to AVL becoming a shareholder of HJV, the legal status of HJV changed to Equity Joint venture (“EJV”), which is a special type of Foreign Invested Enterprise (“FIE”). By the Chinese legal definitions FIE is considered a private company, yet, FIEs is subject to extra regulations (some are a burden and some are advantageous).¹⁰³ After 2008 HJV went through additional and gradual restructures and today 99% of the ownership is held by AVL and only 1% is held by the Long family (with no management power).

My knowledge of JMC Group and HJV is based on recent interviews with the owner of JMC Group (Xiaoli, the son of Mr. Long) and interviews with HJV management (including GM, PR Manager, Finance Manager, Labor Union leader, CPC Party Cell leader, and the CEO of AVL). However, I also have inside knowledge of all these companies from the period (2008-2013) that I represented HJV as their lawyer. In this period I had intensive contact and negotiations with the JMC Group and the local state organs.

¹⁰² Furer, “Economy”, p. 167.

¹⁰³ All the FIE companies in China follow the regular rules for companies, but they are also subject to another set regulations, which have pros and cons. In 2019 the Foreign Investment Law of PRC, abolished many of the differences.

BIT Group: The BIT Group was established around 1998 by three young entrepreneurs who met in China. One is an American, a graduate of a prestigious university in Switzerland, who worked in China in mid-level management position for a famous German car company, and the two others are Chinese women, who at that time, studied English. Since the company is registered on the name of the Chinese shareholders it is treated legally as a standard domestic Chinese company and not as FIE. The combination of Chinese and a foreigner with business relations with the multinational companies (MNCs) located in China, helped in the initial period to obtain a decent foreign client base in China, which paid well for various IT services (Mainly installation of phone systems, networks, and computer systems). Later on, in 2001 the company opened its Shanghai branch and today it also has two small branches in Chengdu and Guangzhou. Around 2001 BIT also got a license to open a small Internet Service Provider (ISP) subsidiary in one district of Beijing. At its pick, the ISP Company had around 20,000 clients. This business did not evolve and now there are only a few hundred legacy clients that still using the service.

Somewhere along the way, two founders (a couple) moved to Shanghai and now the Beijing branch (B-IT) and Shanghai branch (S-IT) are operating, practically, as two separate companies with different business models. B-IT, where the company's headquarter is registered, is still focusing on IT services. But S-IT's main business is a management software that they developed for the hospitality industry in China. Yet legally and also from cooperation perspective all the branches are cooperating well when it is required.

My knowledge of BIT Group is based on recent interviews that I made with the CEOs of B-IT and S-IT, but I also have inside knowledge of both companies from the time that I worked in B-IT (2000-2002) as the CTO of the company as well as the head of Data Services Department.

AIB Group: AIB group was established around 2006 by three serial entrepreneurs with scientific and technology background. It is a leader of digital services for the logistics industry in China (using IoT, AI and big data), and it also has some International activity. AIB improves logistics productivity using digitalization and artificial intelligence (AI) along the whole logistic chain. AIB had several rounds of investments, with total sum of more than \$700 million, and it was valued at over two billion \$US, which makes it a unicorn. Among their investors are central SOEs, Chinese "National Champions" (such as Tencent and Alibaba), Chinese and international PE funds, famous international energy firm, and a foreign sovereign fund. Although many subsidiaries of AIB are formally registered as domestic private companies, the AIB legal structure is very complicated; it includes at least one joint venture with foreign firms and its current structure fits better with the definition of "Mixed Ownership".¹⁰⁴ The three founders who manage the company still have minority share holdings. AIB intended to become a public company in 2022, but due to the weak economic situation at the time, their IPO was delayed for the future. The headquarters of AIB is in Beijing in a special industrial park dedicated for companies with AI technology. AIB has over 16 branches and offices in China (some of the branches are stand-alone companies and some are subsidiaries).

¹⁰⁴ For further discussion regarding AIB structure and governance see sections 3 (below) and Chapter IV (1, 3.3). For further discussion regarding "Mixed Ownership" see also Chapter IV (4.5)

3. Corporate Governance (company structure and management)

As one can tell from the introduction above, the eight companies in our research are very different. However, the differences are not only in location, size, and sector of activity, but also in their management style and corporate governance. Originally, the JMC companies were 100% controlled and managed by the late Mr. Long, but now JMC Packing and the Cherry farm have employee managers (relatives and confidant). The manager of JMC Caps is appointed by the state-owned HBB. B-IT and S-IT situation is different and they are owned and managed by their founders. In contrast HJV is owned by a AVL, which is public foreign company and the GM is a Chinese professional manager without any stake of ownership. AIB is also different, because the founders have two hats, as managers and as minority shareholders.

In this respect, the interest of BIT managers and shareholders is identical, while in all other companies, there may be a conflict of interests between managers and shareholders (the “Agency Problem”). For the JMC Group this problem is minor. Until Mr. Long’s death (in 2021) he managed the companies, but even today the family still has good control and supervision of the companies, due to their small size, relatively simple production process, and loyal managers (relatives and confidants). The Agency problem is bigger for HJV and AIB. In HJV case the owner (AVL) is far away and from different culture, but it seems that AVL and the GM pf HJV have trust relations (he is serving already 11 years). As for AIB, it has complicated legal structure, which is not fully transparent. It has at least 20 big investors, which include central SOEs, IT National Champions (Tencent and Alibaba), Foreign and Chinese PE firms, etc. It is a conglomerate of companies that include at least one joint venture with foreign firms (thus it is also an FIE) and it is likely to have some VIE structure.¹⁰⁵ According to recent available data the three dominant shareholders hold less than 10% each.¹⁰⁶ Thus, the Agency problem is more complicated and the founders-managers have big advantage over the shareholders: First, because nobody understand the complicated technological and commercial sides of the business like them; Second, because such a diverse group of shareholders usually have conflicting interests, which make it harder for them to build a coalition against management; and third, the managers-founders are also minority shareholders, so they have some legal rights that strengthen them.

Chapter III. Vertical Comparison of JMC and HJV (2003-2023)

In this section we will review the relations of state organs with HJV and JMC group (including its subsidiaries), during the period of 2003-2023 and compare the changes along this time line. In Chapter IV we shall horizontally compare the current situation among all the companies that participated in our survey.

1. Historical Background and Proximity to State Organs

In 2013 Lin and Milhaupt coined the term “Institutional Bridging” to explain the importance of the sophisticated network among the management of SOEs and the Chinese Party-State apparatus:

¹⁰⁵ VIE, variable interest entity, is a legal structure in which investors have certain controlling rights despite not having a formal shareholding rights. This is because the controlling rights are arranged via a set of contracts rather than direct ownership.

¹⁰⁶ Details and references of the company structure are elaborated in the confidential Annex B.

These mechanisms create networks among businesses and other organs of the party-state, promote information flow, and provide high-powered incentives to actors in the system by linking corporate performance and political advancement. Together, these features can be thought of as means to assemble what Mancur Olson called an “encompassing organization” — a coalition whose members “own so much of the society that they have an important incentive to be actively concerned about how productive it is.”¹⁰⁷

Later, in 2015, Milhaupt and Zheng researched the situations in the top 100 POEs of China (defined by revenues) and based on their findings they expand this term also to POEs. They explained it as follow:

These bridges consist of dense, stable networks of relationships fostered through rotations of managers, personnel exchanges, and the wearing of multiple hats (on behalf of SOEs, the government, and the Party) by managerial elites in China. Institutional bridges are also prevalent between state or Party organs and senior executives of *large private enterprises* in China.¹⁰⁸ [My emphasis]

In the following sections I shall explain the relations of key people at HJV and JMC Group with the Party-State organs, and show that “Institutional Bridging” exist also in some private SMEs.

JMC Group: Among the companies in our survey, it is clear that JMC Group has the deepest relations with the Party-State organs. This is due to its history as a spin-off from the state-owned HBB, and due to the special position of the founder, Mr. Long, who established the companies. Mr. Long was a senior member of the CPC and his wife is also a CPC member. He served for many years as the chairman of the big state owned HBB; was elected for one term (2002-2003) as representative of the National People Congress (NPC) and was elected for several times as representative of Zhong province NPC (2006-2008). Until his death in 2021, he had an impressive office in HBB headquarter, and when we visited that office, the employees of HBB were showing him very obvious respect (although he left his position five years earlier). When we visited Ofakim, Mr. Long would usually organize dining with senior leaders (Mayor, Party Secretary, etc.). Sometimes it was needed because HJV and/or JMC Group had requests from the local government, but sometimes there was no special reason for those banquets. So it seems to be a part of “maintaining relations” and/or “showing-off” event. Mr. Long was often boasting about his strong relations in Zhong in general, and in Ofakim in particular. When JMC had disputes with AVL he used to threat that he will use his *guanxi* with the government to harm AVL.

Mr. Long’s son (Xiaoli) which used to work in different positions in JMC and HJV, is now the owner of JMC Group. Although Xiaoli lives now in Hong Kong, he visits Ofakim often and he is responsible for the relations with the local government. Xiaoli is not a CPC member but he is a member of China Association for Promoting Democracy 中国民主促进会 (民进) since 2003 (following his father request). Mr. Long’s wife, which is also a CPC member, is keeping the relations with Mr. Long’s friends. Xiaoli told me in the interview that his father connections with the government helped a lot with the business. JMC has a CPC cell in the group level and 30% of the employees of JMC subsidiaries are CPC members (this is a very high percentage and it is due to the origin of JMC as a HBB spin-off).

¹⁰⁷ Lin and Milhaupt, p. 702.

¹⁰⁸ Milhaupt and Zheng, pp. 683-684.

HJV Company: In the initial phase of HJV, it was 100% owned by JMC Group, and as we explained above, the local government and HBB provided HJV special financial, legal and preferential assistance, which shall be elaborated below. In addition, HJV was also established in the EDZ, and thus was eligible for various preferential policies. In 2005, when AVL took 50% of HJV shareholding, the legal status of HJV changed to EJV, which added certain new legal advantages (such as importing machines without custom fees). In 2008 when AVL became the majority shareholder (70%) and took direct management of HJV, Mr. Long still held a management position and was responsible for the PR of HJV, which was actually and mainly handling the communication with the local state organs. After 2013, when AVL acquired 99% of the shareholding, and until his death in 2021, Mr. Long still held the honorary title of HJV president (which does not give legal powers) and he continued to receive certain benefits from HJV (car subsidy, humble salary and PR budget) in order to help in facilitating the relations with the local state organs. The current GM of HJV was hired by the AVL in 2012. He is also a member of the CPC and has extensive experience working in a very big SOE in Shandong province. He also claims that he has some good *guanxi* in Zhong province. However, the GM says that until Mr. Long passed away, he had let Mr. Long to conduct most of the relations with local state organs and he took this responsibility only after the death of Mr. Long. The PR manager of HJV (which was originally Mr. Long personal assistant) is also assisting in the relations with the local authorities. HJV has a CPC Party Cell since its inception and Mr. Long was the head of the Party Cell until 2019. About 10% of the employees of HJV are members of the CPC (which is also quite high percentage).

2. Government Assistance to JMC and HJV during 2003-2023

The local government assistance to JMC Group and HJV can be divided into different categories and we can also differentiate few types of assistance; direct assistance, assistance by one of the government subordinates (like SOEs, Banks, etc.) and assistance to JMC/HJV in conflicts with private actors (e.g. parties in commercial disputes with JMC and/or HJV). In the following sections I shall classify the assistance in rough categories (which sometimes overlap). I will try to list it in chronological order and I shall compare the difference between the periods of 2003-2013 and 2013-2023.

The reason to choose 2013 as the dividing point, is due to two reasons; first this is the year that AVL took full control of HJV management, and HJV became practically a Wholly Owned Foreign Enterprise (WOFE). As such, it was risking a different treatment by state organs, which often give preference to Chinese domestic companies (and also to joint ventures);¹⁰⁹ and Secondly, this is the year when Xi Jinping began implementing new policies, including the Anti-Corruption Campaign, that affected significantly the relations between POEs and state organs (we shall elaborate these further in section 3.5.5).

2.1 Government and EDZ Assistance Related to Land and Property:

¹⁰⁹ See for example: Uri Dadush and Pauline Weil, "How Difficult is China's Business Environment for European and American Companies?", *Bruegel - Policy Contribution*, No. 12/21 (May 2021), <https://euagenda.eu/upload/publications/pc-12-260521-.pdf> The common perception of Chinese discrimination against foreign invested enterprises is not a systematic phenomenon, and in some aspects FIEs also have advantage. According to Dadush and Weil, in 2021, the situation improved and they summarize it as follow (p. 9): "the perception of double standards in treatment by regulators varies across sectors, and the IT sector is among those where discrimination is perceived most keenly. European Chamber (2020) notes China is moving towards a 'one economy two systems' model in which market forces can play a bigger role in some sectors but in others, deemed strategic, Beijing is reasserting its grip."

- 2.1.1 In 2003 JMC Group received all of its assets (factories, land, machines) free of Charge, in exchange for taking the debts of the companies towards its employees (i.e. severance compensation). In addition JMC received soft loans with the government and HBB guarantees.
- 2.1.2 In 2004, JMC leased for 20 years the land plot for HJV factory at a discounted rate. At that time, the Economic Development Zone (EDZ) was just beginning and the land was very cheap. To calculate the land price, EDZ used a legal formula, but at that time the formula provided wide discretion, and thus was easy to manipulate it and provide preferred price for companies that are important for the EDZ (due to legitimate reasons, or due to less legitimate reasons).
- 2.1.3 In 2009, JMC Packing was restructured and relocated to the new EDZ of Ofakim, getting cheap land for their factory and eligible for various preferential policies by the local government. In addition, this move enabled the Long family to rent the old factory to another firm.
- 2.1.4 JMC Caps, the original bottle cap company, purchased 10 years ago (around 2013) a land plot in the EDZ and now it is where the new partnership with HBB is located. They got the land at a cheap price determined by a legal formula, but the relations of Mr. Long enabled a better price.
- 2.1.5 In 2011, EDZ assisted HJV to relocate the adjacent companies, in order to provide their plot to HJV (but it didn't materialize due to HJV decision at the time).
- 2.1.6 In 2011, EDZ provided HJV with a 2,300 sq.m. warehouse for one year, free of charge. Since then it leased the warehouse to HJV at a steep discount (about 40% of market price).
- 2.1.7 The EDZ built for HJV high-capacity electric supply on its own expense (third production line).

Assistance after 2013

- 2.1.8 In 2021-2022, EDZ assisted HJV by relocating one of the adjacent companies, in order to provide that plot to HJV. EDZ paid the difference between relocation cost of that company and the price that HJV agreed to pay for the new plot. The price that HJV paid for the new plot (about 2.3 million Yuan) is about 25% of the relocation cost that EDZ paid for the company that was relocated.¹¹⁰
- 2.1.9 The lease of 2,300 sq.m. warehouse to HJV still continue, with the same discount (40% of market). The official we interviewed stated that the EDZ gives similar lease discounts to at least 9 more private companies in the EDZ.
- 2.1.10 HJV is currently negotiating with the EDZ the renewal of its 20 years lease of the original land plot (to be expired on June 2024) and they expect a big discount off the market price.

Summary: It seems that there is not much difference in the procedures and the benefits that the local government provides in terms of land and properties. It seems that this is the major tool of the local government to encourage new investments or expansion of existing companies. However, there is some difference related to the negotiation process on the land price. According to our interviewees, it is more structured and less personal.

2.2 Government and EDZ Assistance related to Loans and Finance

¹¹⁰ The price for the new plot was agreed upon the fulfilment of certain commercial and investment conditions, which HJV owner (AVL) still did not decide whether to fulfil or not.

- 2.2.1 JMC Group received a preferential loan of about 89 million Yuan to finance the establishment of HJV (“HJV Loan”). It was received originally from ICBC and ABC banks,¹¹¹ but due to some illegalities, it was replaced in 2004 by a loan from Bank of China (BOC). This loan was guaranteed by the state owned HBB, and in return JMC Group pledged its equity share in HJV to HBB. In other words, HBB could take over HJV if the loan was not paid.
- 2.2.2 Although JMC did not pay the HJV Loan in time, no actions were taken against it by BOC. Then in March 2008 HJV accepted to transfer the loan balance (84 million) on its name as part of the restructure transaction that gave AVL larger equity share and the control of HJV.
- 2.2.3 In 2004 JMC Group received a preferential loan of 47 million Yuan from ICBC bank (“ICBC Loan”). This loan was also guaranteed by state owned HBB, and in return JMC Group pledged its equity share in HJV to HBB. Around 2006 ICBC sued JMC and HBB to pay the loan and in 2008 the court gave a temporary injunction to freeze the equity share of JMC Group in HJV. However, the court encouraged the parties and government to find an amicable solution and in the meantime it delayed the case. In 2012, as a part of HJV final restructure, the debt to ICBC Bank was paid by AVL.
- 2.2.4 In 2004 JMC Group received loans from BOC in total of 24 million Yuan. These loans were not paid in time but BOC did not sue JMC. In 2010 the parties signed an agreement to reduce the interest rate to 2.25% if it is paid within three months.
- 2.2.5 In 2006 JMC Group received a direct loan of 3,000,000 Yuan with preferential terms, from the EDZ authorities (initially under the name of HJV, cause it was easier, and later it was transferred to the name of JMC). This loan was not paid back on time, but the EDZ did not take any actions against JMC Group. In 2012 at the final restructure of HJV, the debt of JMC was paid by AVL.
- The local government and especially the EDZ management were involved in approving all the above loans, guarantees and facilitate the procedures required for the processes.
- 2.2.6 HJV received in 2007 short-term loan of 5 million Yuan from XinYe Bank in Zhong province. It seems that this loan was without involvement of the local government. However, the guarantee for the loan was provided by a big state owned Media Group in Zhong province.¹¹²

Assistance after 2013

- 2.2.7 In recent years HJV did take few loans from communication bank and HSBC but it was on a purely commercial basis, with no government assistance.
- 2.2.8 According to the EDZ officer. The EDZ is no longer giving direct loans to companies, but the EDZ is introducing relevant companies that are located in the EDZ to the Banks. The official was proud that in 2023 they introduced 13 companies, and they all received “good loans”.

Summary: there is a clear tendency of the local government to distance itself from direct finance assistance to local POE companies and from encouraging SOEs to assist in loans or guarantees. This attitude is in accordance with the central government policies that is reflected, inter alia, in many regulations that are

¹¹¹ These loans were granted due to Mr. Long’s *guanxi*, local government support and Mr. Long’s wife, who worked for ICBC bank.

¹¹² The state owned “Media Group” is an SOE with around 5k employees, located in capital of Zhong province. Mr. Long had good relations with the company, but it seems that the local government of Ofakim was not involved in obtaining this guarantee.

updated frequently. Already in 2007, Zhong province published regulations that restrict SOEs from giving guarantee to other companies without special approval (especially restricting guarantees for FIEs).¹¹³ More restricting national regulations were published in 2021, limiting such guarantees only between SOEs of the same group.¹¹⁴ Recent regulations by SASAC clearly preventing SOEs, which are not financial institutions, from providing loans and guaranties to private companies or to other SOEs which are not part of the same group.¹¹⁵ Thus, the “legal way” for the local governments to assist financially is limited to “introducing” the relevant companies to the state-owned banks and “requesting” favorable conditions.

2.3 Government and EDZ Assistance related to Taxes, Fees and Social Benefits

- 2.3.1 The main direct financial assistance that the local government in Ofakim provides to encourage investment is based on local regulations. These regulations are updated often (usually once a year). The 2008 version of the regulations were named “Interim Measures on the Investment Incentives for the Industrial Project in Ofakim City Urban Area.”¹¹⁶

These regulations stipulated some principles for providing the incentive (“refund”), mainly related to the scale of investment, and then the company shall receive back a certain percentage of the investment (there are also small incentive based on number of employees). However, the regulations also emphasized the need for a case-by-case inspection and decision. Thus, they left a large space for negotiations and manipulation. In the case of HJV, in 2011, the refund was about two million Yuan, which was received after they built the third-production-line.

- 2.3.2 The EDZ waived the admin fees for HJV third line project (Not based on regulations).
- 2.3.3 EDZ provided HJV with exemption for 2007 Land Use Tax, and 50% discount off the tax in 2008.
- 2.3.4 The EDZ did not enforce the payment of local property tax (2006-2009) and later gave discounts off the original tax assessment.
- 2.3.5 There is a “silent agreement” with the city labor bureau, that payments of social benefits (pension, unemployment insurance, medical insurance, work-injuries insurance, maternity insurance and housing fund) shall be based on the local average salary, rather than the actual salary. This usually increase the net salary of high-paid employees and reduces the employment cost of the employer. In the case of HJV which pays rather high salaries it reduce the cost of the company.¹¹⁷

Assistance after 2013

- 2.3.6 The new local regulations of Ofakim became gradually more comprehensive, and compared with the 2008 regulations, the 2022 regulations are more detailed, they have new types of incentives

¹¹³ “Interim Measures for the Administration of External Guarantees for Enterprises Invested by the Zhong Provincial State-owned Assets Supervision and Administration Commission” (10 Jan’, 2007). Articles 5-6.

¹¹⁴ “Circular on Strengthening the Management of Financing Guarantees of Central Enterprises” (9 Oct’, 2021). Article 3
加强中央企业融资担保管理工作的 通知

¹¹⁵ “Opinions on promoting central enterprises to accelerate the construction of treasury systems and further strengthen fund management” (8 Jan’, 2022). Article 3 (8) 推动中央企业加快司库体系建设进一步加强资金管理

¹¹⁶ “Interim Measures for Investment Rewards for Industrial Projects Ofakin Urban Areas” (16 May, 2008)

“Ofakim 工业项目投资奖励暂行办法”

¹¹⁷ This is a common practice all over China and we witness it everywhere we checked (Beijing, Shanghai, Suzhou, Hubei, etc.)

(e.g. for logistic issues), and refunds are more related to the tax paid by the firm.¹¹⁸ Thus, the regulations are clearer and less exposed for personal discretion and manipulation. The incentives that HJV deserved under the new regulations and policies continue to be granted regularly and smoothly, including 13 million Yuan tax refunds (for the years 2016-2019), and three million Yuan tax refund for upgrading spare parts of the production lines.

- 2.3.7 As mentioned in sub-section 2.2.8, the EDZ is no longer giving direct loans to companies, but it is “introducing” to the banks companies that reside in the EDZ and request loans.
- 2.3.8 The “silent agreement” of the city labor bureau, that payment of social benefits, are based on local average salary, rather than the actual salary, continues. In addition, during the first wave of Covid-19 the labor bureau approved the delay of payment of social benefits for two months.

Summary: Comparing the 2003-2013 period with the current situation, shows clear tendency of the Ofakim local government to simplify and clarify the taxes, fees and deductions required by the state, in order to establish rule-based tax system, rather than man-based system. This tendency is influenced by the central government policy, which is published in many channels. Here is one source: “tax collection and administration system has been continuously optimized. The standards, convenience and precision of taxpayer services and tax law enforcement have also been constantly improved.”¹¹⁹

This tax policy of the Chinese government is supported by findings of researchers including the IMF,¹²⁰ and all our interviewees confirmed that the available tax benefits and incentives are based on relevant regulations or written policies. No special *guanxi* is required in dealing with the VAT, Income Tax and Custom authorities. The local taxation is still more flexible, but it is also based on regulations and it is done in a more transparent way compared with the past. The “assistance” of the labor bureau regarding social benefits deduction is actually favoring strong companies where the average salary is above the local average salary (like HJV), and actually harm companies and employees with low salaries, that required to pay more social benefits than what is required by the law (this is the case in B-IT for some employees).

2.4 Government Assistance in Solving Disputes

Assistance for solving disputes by the government and state organs is part of a long tradition in China to solve disputes through mediation (or arbitration) without using of the court system. It is corresponding with the ideas of collective society, harmony, non-binary solutions and losing face (which usually happens to one of the parties in court). This tradition was also strongly encouraged by the PRC during Mao’s reign (roughly until 1980).¹²¹ Therefore, it is not surprising that the local government in Ofakim and the EDZ authorities in particular, are involved in settling civil, commercial and personal disputes. The motives for such assistance can vary, from desire for social stability, the economic development of the region, or *guanxi* with one of the parties. In addition, the worldview of many officials resonant with the Confucian and the CPC approach of unified and hierarchical governance system. In this system all entities under the

¹¹⁸ “Ofakim City Center Investments Promotion Policy” (2022 edition). Ofakim 中心城区招商引资政策（2022 版）

¹¹⁹ This example was published in December 2022, by the State Taxation Administration and Guangdong Provincial Tax Service. Online : https://guangdong.chinatax.gov.cn/gdsw/hzsw_yhssyshi2022E_zxfb/2022-12/10/content_04a8c6ed062840b6866794104324ae8a.shtml

¹²⁰ For example: John Brondolo and Zhiyong Zhang, *Tax Administration Reform in China: Achievements, Challenges, and Reform Priorities*, International Monetary Fund (IMF), 2016. <https://www.elibrary.imf.org/view/journals/001/2016/068/article-A001-en.xml>

¹²¹ For elaboration see: Gal Furer, “When the Judge Gives “Hi Fives” to the Parties’ lawyers”, *Israel Bar Journal* (March 2005), pp. 50-52. <https://www.viz-asia.com/wp-content/uploads/2020/10/Article-to-the-Bar-2005.pdf>

government jurisdiction, state owned or privately owned, are “subjects” or “children” of the “emperor”/ “father”. Thus, it is the responsibility and duty of the officials to resolve the dispute and facilitate the harmonious society “when there is a children brawl”. Moreover, the unified and hierarchical pyramid structure also infer that the legal system and the courts are not independent, and they are just one arm of many, that the government can use. Therefore, the government, which is superior to the courts can intervene in disputes even when court procedures has already begun.

One of our interviewees (AIB CEO) described it as “the local government feels that it is the holding company of all the companies under its jurisdiction”.¹²² Another scholar preferred to describe it as “local state corporatism”, in which local governments have come to resemble business corporations, with officials acting as the equivalent of a board of directors”.¹²³ The official we interviewed in Ofakim also demonstrated this worldview by showing overwhelming pride in his deep care of the companies in the EDZ, and by emphasizing the personal side of the relations (knowing every GM, birthday parties, etc.)

Whether they feel like directors of a “holding company”, or an “emperor that need to “serve the people”, our interviews and experience revealed that many local officials have a sincere feeling of responsibility towards “their” constituents and this feeling contribute to the disposition to assist in general, and solving disputes in particular, among the companies under their jurisdiction. This is especially true for the EDZ management, which developed personal relations with the companies in the EDZ.¹²⁴ Below are major cases that the government assisted JMC Group and HJV in such matters:

- 2.4.1 In 2006-2008 many parties, including ICBC bank, sued JMC Group for various debts. As a result, in the beginning of 2008 the local court froze most of the equity share of HJV that was held by JMC. This freezing order prevented the completion of the transaction to sell part of JMC Group share in HJV to AVL. The local government put pressure on all parties, discussed the issues with the court and ICBC, and as a result, ICBC agreed to postpone the payment of JMC Group debts, and AVL paid part of the purchasing price (for buying JMC Group shares) directly to the other debtors, so the freezing order on the equity share was canceled and the transaction completed.
- 2.4.2 In 2010 HJV had a work related accident in which one of its employees was killed by a machine. Although HJV had all the relevant obligatory insurance required by the law, the family and the clan of the dead employee, represented by a relative who was a junior police officer, asked for a total compensation of 1.5 million Yuan to be paid immediately, and did not agree to leave the hospital ground and take the body until HJV agrees. The negotiations prolonged for more than 14 days and the nervous government told HJV that the Work Accident Supervision Department will release a report that acquit HJV, but only after HJV reach a settlement. They also said that all the state insurance that the family deserve, and should be paid in monthly instalments along many years, will be redirected to HJV in one lump sum, when and after HJV reaches a settlement (this sum was estimated at 0.5 million Yuan). After 14 days, when no settlement was reached, the government sent the chief of police of Ofakim to “mediate” the settlement. The police chief negotiated

¹²² This is how the CEO of AIB described it when we discussed the situation in Ofakim and other peripheral regions.

¹²³ Kirby, p.58.

¹²⁴ See more regarding the personal relations in section 3.5.

“assertively” with the police officer that represented the family, and within a short time reached a settlement of around 0.6 million Yuan, which was approved by the court.¹²⁵

- 2.4.3 In 2011-2012 HJV had a commercial dispute with a company from Zhejiang province that did not pay for the products they purchased from HJV. It turned out that the Zhejiang company is insolvent, but that the two individual shareholders have money in their bank accounts. So at the very beginning of the legal procedures the city court decided to freeze the money in the bank accounts of the shareholders, under the rarely used legal doctrine of “lifting the veil”, in spite of the “limited liability” of the company. Later on, the court gave a verdict in favor of HJV, there was appeal to the next level court but the appeal was also denied.¹²⁶
- 2.4.4 In 2011 during the third-production-line expansion of HJV, JMC Group and AVL had a dispute over the restructure of their equity shares in HJV (increasing AVL share to 95%). During the dispute, JMC and Mr. Long threatened AVL that they will use their *guanxi* to damage HJV and AVL interest, but the local government assured AVL that they support AVL and they will give AVL assistance to complete the third-line (including finding alternative local partner that will replace JMC).¹²⁷

Assistance after 2013

- 2.4.5 In 2022-2023 when JMC Caps was restructured, the process required to close the old company (in which JMC had 100% ownership) and establish a new company (in which JMC has 24% and HBB 76%), while transferring the assets and employees from the old to the new company. Legally wise, this process required dismissing the employees and re-hire them by the new company, which made the employees eligible for expensive severance compensation. JMC Group was trying to settle this issue by offering the employees “continuation of seniority” in the new company, but they refused. Thus, the work-around solution was to keep the old company alive, and lease the employee services to the new company. Obviously the employees did not like it and all of them sued JMC Caps. But although, normally the local government is very sensitive to large labor disputes like this one, and would often intervene to solve it. Usually, when POEs are involved, the government would be in favor of the workers, but this time it was not. The court was not pushed by the government and the case was decided in favor JMC Caps.

2.5 Government and EDZ – Additional Assistance (After 2013)

- 2.5.1 The EDZ Provides free training to companies located in the EDZ, Including safety training (every year), training for business development (e.g. how to use Ecommerce by SMEs), training for general managers (“GM”), etc. In general, the EDZ offers over 20 training courses per year.
- 2.5.2 The EDZ provided assistance with the legal procedures of registration and expansion (coordination with other state organs, etc.).
- 2.5.3 The EDZ keeps direct contact with all the companies in the EDZ, in order to assist with specific problems. For this purpose they have three full-time employees who are responsible for about 180

¹²⁵ I drafted the final agreement, facilitated the court decision and was personally supervising the negotiations.

¹²⁶ In this case Mr. Long tried to pull some strings in the government and court, but it is also likely that “local protectionism” 地区保护主义 played a major role in this relatively rare and radical decision of the court. My law firm was monitoring the case, which was handled by a local lawyer in the city.

¹²⁷ The government support, forced JMC Group to accept the contract’s stipulations and accept the demands of AVL.

companies that are located in the EDZ. These employees meet the companies upon their requests, but also initiate friendly meetings for the GMs on their birthdays. Meetings for celebrating the spring festival holiday, and also organizing policy meetings such as “government-enterprise breakfast meetings” “entrepreneur days”, and “entrepreneur forum” meetings.

- 2.5.4 According to our interviewees, obtaining various licenses by JMC Cap (printing license) and HJV (pollution certificate, etc.) was done without special *guanxi* and the procedures with the relevant departments were transparent, professional, and with a matter-of-fact attitude.

3. “Reciprocal Benefits” between State Organs and Private Companies

In this section we shall present some typical relations and incidents between state organs and/or officials in Ofakim with the POEs, which provide benefits to all parties or for some of them:

3.1 Deployment of Government Officials to POEs

The deployment of officials to serve in management positions in private companies for periods of 1-2 years was a common practice in Ofakim before 2013. According to our research it was usually announced only after mutual agreement of the deployment was agreed between the local government and the company. In August 2008 the local government of Ofakim published official document appointing an officer from the Municipal Audit Bureau, to be a vice-general manager at HJV for a period of two years, with option for extension. The appointment was coordinated with Mr. Long without notifying AVL, so after it was discovered, AVL raised all kind of questions and reservations regarding this appointment, and Mr. Long settled with the government to abandon this appointment.

The mutual benefit of this “arrangement” is quite clear. Officially, the government states that it will help the officials to understand and learn modern management practices of the private sector. Unofficially it also can help the government to balance “hidden unemployment” in its ranks and save some costs (the base salary is still paid by the government but all expenses and additional benefits should be paid by the company), it can assist to supervise rogue companies, and maybe used even to obtain confidential information of private companies. From the POE perspective, it is a “favor” that they do for the government and thus they can expect something in return. In addition the appointed official can assist the company in obtaining benefits from the government, either due to his knowledge of the system or through his personal connections (*guanxi*). As far as we understood, in recent years Formal Deployment of government officials is not used anymore.

3.2 “Deployment” of Officials’ Relatives;

According to the literature, there is a common phenomenon of hiring relatives or friends of government officials in private companies. Sometime it is initiated by the POEs themselves and other times it is initiated by the government officials.¹²⁸ Generally both parties are enjoying the deal. The official finds a “good job” for his family and friends and thus strengthen his *guanxi* network and increases the household income. The company receives a direct *guanxi* with the official, who “owes a favor” to the company, and

¹²⁸ See for example: “J.P. Morgan Hired Friends, Family of Leaders at 75% of Major Chinese Firms It Took Public in Hong Kong”, *Wall Street Journal* (30 Nov’, 2015). <https://www.wsj.com/articles/j-p-morgan-hires-were-referred-by-china-ipo-clients-1448910715>
See also: “U.S. Fines Qualcomm for Hiring Relatives of China Officials – SEC”, *Reuters* (2 March, 2016). <https://www.reuters.com/article/idUSKCN0W35IH/>

the company will use it when they are in need of assistance. Xi Jinping's Anti-Corruption Campaign is trying to curb these phenomena and the CPC enacted various rules to eradicate it.¹²⁹ Below we will present such "deployments" that happened in JMC Group and HJV:

- 3.2.1 As a spinoff of a big SOE, JMC Group has very high percentage of CPC members in its subsidiaries (about 30%), which increases the probability that some of their relatives are government officials. According to our interviews, JMC Group hired relatives of government officials, based on requests by those officials. However, in recent years such requests are fewer, but they did hire few relatives of officials (including relatives of judges) for medium level positions.
- 3.2.2 Although HJV was established from scratch, it has relatively high percentage of CPC members (about 10%), because Mr. Long brought with him many confidants from HBB and JMC Group. During the years when Mr. Long managed HJV, he was happily accepting requests of government officials to hire relatives and friends and he also employed many of his relatives in different key positions, including his son. Since AVL took control of HJV (2009) This phenomenon was reduced, but there are a few employees who are related to government officials and also at least one case that HJV hired a medium-level employee based on direct request by an official. Another common phenomenon is accepting for internships (2-5 months), young graduates who are relatives of government officials. HJV receives and accepts such requests quite often (2-3 per year) and the internship is much desired because HJV is a FIE and thus it contributes to the CV of these young interns. From HJV point of view, the cost is minimal because it only pays the interns transportation and lunch, but the potential benefits are high.

Summary: Comparing the 2003-2013 period with the current situation, we see a tendency to reduce the phenomenon that relatives of government's officials work in HJV and JMC, especially in senior position. However, the phenomenon still exist in Ofakim and we have good reason to believe that the phenomenon is more common in private companies that are not FIE.

3.3 Other Requests by Government, or by Officials

- 3.3.1 **Establishment of Government and HJV Joint Venture:** In 2009 the local government requested HJV to establish together a cooperative joint Venture ("CJV") that shall function as "Zhong Products Quality Supervision Testing Center" for materials produced by HJV. The initiative was "sponsored" by Mr. Long, but AVL did not approve it, and after AVL raised "politely" many questions regarding the project, the government and Mr. Long "understood" the situation and abandoned it. In this case the CJV could bring the Ofakim city, and its leaders, valuable esteem among the leaders of Zhong province and thus future promotion. If this venture also turned to be economically successful, it would also bring additional income to the city's coffers.
- 3.3.2 **Request for HJV hygiene products during the Corona epidemic:** during the first period of the corona epidemic, HJV produced certain hygiene products that were highly needed to combat the epidemic. Thus, some officials asked to make priority shipments of those products at discounted price to designated localities and certain companies. HJV ignored some of the requests but had to

¹²⁹ See for example the rules that were declared in 2022: "China Further Reins in Business Activities of Officials' Families", *Reuters* (19 June, 2022). <https://www.reuters.com/world/china/china-further-reins-business-activities-officials-families-2022-06-19/>

comply in those cases that the official was a friend or important enough. However, those requests were in small quantities and the price was still profitable to HJV.

- 3.3.3 **Minor Requests:** the local government asked JMC Group and HJV to have several subscriptions for two newspapers. One is the local paper of Ofakim city and one is the official newspaper of the CPC (*Peoples' Daily* 人民日报). The total cost of such subscriptions is negligible.

Government Requests after 2013

- 3.3.4 Based on our interviews, the personal requests by government officials declined in recent years both in HJV and JMC (although in JMC case, it may be attributed partly to the changes after the death of Mr. Long). On the other hand, donations under the new trend of “Corporate Social Responsibility” (CSR) did increase in recent years. We discuss it further in section 4.4.

3.4 Alignment with the Government Targets and Policies:

Milhaupt and Zheng point out this factor, when they evaluate the taxonomy of a company on the spectrum between SOE and POE. They argue that companies that aligned themselves with policies, sectors and industries that are encouraged by the government (such as high-tech, AI, renewable energy, etc.) can gain various privileges. Thus, POEs which are aligning themselves with government policies gain a status similar to SOEs.¹³⁰ This factor seems important when you examine large POEs at strategic sectors, but is it also important for SMEs in the local level? Below we review the situations in which JMC and HJV were aligned with the local or central government policies:

- 3.4.1 According to the interviewees the establishment of JMC group in 2003 was, on the surface, part of the central government policy to privatize the small, and less profitable companies in the state sector.¹³¹ This also explains the financial assistance and other support that the JMC group received from the local government in the early years.
- 3.4.2 The establishment of HJV had two targets, first as a tool to stabilize the financially weak situation of JMC Group, but it was also aligned with the aim of the local government to bring to Ofakim new and leading technology oriented firms. In 2004, when HJV was established, their industrial technology, which is based on German production machines, was the most advanced in China. Announcements regarding this cutting-edge technology were published with pride by the local government as well as the Zhong province government.¹³²
- 3.4.3 The attempt to establish a CJV between the local government and HJV, which we described in section 3.3.1, could clearly contribute to the economic development of Ofakim, but it could even more enhance the political prestige of Ofakim and its officials within Zhong province. However, the fact the AVL declined this opportunity without retaliation by the government, shows that you do not *always* have to align with the government policy.
- 3.4.4 Around 2011 the economic benefits of HJV to the local economy of Ofakim were very significant and it was ranked 5th among the top payers of income tax in the EDZ. It was also among the biggest

¹³⁰ Milhaupt and Zheng, p. 696.

¹³¹ See: Furer, “Economy”, p.167.

¹³² Such an announcement is still in the Zhong government website (more details in the confidential Annex B)

companies in China in its industrial sector. During the discussions with the local government, HJV raised the option to establish a fourth production line and even a fifth one. This was obviously aligned with the city development goals and HJV was offered very generous assistance (mainly in providing land and tax benefits) in case such plan will materialized.

Alignment after 2013

- 3.4.5 HJV developed new technology with unique IP (intellectual property), and thus could apply for the High and New-Technology Enterprises (HNTE) tax status, which is a national level status. This status could make HJV eligible for tax incentives and other benefits. Having such companies with HNTE status in the EDZ is an advantage for the local government in general and the EDZ and particular, so they were happy to support HJV. Some of the conditions to receive the HNTE status are strict, but others are more fluid and this is where the local government could assist in verifying that the conditions were fulfilled.¹³³
- 3.4.6 In 2020, after the break of the Corona epidemic in China, there was an urgent need for some of HJV products, which are used as a component in hygiene products required for combat of the covid-19. The GM of HJV estimated that this was the main reason that HJV was the first company in Ofakim that received permission to restart production after the first lockdown.¹³⁴ HJV also got special permission to house the employees in its facilities and thus, in the later lockdowns that followed, it received permission to continue production and shipment during lockdowns. Many other companies did not receive such permission and had to stop production.

3.5 Reciprocal Social Activities (*guanxi* and Networking)

This category of activities includes banquets, ceremonies, awards, joined trips, publications and thank-you-letters, gifts, etc. Actually these activities serves few different purposes. First, it is a way to build the networks, *guanxi*, between officials and business people, but it has all kind of side benefits for the state organs, government officials and of course for the POEs and the businessmen that manage them. The networks that Chinese people build in general, and in the business context in particular, are a significant component of Chinese society and Steidlmeier described it as follow:

The predominant social structures of Chinese society are found in the web of significant relationships (*guanxi*), based upon family, geographic origin, school mates and so forth. A person's *guanxi* outlines who matters and how much they matter and provides the primary basis of moral claims for one person upon another.¹³⁵

Other scholars, like B.X. Wang, emphasize that in Chinese culture and tradition there are strong relations between reciprocal benefits and *guanxi* and he claims that: "Therefore, there is a moral obligation

¹³³ Ultimately, HJV did not apply for the HNTE status due to AVL global IPR considerations.

¹³⁴ See later in section 3.5 - regarding the additional *guanxi* factor in this government decision.

¹³⁵ Paul Steidlmeier, "Gift Giving, Bribery and Corruption: Ethical Management of Business Relationships in China." *Journal of Business Ethics*, Vol. 20 No. 2 (June 1999), p. 121.

between *guanxi* holders, and the relationship is mutual rather than separate. The core of reciprocation is mutual benefit, and it is the basis of *guanxi*.”¹³⁶

Many scholars argue that the *guanxi* system in China is so widespread and important due to the weak institutional system (weak enforcement of law, etc.).¹³⁷ Naturally, the combination of *guanxi* network with weak institutions can lead and deteriorate towards corruption, in which exchange of favors and illegal benefits is the common practice. This is a phenomenon that the Chinese central government always tried to reduce, and this is one of the leading mottos of Xi Jinping since he had come to power in 2012, and initiated the Anti-Corruption Campaign.

As we mentioned earlier, if you look at all the networking activities, only from the view point of the POE, and ignore the *personal* motives of the people involved, as well as the social and institutional context, you may think that all the network activities are a part of CPS (Corporate Political Strategy). Deng, Tian and Abrar created an impressive list of CPS activities and divided them to six groups (see Annex A).¹³⁸ However, some CPC activities that they described are not related to *guanxi* and many others are not relevant to the SMEs we explored. Moreover, our social viewpoint is wider and considering the context of both sides of *guanxi*. Therefore, I shall present the major building blocks of *guanxi* network in Ofakim according to the following relevant categories..

- 3.5.1 Banquets with Government Officials: Banquets of government officials in general, and with business owners in particular, used to be a very common phenomenon until 2013, when it was curtailed by the CPC policies and rules.¹³⁹ So, before 2013, almost every visit that I had in Ofakim (five-six per year) we had banquets with some officials (many times two-three banquets per visit). The banquets were usually held in the evenings in the VIP rooms of lavish restaurants, usually with many people (5-15), and Mr. Long would pay the bills (probably from HJV account). We also had some banquets in the government guesthouse and also rarely in Mr. Long private house. Unlike other places I visited, our dining in Ofakim included less spirits and it was very rare to see someone heavily drunk. Some of the banquets were organized with specific issues to be discussed with the officials, but, in most of them, business was discussed only occasionally.
- 3.5.2 Business Trips, Delegations and Social events: are other ways to tighten the relations between officials and private businessmen. Trips and delegations abroad were especially popular before 2013, and they would often be financed, at least partly, by related POEs. It used to be common and “legal” to transfer benefits to Chinese officials, and normally few days of the trip will be dedicated to training and/or official activities, and the rest would be used for leisure activities (sightseeing, shopping, etc.).

During 2003-2012, local government delegations visited Avalon twice. The first delegation trip (end of 2008) was arranged in parallel to the delegation of the Zhong governor, with the official goal to have a signing ceremony for the restructure of HJV. The Ofakim delegation included five

¹³⁶ B.X. Wang, *Guanxi in the Western Context: Intra-Firm Group Dynamics and Expatriate Adjustment*, New York: Springer, 2019, p. 10.

¹³⁷ B.X. Wang, *ibid*, p. 10. Where she quoted many other scholars who agree with this opinion.

¹³⁸ Deng, Tian and Abrar, p. 377.

¹³⁹ In the beginning of 2013 the CPC established new rules to curb extravagance behavior of Chinese officials specifying lavish banquets as one of the most improper behavior. See: “Xi Jinping Calls for Curbs on Lavish Official Banquets”, *South China Morning Post* (30 Jan’, 2013) <https://www.scmp.com/news/china/article/1138864/xi-jinping-calls-curbs-lavish-official-banquets>
Also: “China Turns Against Official Extravagance”, *BBC Online* (6 Feb’, 2013) <https://www.bbc.com/news/world-asia-21342933>

people,¹⁴⁰ and they spent five days in Avalon (including two days sightseeing) and three days tour in a nearby state (only sightseeing). All expenses were covered by AVL. When we visited Ofakim we had a trip to a local lake and then we had lunch at the local government guesthouse near the lake. Another important social event was the marriage of Mr. Long' son, and many officials attended the three days event. During the event some officials gave speeches and congratulate Mr. Long, his son and their huge contribution to the local economy. The officials also gave gifts of moderate value (1,000-2,000 Yuan).

3.5.3 Public Relations, Ceremonies and Awards: Improving the public image is a very important goal in the reciprocal relations of the government and the private sector. It is done, via various publications that compliment both sides, via ceremonies and awards that praise the company and/or its people, but also expose the government officials to the public, especially, if during the ceremony, the company representatives thank the officials for their assistance. Thus the government can pride itself for “creating” a “successful” company under its jurisdiction. The ceremonies also provide an opportunity to tighten the relations between the parties. Another way to improve the public image is via various state publications about the innovation and success of HJV, JMC Group and Mr. Long as a business leader.¹⁴¹ In addition, every milestone in the development of HJV and JMC Group would be a reason for ceremony and “ribbon cutting” by local officials of Ofakim and Zhong province. Thus, the Zhong governor was attending the 2008 HJV restructure signing ceremony and the 2010 third-production-line inauguration. HJV received in 2020 a special award for its industry association for development of a new material. Around 2010, Mr. Long received the city award and carried the torch in the sport ceremony in Ofakim.

3.5.4 Gifts and Other Benefits: Gifts giving in China is part of the reciprocal relations and it is well explained by Steidlmeier as follow:

Gift giving is a prevalent social custom in China in all areas of life: in family and in significant relationships (*guanxi*), as well as in dealing with political authorities, social institutions and business people. For all that, from an ethical perspective, it is very difficult to know when it is proper to give or receive a gift, what sort of gift is appropriate, or what social obligations gift giving imposes.¹⁴²

In the context of this research, gifts and other benefits are an important component of building relations (*guanxi*) with business partners and officials. However, sometimes, when the gift value is high and connected to a specific action of the official, it becomes an act of illegal corruption.

¹⁴⁰ Including the mayor, head of EDZ, Head of City Economic Development Committee, Mr. Long and his son.

¹⁴¹ For example: around 2007, the Zhong government website published that the production-line of HJV is technologically the most advanced in China (at that time) with superb German technology. In 2013 publication of the industry association reggraded HJV in sixth place in China (in term of product capacity). In 2022 HJV was awarded the title “provincial level champion” by the Ofakim local government. In 2022 Zhong government published the success of the RECP Agreement (reducing tariff among countries in the Asia-Pacific region) and that HJV is one of the biggest beneficiaries of it. In 2023 the Zhong FIE Association included HJV in its recommendations list. In 2021 a long article praised Mr. Long and also the JMC Cherry farm, which shall be the only large European cherry orchard in south China. There are many other publications regarding Mr. Long history as a great communist leader, “model worker”, “great business entrepreneur”, etc. All references are in the confidential Annex B.

¹⁴² Steidlmeier, p. 121

The fine-line between a decent gift and illegal gift is quite blurred in China.¹⁴³ Certain gifts that are deemed decent by Chinese standards may be considered outrageous in Western culture. Yet, the Chinese know very well when the gifts are part of a natural relations gesture, when it is a “thank-you-gift” for specific favor you did (Gratuity), and when it is a bribe.¹⁴⁴ Gifts giving is an important reciprocal action, and it also connected closely with the concept of “Face” (*mianzi*).¹⁴⁵

For example, once, before the spring festival holiday, Mr. Long gave me and my assistant red envelopes, each one with 1,500 Yuan. I thought that this is a decent gift based on our long relations, based on our financial status, which made it an insignificant sum for both sides, and due to the fact that it is the most important holiday in China, in which it is common to give cash gifts. However, as a lawyer representing AVL, I reported the gifts, explained the cultural context and tried to convince that it is a reasonable gift and not a bribe. Yet, it did not help and AVL ordered me to return it. My assistance was very disappointed, and Mr. Long was very upset and refused to take it back. By returning the gift to Mr. Long he lost face (even though it was not public, which reduced the level of disrespect). Finally, I waited for few weeks and returned the money to Mr. Long’s son, and he accepted it. In the following paragraphs I will present various situations of gifts giving that occurred in the relations of HJV and JMC Group with local government officials.

- a. Gifts giving in Meetings with Officials: This used to be a very common custom in meetings with government officials, and it is still common in meetings between officials and foreign visitors. In these situations the visitor will usually receive high-quality tea and/or wine and/or Chinese painting,¹⁴⁶ and he will present the official with a gift of his own.¹⁴⁷ However, due to the Anti-Corruption Campaign, it is now quite rare phenomenon to exchange gifts in business meetings between government officials and local business people. In some cases that I witnessed, the officials refused to accept even a symbolic gift from the business party. In the “old days”, before 2013, and during meetings with officials, HJV/JMC representative gave the officials a bottle of quality wine, or baijiu (Chinese spirit) or a local specialty (such as smoked goose neck, *yabozi*). However, in recent meetings in Ofakim this phenomenon disappeared.
- b. Gifts of Routine Nature: HJV and JMC would normally provide government officials and business partners with gifts during major Chinese holidays and especially before the spring festival (*Chunjie*). Until 2013, Mr. Long was responsible to handle these gifts and after AVL received the management of HJV, he received a specific PR budget for this purpose. The list of people who received the gifts in 2008 and 2010 is in the confidential Annex B of the thesis. Some of the interesting facts are as follow:
 - The list of 2008 includes 28 government departments and SOEs, while the list of 2010 includes 33 departments and SOEs, but this time also with specific names of 170 officials.¹⁴⁸

¹⁴³ Steidlmeier, p. 128

¹⁴⁴ Steidlmeier, , p. 126. Steidlmeier defines the three types a bit differently, but I think we can agree on the principle.

¹⁴⁵ Steidlmeier, p. 123

¹⁴⁶ For example: This is what a wide list of organizations in Israel received from the Chinese embassy during holidays and meetings.

¹⁴⁷ As an Israeli I will try to bring a gift that has some connection to Israel (Israeli food, like olive oil), a book about Israel, etc.

¹⁴⁸ The list includes mainly government departments but also some SOEs (mainly banks).

In some departments the list does not elaborate the name of each official.

- The 2008 gift budget is around 300,000 Yuan, reaching around 400,000 Yuan in 2010.
- The lists include mainly government departments from Ofakim, but the 2008 list includes nine institutions of Zhong province (including SOEs), while the 2010 list includes 10 such institutions.
- According to the 2010 list the average gift per official is around 2,400 Yuan. The top officials received usually around 5,000 Yuan. Less important officials received 2,000-3,000 Yuan.
- Some of the gifts in the 2010 list stipulate clearly, which officials assisted HJV and thus it is also a gratitude type of gift (Gratuity). For example: officials in Bank of China that provided the loans, Officials at HBB and SASAC that approved the HBB guarantee to the loans that HJV took. Officials in Zhong custom that approved lower tariff on imported machines.
- In both lists there are gifts for retired Zhong province leaders (about 2,000 Yuan per person). This is interesting and may show that the x-leaders are still influential. Yet, it is also likely that they were personal friends of Mr. Long and it is a show of respect and keeping *guanxi*.

Another occasion in which it is a social obligation to give high value gifts is at important family events, such as marriage, birth of babies and funerals. During the marriage of Mr. Long's son, many local government officials attended and gave gifts. I also attended and after inquiry for the proper value of the gift, I brought jewelries in the value of 4,000 Yuan.¹⁴⁹ AVL gave a brand name watch worth about US\$ 10,000. The government officials probably gave gifts at a value of 2,000-5,000 Yuan. This is of course a reciprocal gesture, so when Mr. Long or the GM of HJV attend such family events of officials, they must offer gifts of 5,000-10,000 Yuan (the expectation from rich people are higher than from officials with a government salary).

- c. Gifts of Gratuity: As shown above, some of the gifts in the 2010 list of HJV stipulates that, besides being a traditional gift for the spring festival, it was also a gratitude for specific help that those officials had provided, *within their authority*. The business trips abroad, mentioned earlier, are another way to show gratitude to government officials, who were instrumental in the facilitation of major business transactions and activities. From the information we received recently, some officials in Ofakim, who were instrumental in providing discounted land plots to private companies at a much discounted price, received gratitude gifts in the value of 20,000-30,000 Yuan. So we assume that such gratitude gifts existed also before 2013.

Social Activities after 2013

- 3.5.5 Social Activities after 2013: Due to the Anti-Corruption Campaign, the nature of social activities between businessmen and government officials experienced major changes since 2013. This was confirmed by the media,¹⁵⁰ by the interviewees and in our own experience, as elaborated below:

¹⁴⁹ The Chinese social etiquette "forced" me to attend this marriage, and besides providing the gifts, I also financed the trip from Beijing to Ofakim for me and for my assistant, which was of course much more expensive than the gifts.

¹⁵⁰ For detailed description of the anti-corruption measures and consequences during the period of 2012-2014, see: Christina Nelson, "China's Crackdown on Corruption and Government Spending: A Timeline", *China Business Review* (23 Jan', 2014). <https://www.chinabusinessreview.com/chinas-crackdown-on-corruption-and-government-spending-a-timeline/>

First of all, the amount of banquets was reduced drastically. Most meetings with officials are a matter-of-fact events, located in the government offices. Invitations of officials to dine with private entrepreneurs are often declined, unless they have previous acquaintance and relations. In my visit to Ofakim and unlike previously, the meeting with the official (medium seniority) required strict advanced procedures, including submitting recommendations, request letters and CV. The meeting was in the government office. It was short, straight to the point, and cordial but cold. On the other hand, and as described in section 2.5.3, the EDZ in Ofakim managed to maintain the banquet tradition by “formalizing” it (GM birthdays, Holidays such as Spring Festival, Government-Enterprise Breakfast). So, by structuring it and making it available to all the companies in the EDZ, it becomes legitimate. Our interviewees also explained that if they have personal friendship with an official they may dine or have joined activities with him from time to time, but it would be usually in a small company (often only two people) and in unflashy places, often during trips outside the city, while eating at a “farmers home eatery” (农家菜).¹⁵¹

Some of the interesting side-effects of restricting the banquet extravagance, are that officials in China lost weight and their BMI and health improved, due to lower consumption of food and alcohol.¹⁵² In addition, the hotel industry and the luxury goods sector also suffered significant decline in revenues.¹⁵³

The same is true for joint trips of government officials and business people. The procedures to approve government trips abroad became restrictive and complicated in 2013, whether on private trips or government funded trips.¹⁵⁴ The local government visited Avalon in 2015 in order to encourage AVL to increase its investments in HJV, and we were told that such trips to secure investments are common, but they are financed by the local government and not by the hosting POE. In recent years, and due to the Anti-Corruption Campaign, as well as “national security” reasons, the central government policy is to curb such trips and delegations, especially overseas trips.¹⁵⁵ In some places there are now standard limitations not to have more than one trip per year. In some cases the trips abroad are completely banned.¹⁵⁶

¹⁵¹ Actually, during this summer 2023 I had a surprising banquet with the Ofakim official that I interviewed. This was arranged in the *private suite* of a local tycoon (so public eyes will not see it). I was invited to the banquet by the PR manager of HJV. I assume that the local tycoons invited me to show the official that they are connected with foreign dignitaries (as I have the title of Chairman of Israel-China friendship society). The PR manager of HJV also had her reasons, this was her way to tighten her relations with the local tycoons and the government official. In any case, I was just an “extra” in that meeting, which was obviously arranged for the tycoons and the official to talk about their businesses. As a side comment, this is actually quite common in China, where “white faces” are required for “Face” purposes. In this meetings the official was offered to drink spirits but he refused. The meeting atmosphere was very different from the period before 2013. More formal, polite and people were careful about their words.

¹⁵² See: Xun Li, Wensi Pan, and Gang Xu, “A ‘Leaner’ Government? The Effect of China's Anti-Corruption Campaign on the Body Weight and Health of Public Sector Employees.” *Journal of Economic Behavior & Organization*, Vol. 217 (2024). pp. 141-169.

¹⁵³ Nelson, p. 150.

¹⁵⁴ The first rules restricting traveling abroad was published in November 2013. See: “China Inks Regulation to Ban Official Extravagance” *China Daily* (26 Nov’, 2013). https://www.chinadaily.com.cn/china/2013-11/25/content_17130522.htm Later on, more regulations, directives and internal rules were published by various departments and in different provinces. So, the actual policy can vary from place to place.

¹⁵⁵ For example: “China Tightens Curbs on Foreign Travel by Bankers, State Workers”, *Reuters* (17 Oct’, 2023). <https://www.reuters.com/world/china/china-tightens-curbs-foreign-travel-by-bankers-state-workers-2023-10-17/>

¹⁵⁶ Reuters, *Ibid*. Current policies restrict officials at certain SOEs and government departments from traveling abroad for personal reasons to once a year and only up to 12 days. In some places the restrictions totally banned traveling abroad.

The policy on joint trips and activities inside China also changed. There is more scrutiny of any extravagant expenses and the officials care to avoid a “wrong impression”. However, some joint activities in small gathering and modest form still exist. For example one of our interviewees often goes for fishing trips with officials that he has personal relations with.

Regarding public relations, ceremonies and awards, there is no big difference than the period before 2013, because building a prudent image of the companies and the government assistance is serving, in principle, the legitimate goal of economic development. However, one difference is that the local government is now much more focused on CSR activities, (which is in fact one aspect of the Western concept of ESG).¹⁵⁷ Thus, JMC Group was asked by the government to give some small donations to charitable goals. HJV received similar requests to donate food to poor villagers. HJV usually cooperates with the requests because it builds good image and publicity, but HJV also declined some of the government requests.

The sensitivity of “gifts giving” also increased dramatically. Our interviewees mentioned how sensitive it is and how government officials do not accept even small gifts during official and public meetings. However, HJV and JMC Group still offer gifts for the New Year or family events, though it is not cash, but rather as coupons for supermarkets and the value is usually modest, at 1,500-2,000 Yuan. Originally, our interviewees insist, that cash gifts at higher value do not exist. But after they pride themselves for the huge discount that HJV received on the new plot of land (25% off the EDZ cost) and after I asked which officials were instrumental in reducing the price, they admit that it was natural to show gratitude to those officials and thus they reward them with gifts of 20,000-30,000 Yuan, per official.

Summary: The reciprocal social activities described above are common in many regions in China, although, as we shall see later in Chapter IV, they are less common in the developed metropolises, like Beijing and Shanghai. Beside the activities described in this section 3.5, most activities described in sections 3.2-3.4 also assist in building the *guanxi* networks. In their research, Deng, Tian and Abrar presented a list of 35 different CPS activities (see Annex A), and most of them are part of *guanxi* building activity.¹⁵⁸ This comprehensive list demonstrates to us how sophisticated, complicated and embracing is the scope of *guanxi* networks.

4. Extra-legal Measures of Controlling Private Firms

Laws, regulations, directives, industrial policies and any other type of published guidelines by the government, affect, direct and to some extent supervise and control the behavior of private firms as well as state-owned firms. This legal and legitimate method of influence, assumes that the system is transparent and the enforcement is fair and equal. However, there are other, less formal and less transparent, mechanisms, which can direct and control the behavior of POEs in general, but especially in China. Milhaupt and Zheng argue that in China the *big private firms* are quite similar to state-owned firms in many levels and this is how they phrase it:

¹⁵⁷ ESG or Environmental, Social, and Corporate Governance is, according to Wikipedia definition, a set of considerations, including environmental issues, social issues and corporate governance that can be considered in investing.

¹⁵⁸ Deng, Tian and Abrar, p. 377. However, the list also includes a class of activities that is called “Challenging Strategies”, which cannot be regarded as reciprocal social activity or *guanxi* (e.g. push research reports from firm’s own angle to government and industry organizations).

POEs bear striking resemblance to SOEs along the dimensions typically thought to distinguish state-owned firms from the private sector: ready access to state power and largesse, proximity to the regulatory process, and little autonomy from discretionary state intervention in business judgment [...] formal membership of top management in party-state organs, large government subsidies, and extralegal control by the state.¹⁵⁹

We already discussed in sections 1-2 the “Institutional Bridging” and the assistance that enables the government to control and direct some of the activities of HJV and JMC, and in section 3 we described the reciprocal social relations that create mutual impact between the state organs and the private SMEs. Now, in this section, we will discuss some other extra-legal mechanisms that, in theory, enable the state additional layer of supervision and control over POEs (but also SOEs). Some mechanisms are formal institutes like industrial associations, labor unions and Party Cells, and some are less formal such as “polite requests” by government,¹⁶⁰ which in extreme cases may end up in “nationalization” of companies (e.g. Hainan Holdings, Anbang, Ant Financial, etc.).¹⁶¹ In this regard it is important to remember that, already in 2003, Dickson noticed that “Most organizations have a dual character: they ensure state leadership over the organized group but at the same time convey the views of their members to the state.”¹⁶²

4.1 Industrial Associations and Chambers of Commerce:

Milhaupt and Zheng argue that Chinese industrial associations can have effective influence on private firms, within their industry, and they explain it as follow:

The Chinese state relies on several means to exercise extralegal control of private firms. One such mechanism is so-called industrial associations, also known in some sectors as chambers of commerce. Established in industries for which supervising ministries have been disbanded, these ostensibly private organizations are designed to coordinate activities within an industry. Yet the industrial associations are staffed by former government officials from the defunct ministries and have the same organizational structures and functions as those ministries. The industrial associations actively supervise the operations of firms in their respective industries and have retained much, if not all, of the power exercised by their state predecessors.¹⁶³

In the case of HJV, it is a member of its industrial association and it pays few hundred Yuan for an annual membership. The industrial association visit HJV each year, and according to the GM they may give useful macro-economic advices, but they refrain from giving concrete advices or requests. In the case of JMC, it is a member of the local Industry and commerce association and it pays symbolic fee. According to Xiaoli, JMC joined this association mainly to facilitate the social network with other business people and government officials. In both cases, our interviewees did not feel that the associations influence or direct the companies in anyway.

¹⁵⁹ Milhaupt and Zheng, p. 683.

¹⁶⁰ Pearson et al. pp. 156-157. Showing a list of over 30 foreign companies working in China that were “requested” to apologize for “political mistakes”. Obviously, such requests for Chinese domestic companies are much easier.

¹⁶¹ Milhaupt and Zheng, give some examples for that. pp. 687-688. See: notes 98-100 (where we elaborated those cases and more)

¹⁶² Dickson, p. 159. In this statement Dickson seems to refer to the CPC as well.

¹⁶³ Milhaupt and Zheng, p. 686.

4.2 Labor Unions

Labor unions (or “trade unions” as it is often translated) are legally required by the Chinese law for any company in China that has more than 25 employees.¹⁶⁴ Specific laws for foreign invested enterprises (FIE) also emphasize this obligation.¹⁶⁵ According to the law, every labor union at the company level must report, be supervised and be directed by the local branch of All-China Federation of Trade Unions (ACFTU).¹⁶⁶ ACFTU is the only legal labor union in China (although today there are some NGOs working in the grey zone),¹⁶⁷ and it may be described properly as follow:

The ACFTU is organized according to a hierarchy of local and regional union federations that basically reflects the structure of the Party and government. This is because the ACFTU is classified as a “mass organization” that serves the interests of the CPC and local government rather than its members, the workers. In nearly all cases, local trade union offices have to defer to higher level union offices or to local government and Party organizations for guidance.¹⁶⁸

According to article 4 of the PRC Trade Union Law, all trade unions at all levels must “Focus on economic development, adhere to the socialist road and people's democratic dictatorship, insist on the leadership of the Chinese Communist Party and the guidance of Marxism Leninism, Mao Zedong Thought and Deng Xiaoping Theory.”

So, in theory, if we combine the different legal obligations mentioned above, with the legal goals, and the ACFTU supervision and directive powers, then, the labor union of a company can be used as a powerful tool of the Party-State to control and influence the operation of POEs. This was the fear of Walmart, in 2004-2006 when it conducted a battle with the ACFTU in order to prevent the establishment of a labor union in its supermarkets’ chain in China.¹⁶⁹ Eventually, after two years’ battle, the parties reached an agreement established the labor unions of Walmart. Some scholars argue that Walmart and the ACFTU created a labor union, which is quite docile, cooperative with the Walmart management and does not really protect workers’ rights.¹⁷⁰ He & Xie describe it as follow: “Consequently, all the trade unions of Wal-Mart in China have ended up like a club or welfare organization”.¹⁷¹ With this background in mind, I review and compare the composition and the behavior of the labor unions of HJV and JMC.

HJV Labor Union: The labor union of HJV was established shortly after the company was established in 2004. The union has a five members’ committee. The chairman and three members were elected in 2010

¹⁶⁴ According to article 10 of the “Trade Union Law of the PRC” (2001) 中华人民共和国工会法.

¹⁶⁵ For example, according to Article 8 of the “Foreign Investment Law of the PRC” (2019) 中华人民共和国外商投资法.

¹⁶⁶ See Articles 9 and 11 of “Trade Union Law of the PRC” (2001).

¹⁶⁷ For comprehensive description of labor-state relations and ACFTU transition see: Jude Howell and Tim Pringle, “Shades of Authoritarianism and State–Labour Relations In China”, *British Journal of Industrial Relations*, Vol. 57, No. 2 (2019).

¹⁶⁸ “Workers’ Rights and Labour Relations in China”, *China Labour Bulletin* (10 July, 2023).

<https://clb.org.hk/en/content/workers%E2%80%99-rights-and-labour-relations-china>

See also: He and Xie, p. 423. He and Xia quote the opinion of Taylor and Li (2007) that “argue strongly that the ACFTU is not a trade union organization but a ‘state organ’, closely subordinated to the Chinese Communist Party”.

¹⁶⁹ Baogang He and Yuhua Xie. “Wal-Mart’s Trade Union in China”, *Economic and Industrial Democracy*, Vol. 33, No. 3 (2012), pp. 427-430.

¹⁷⁰ He and Xie, p. 436. Also see: “Wal-Mart Uprising: The Battle for Labor Rights in China”, *The Diplomat* (14 Nov’, 2015).

<https://thediplomat.com/2015/11/wal-mart-uprising-the-battle-for-labor-rights-in-china/>

¹⁷¹ He and Xie, p. 436.

and one member was elected in 2016. Each department of the company elects one representative and all these representatives elect the committee members and the chairman.

The current chairman of the union is Mr. Feng, who is the ex-driver of Mr. Long (since the days in HBB). When he joined HJV he was promoted to the position of Vice HR & Admin Department, but this is mainly an empty title and he usually manages the firm's cafeteria. In addition to his work in HJV he used to work simultaneously for JMC until the death of Mr. Long in 2021. Mr. Long suggested Mr. Feng to apply for the chairman's position after the previous chairman left HJV. Legally, there should be new elections for the labor union committee every five years, but HJV did not conduct such elections, and the ACFTU branch that supervise them did not request to have new elections.

Mr. Feng explained that the committee meets usually once a year. During the year they would usually have 6-7 times communications and reports with the ACFTU leaders in Ofakim (Mr. Feng described the leaders as "the government"). Once a year they hold a sport event for the employees and it is usually done together with other companies, such as the state-owned HBB. Once a year they will organize a safety event with safety training to workers and they may have additional safety training during the year.

Mr. Feng could not recall any event when the labor union challenged the management except for one occasion, in which they complained about uncomfortable uniforms. The GM of HJV confirmed that the labor union is only focusing on social activities and that often he is the one who suggest the union, which social activities to hold. The budget of the union is coming from members fees, which are deducted by HJV (2% of each employee salary) and transferred to the responsible government office (probably the ACFTU). The government office pay back 1% to the union of HJV, which is about 50,000 Yuan per year. The labor union does not have a separate bank account and its monies are held by HJV. Originally, the labor union of HJV was a sub-organization of JMC labor union and they would organize activities together. After the restructure of HJV in 2009 and since AVL took control of HJV, the labor union of HJV was separated from the labor union of JMC and since then it is supervised directly by local ACFTU office.

JMC Labor Union: the labor union of JMC Group was active until 2009, when HJV labor union was under its control. Since the separation the labor union of JMC become inactive and at some point the JMC Group stopped to deduct the membership fees to the ACFTU. According to Xiaoli, the ACFTU did not complain about it and did not approach him to renew this obligatory payment.

4.3 Party Cells and Party Members in Private Companies

According to article 30 of the CPC Constitution, any company, or working unit, with three or more Party members, shall establish primary-level Party organization (hereinafter "Party Cell" or "Party Committee").¹⁷² According to Article 19 of the Company Law of the PRC, companies shall provide necessary conditions to facilitate the activities of the CPC. These laws exist for a long time, but they were rarely enforced in private firms. Thus, between 2000 and 2013, the percentage of Party Cells in private companies increased only from 3% to 13%.¹⁷³ However, during the Xi Jinping era, the party prioritized the expansion of Party Cells in the private sector, and the CPC reported that at the end of 2017, over 73%

¹⁷² Article 30: "A primary-level Party organization shall be formed in any enterprise, villagers' committee, government organ, school, hospital, research institute, subdistrict and community, social organization, company of the People's Liberation Army, and any other primary-level work unit where there are three or more full Party members"

¹⁷³ Furer, "Economy", p. 173.

of the private companies (including partnerships) had Party Cells.¹⁷⁴ Other official sources like the United Front quote even 90% at the end of 2018.¹⁷⁵ This phenomenon is described by Doyon as follow:

The increased penetration of the private sector by the Chinese Communist Party (CPC) is causing widespread concern. The establishment of party branches within private companies is perceived as a potential lever of control, alongside financial and regulatory tools, that the government could wield to keep businesses in line.¹⁷⁶

The spread of Party Cells in POEs (and other businesses in the private sector, such as partnerships), as well as other supervision and controlling mechanisms that we don't discuss in this paper,¹⁷⁷ lead many Western governments to believe that the state organs of China can direct and keep in line the private sector in similar way that China controls its SOEs. Thus, in 2019 the Australian foreign investment regulator stated that he no longer believes private companies in China are free of the CPC control, and his statement was accompanied by a practical move, which ensure that all Chinese investment in Australia are now subject to enhanced screening on national security grounds.¹⁷⁸ For this reason many other countries such as the USA, Germany and also Israel revised, or in the process of revising, their inbound investment policy as well.¹⁷⁹ With this background in mind, we can now check how the Party Cells in HJV and JMC actually function.

HJV - Party Cell and Members: HJV work force includes about 10% of party members. This percentage is relatively high if we consider that the party members are only 7% of the Chinese population (especially given that most of these members are employed by state organs and the army). This high percentage is explained by the fact that a lot of the original employees came from JMC and HBB and also due to the affiliation of Mr. Long with the CPC apparatus. Since the establishment of HJV the leader of the Party Cell was Mr. Long. When he became sick, around 2019, he asked the current GM of HJV to replace him but the GM refused and preferred to separate the management of HJV from the Party Cell activities. Then the position was offered to HJV finance manager, which was Mr. Long confidant, since they worked together in HBB. The GM agreed because he thought it was "easy" to work with her.

The Party Cell activities include a monthly session of 1-2 hours, which occur during working hours. Yet they postpone or change the activity timing if one of the members is required at work. During the session

¹⁷⁴ Jerome Doyon, "CCP Branches Out into Private Businesses", *East Asia Forum* (11 August, 2023).

<https://www.eastasiaforum.org/2023/08/11/ccp-branches-out-into-private-businesses/>

¹⁷⁵ "Beijing Puts Private Firms under its Political Wing", *Asia Times* (23 September, 2020). <https://asiatimes.com/2020/09/beijing-takes-private-firms-under-its-political-wing/>

¹⁷⁶ Doyon, p. 174.

¹⁷⁷ Additional measures, which we do not discuss in this paper, include a long list of "Security laws" that ascribe national security roles to Chinese firms, for example, the National Intelligence Law (2015) and the Cyber Security Law (2017). See: Pearson et al, pp. 150-151. And see: Furer, "Economy", pp. 173-174.

¹⁷⁸ "No Such Thing as a Private Company in China: FIRB", *Australian Financial Review* (16 January, 2019).

<https://www.afr.com/policy/foreign-affairs/no-such-thing-as-a-private-company-in-china-firb-20190116-h1a4ut>

¹⁷⁹ For USA: Mira R. Ricardel, "These New Rules Might End Tech's Reliance on Chinese Investors", *Fortune Magazine* (20 January, 2020).

<https://fortune.com/2020/01/20/cfi-us-rules-regulations-china-investment/>

For Germany: "German Minister Proposes Tougher Rules on Chinese Foreign Direct Investment", *Financial Times* (20 August, 2023).

<https://www.ft.com/content/1f37a5f2-0aac-4940-8071-963e967496e4>

For Israel: "Under Pressure from US, Israel Forms Panel to Examine Foreign Investments", *The Times of Israel* (30 October, 2019).

they study relevant materials of policy, local laws, and the party ideology. The GM said that sometimes he joins the sessions in order to encourage the party members “to lead and lift the moral of the other employees”. The Party Cell also evaluate potential party candidates who work in HJV. The Party Cell reports to and supervised by the CPC “street office” (which is in the EDZ). The Party Cell has a WeChat group that includes all the members and also the leaders of the “street office”. The Party Cell of HJV receive an annual budget of around 3,000 Yuan from the “street office”. HJV does not provide budget for the Party Cell. According to our interviews, the leaders of the “street office” do not mind and never inquire about the business of HJV. According to the GM, the Party Cell never interfere with the management of HJV. According to the interviewees the Party Cell activity slowed down after 2020.

JMC Group - Party Cell and Members: JMC as a spinoff of the state owned company HBB, has a very high percentage of party members in its subsidiaries (30%). Both JMC Caps and JMC Packing have Party Cells and they were a continuation from the period that the companies were part of the HBB group. Mr. Long supported it from the very beginning, because he identified himself with this ideology. The leader of the Party Cells used to be Mr. Long’s secretary at HBB and he was his confidant. According to Xiaoli, the Party Cells mainly focus on study sessions of Party materials and they never interfere with the companies operation and management. Since the death of Mr. Long, and due to the shrinking of the JMC group, the Party Cell is not active.

4.4 Informal Policy Request from State Organs:

One of the major differences between China and Western countries is the power of state organs to use informal methods to effect the behavior of individuals and companies. Milhaupt and Zheng give example of the NDRC “requesting” companies to adjust the prices of products, in fields that the NDRC doesn’t have legal authority. They also point out cases of restructuring private firms against their will (which meant practically partial nationalization).¹⁸⁰ In other cases, the Chinese banks were “requested” by the regulator to keep profit growth below 10%,¹⁸¹ private companies were requested to pay “advanced tax payments” in order to help the tax bureau to fix budget gaps, companies were requested to “donate” large sums to establish an Opera House in the city, High-Tech companies were forced to sell stakes to state investors, and Internet companies had to hire “police units” that will censor the online content of the company.¹⁸² In this regard, the tweet of Wang XiaoChuan, CEO of SOGOU, is very telling:

We are entering an era in which we’ll be fused together. It might be that there will be request to establish a party committee within your company, or that you should let state investors, take a stake, you know, as a form of mixed ownership. If you think clearly about this, you really can resonate together with the state. You can receive massive support. But if it’s your nature to go your own way, to think that your interest differs from what the state is advocating, then you’ll probably find that things are painful. More painful than in the past.¹⁸³

¹⁸⁰ Milhaupt and Zheng, pp. 687-688.

¹⁸¹ “China Asks Banks to Forgo \$211 Billion to Help Boost Economy”, Bloomberg (17 June, 2020).

¹⁸² Furer, “Economy”, p. 174

¹⁸³ SOGOU is one of the major search engines in China, especially in the mobile market. Major shareholders include Tencent and Soho. This tweet was published on March 2018 in Soho.com website. It is also quoted by Pearson et al., p. 174

Wang Xiaochuan statement reflects the common Chinese perception of the immense powers and the deep penetration of the Party-State into every aspect of life. This perception conflates the traditional worldview of a unified, hierarchical governance system, and the view of the CPC as an “encompassing organization” that surround you in every aspect (from streets committees to digital surveillance). This perception of governance is embedded into the ordinary mind, and thus, when businessmen or ordinary people receive a “request” by the government, or invited for “drinking tea” with plain cloth security officers, they know that they must obey the “request” of the government. When such perception is the normal, the Party-State have a very powerful extra-legal tool. However, most of the cases we mentioned above are related to big POEs, and especially in the tech and internet sector. Now we should examine if these extra-legal request applied also in the SME sector.

Requests from JMC: As we mentioned above, JMC received minor requests that we can consider as “policy request” (versus “personal requests”), and most of them were requests for charity donations (CSR) and the subscriptions for certain newspapers. Xiaoli stressed that JMC declined some requests.

Requests from HJV: As we mentioned above, HJV received few requests of the local government that we can define as “policy requests”. Among them, the request for formal deployment of government official for a senior position in the company; the request to establish the CJV that will function as “Products Quality Supervision Testing Center” of Zhong province; the request to increase production of certain hygiene products that were highly needed to combat the Corona epidemic; and the minor request to subscribe for certain newspapers (see sections 3.1, 3.3 above). Of the major three requests HJV declined politely two requests. The managers of HJV and AVL believe that they could decline those requests, due to their position as a foreign company with “different management culture” as well as the importance of HJV to the local economy of Ofakim.

The policy requests mentioned in this section, usually came from local government officials. Most of these officials are also CPC members and may simultaneously hold positions in local CPC organs. However, their requests may have originated in higher level state organs, or from a CPC organ. For example, the request to subscribe for the *Peoples’ Daily*, the mouthpiece of the CPC, is probably given by local organ of the CPC, which may have received it from a central CPC organs.

Changes after 2013:

Our research shows that the main changes that HJV and JMC Group experienced after 2013 are the additional CSR requests, which in many cases are just PR efforts for the local officials and/or government, as well as for the companies that are involved. However, unlike some empirical researches in this field, the Party Cells of HJV and JMC are not involved in the promotion of the CSR activities and the Ofakim state organs communicate directly with the management.¹⁸⁴

¹⁸⁴ See: Zhenjiu Yao, Zengtian Zhang and Jun Ma, "Party Branches, Policy Perception and Corporate Social Responsibility: Evidence From Chinese Private Enterprises", *Frontiers in Psychology*, Vol. 13 (Jan’ 2023), p. 13. Yao, Zhang and Ma, also provide deeper analysis of the CSR activity and the complex motives and reasons to participate in such activities.

5. Summary of the Vertical Comparison:

The results of the vertical comparison shall be analyzed in Chapter V (1) and the details we presented shall also be used in the analysis of the horizontal comparison, in Chapter V (2). Yet below we shall present briefly the two main results of the vertical comparison:

- First, there is a clear tendency of the local state organs to move towards a more transparent, rule-based and equal policies that govern the relations between the state organs and the POEs.
- Second, the traditional social values, including reciprocity and *guanxi*, continue to play important role in Ofakim, and when new policies attempted to diminish the traditional mechanisms, such as social banquets and close social relations between officials and businessmen, the locals found ways to circumvent the prohibitions. However, there is some success in reducing the importance of *guanxi*, due to a shift towards regulated and bureaucratic governance, as well as due to the influence of the “Anti-Corruption” policies.

Chapter IV. Horizontal Comparison of the SMEs

In this Chapter we will compare the relations between the state organs and each of the SMEs that we described earlier. We will do it in the same order and sections that we discussed in Chapter III. In this regard, the general background we gave for each section in Chapter III (e.g. Gift Giving in China) should be kept in mind, when we read this Chapter.

1. Proximity to State Organs:

In this section I compare the “Institutional Bridging”, or proximity to state organs. In Chapter III(1), we discussed the tight relations between Mr. Long, the founder of JMC Group and HJV, with various state organs. His death in 2021 changed the picture, but as we shall see below, not that much.

The JMC Group: currently JMC Group still has tight relations with the state organs of Ofakim, due to the following reasons: First, Mr. Long’s friends and Mr. Long’s wife and son continue to keep and nurture their relations and *guanxi*. Thus, Xiaoli keeps close contact with two officials, while his mom joined some events of the party and the government; Second, due to its history as a spin-off from HBB and the high percentage of CPC members (30%) the government is inclined to assist the JMC group. Third, JMC Group improved its business relations with HBB (Selling its products to HBB and Co-Shareholders in GMC Caps), so HBB, as a powerful SOE, can support JMC in dealing with state organs.

HJV Company: currently HJV has very good relations with the state organs in Ofakim, due to the following reasons: First, the good reciprocal relations that Mr. Long established in the past with Party-State officials. Second, Mr. Long introduced relevant officials to the current GM and the PR manager of HJV, and they enhanced those relations and created their own *guanxi*. Third, the current GM is also CPC member and previously he worked as senior manager in a very big SOE, this experience helped him to nurture personal relations with two senior officials in Ofakim and he also has prior *guanxi* with some officials in Zhong province. Fourth, since its establishment HJV contributed significantly to the economy of Ofakim as one of the largest and sophisticated companies in the EDZ (in terms of revenues, tax, technology and advanced

foreign management). So officials in the city were always proud of it and used it as a show case and a model company. In this respect, the EDZ continues to expect future investments by HJV.

Ofakim Local Culture: Is another factor that influences and enhances the relations of JMC Group and HJV with state organs. This culture may be described as a Confucian “family atmosphere” that exists between officials (“emperor”) and the companies under their jurisdiction (“subjects”), or we can see it as the traditional Maoist concept of “serve the people” (or a mix of both). Chapter III.(2.4) discussed this phenomenon, which fits in nicely with the old-new concept of harmonious society, and in Chapter III (3.5.5) we described how, in spite of the Anti-Corruption Campaign, local officials created structured procedures that enabled to keep the *guanxi* tradition via meeting and dining with businessmen in a legitimate manner.

BIT Group: As mentioned before, BIT Group initial success was based on some *guanxi* with several multinational companies in China, using their “foreign image” to sell high-quality IT services. Thus, they didn’t need, and didn’t have, much proximity to government officials and they tend to stay “under the radar”. However, in the early days (2001-2003) when BIT Group established a subsidiary to provide internet services in one district of Beijing, they needed strong support of various officials in order to receive the “hard to get” ISP license. In order to do so a relative of one of the founders had to finance and engage with the officials in various immoral activities (including sharing some of the revenues).¹⁸⁵ BIT Group also used to “cultivate” relations with the local tax bureaus in Beijing and Shanghai. However, these relations were never very deep and did not achieve a level of personal “friendships”. In recent years the relations with the government become more professional and distant and I will elaborate about it more in section 3.3. Since BIT Group prefers to minimize its proximity to state organs, they prefer to deal with the government via legitimate intermediaries (“Agents”), which are very popular in Beijing and Shanghai. For example, when they needed a high-tech tax certificate they hired formal Agent who has the *guanxi* in this field.

AIB Group: As described in Chapter II, AIB Group is a promising high-tech unicorn,¹⁸⁶ with complicated legal structure and distinguished list of investors/shareholders, including foreign investors. However, according to our information, none of the investors holds more than 10% of the shares (and voting rights) and thus it may be easier for the founders-managers to manage and direct the company’s operation in the way that they wish. The CEO of AIB insisted that he doesn’t have any special *guanxi* with state organs and he doesn’t use or need *guanxi* to gain state benefits or permits for the company. The CEO said “we are too small for the government to interfere or be interested in our company”. However, the fact that the company is a technological pioneer and leader (including in AI and autonomous driving technology) and the fact that it has many distinguished investors including important SOEs, may be “alternative” explanation for receiving government assistance and permits, without exercising “direct” *guanxi*. We may call this “Image of *guanxi*”. In section 3.3 we shall elaborate, why “Image of *guanxi*” may shed doubts, and different light, on the statements of the CEO.

2. Government Assistance to the Private Companies

In Chapter III(2) we discussed various types of assistance that the Ofakim government provided to JMC Group and HJV. In this section we shall compare it with the assistance received by BIT Group and AIB Group.

¹⁸⁵ In the confidential Annex B we describe some of these activities.

¹⁸⁶ A unicorn is a financial term, which defines a private, non-listed companies that worth over one billion \$US.

As we described in previous section, the relations of BIT and AIB with the state organs in Beijing, Shanghai and other locations where they operate, are less tight than the relations of JMC and HJV. This difference is reflected in the level of assistance that they receive from the local governments, and this assistance is usually based on general policies and regulations, rather than personal relations.

BIT Group: The subsidiaries of BIT received certain assistance from local governments based on some local policies and regulations that applied to its scope of business. This was actually one of the reasons they opened a branch in Chengdu (as a separate legal entity), where they received very low rate leasing fee for their office and also special tax rate for two years (2007-2008). B-IT leases its office in Beijing from an SOE, and in 2023 they received a very big discount of 50% due to a policy that assist businesses to recover from the Corona effect. In terms of taxation, BIT Group had a high-tech status for few years, which reduced the income tax to 15% (instead of 25%). Due to this status they also received special subsidized loans (2016-2018) with guarantee from Zhongguancun 中关村 district government. Regarding the local labor bureau, BIT subsidiaries declare the social benefits deductions of its high-paid employees, based on 60% of the average salary in Beijing / Shanghai, rather than the actual salaries.

BIT Group acquired several important licenses such as security surveillance and digital data licenses, but these licenses were granted based on standard procedures and no special *guanxi* or assistance was needed. On the other hand, in order to receive the high-tech status they used an agent company that does have *guanxi*. It cost BIT around 60,000 Yuan for the first year and another 25,000 Yuan for renewal.

The S-IT branch had a labor dispute with its accounting manager. This dispute evolved to include the tax bureau since the employee exposed certain irregularities in S-IT tax report. However, due to the good relations with the tax bureau, the 100,000 Yuan fine was reduced to 3,000 Yuan, and the tax bureau was also actively involved in settling the labor dispute.¹⁸⁷

AIB Group: AIB and some of its subsidiaries received certain assistance from local governments based on some local policies and regulations that applied to its scope of business. Their Tianjin subsidiary received preferential taxation, 500 sqm of office free of charge, and discounted rate for the lease of land. These benefits were based on some local regulations, but the local government had a discretion on the rates and AIB negotiated with few cities in China before settling in Tianjin. The AIB headquarter in Beijing is located in a special government run industrial park (managed by an SOE) that is dedicated to AI. Thus the local policy is to give 20% discount on the market lease price of the office. This discount is given to any company that is qualified to lease an office in this park.¹⁸⁸

The CEO of AIB claims that all the technology licenses that they acquired were granted by following the procedures, and no *guanxi* was required. The same was true for the IPO procedures, which did not materialized yet. He also stated that all loans are obtained on a strictly commercial basis, which makes sense because, according to the CEO himself, the company is awash with cash injected by the rich investors.

The CEO of AIB mentioned that although they went through a very painful process of merger and restructure, that involve the dismissal of almost 1,000 employees, and although some of the dismissed employees

¹⁸⁷ The dominant factor in providing the assistance by the tax bureau was probably the “reciprocal benefits” relations that S-IT has with the tax bureau, see below in section 3.3

¹⁸⁸ In order to be qualified for that AI park, companies need certain IP portfolio and tax high-tech status.

initiated legal procedures against AIB, the procedures in the labor court were fair and the local government and the labor bureau did not intervene in favor of the employees.

3. “Reciprocal Benefits” Between State Organs and Private Companies

In Chapter III (3) we described the intricate reciprocal web of benefits that JMC Group and HJV established with the local government and officials in Ofakim. In this section we shall see, that in comparison with JMC and HJV, the BIT Group and AIB have much less contact points with state organs and thus the “exchange of benefits” with local governments and officials is very limited.

3.1 Requests by the Government or Officials

In our interviews the managers of BIT and AIB downplayed the importance of their firms. The CEO of S-IT claim that they try to “stay under the radar” while the CEO of AIB said that “in Beijing we are considered too small to be important”. They also emphasized that they have very little interface with the local governments. However, unlike S-IT that admits some special relations with the tax bureau, AIB insists that all interactions with local governments are following transparent administrative and legal procedures, which brings the required results without the exchange of benefits or *guanxi*.

3.2 Alignment with the Government Targets and Policies

Unlike JMC Group and HJV, the AIB Group, and to a lesser extent BIT, operate in the forefront of the high-tech industry, which is one of the most supported industries in China. The high-tech industry is promoted by formal incentives, such as lower tax rates, but also through various financial and real-estate subsidies that AIB and BIT received (section 2 above). In this regard, S-IT that developed software for the hospitality industry and AIB, which develops software, hardware, AI tools and big data analytics, are clearly aligned with the Chinese government policies and goals. In order to enjoy additional benefits, both companies established some of their offices on those jurisdictions that provide additional benefits. Thus BIT headquarter is located in Zhongguancun high-tech district in Beijing, where there are special policies to assist high-tech and software companies, and they opened the branch in Chengdu due to such benefits. AIB headquarter is located in a special AI industrial park and they opened the Tianjin subsidiary in a location that gives additional subsidies to companies of its kind. AIB also initiating projects related to green energy, zero-carbon operation, which are supported by state policies.

Participating in CSR / ESG projects is another recent trend, which show alignment with government policies.¹⁸⁹ Although, in many cases this is just a PR and leaps service activity, it can reflects the proximity of the relations with the government, or the attempt to do so. AIB is using often the terminology of CSR and ESG in its publication (including “green” initiatives), to “gain points” in the eyes of the public and relevant state organs. JMC Group and HJV also participate in such activities, but they also sometime decline the local government requests. In contrast, B-IT and S-IT do not participate in such activities and also were not requested to do so.

¹⁸⁹ See: Yao, Zhang and Ma, (regarding CSR activity in China)

3.3 Reciprocal Social Activities (*guanxi* and Networking)

Due to the limited interface that BIT and AIB have with their respective local state organs and their officials, their social activities are also limited. Thus we will discuss each group separately and discuss in tandem the various sub-topics (banquets, business trips, delegations, gifts and various public relations activities).

BIT Group: As we mentioned in section 1 above, in the early days (2001-2003), BIT established a subsidiary to provide internet service (ISP) and they had close relations with the local district government. For this purpose, they also cultivated special relations with specific officials, including some indirect ways to share revenues with relatives of the officials. In this endeavor they had many flashy banquets together, wild nights adventures and business trips to a sea-side town (where money was spent generously on food, drinks and women). During this endeavor, gifts giving was very common.¹⁹⁰ However, in all other fields of activity, the main business focus of the company was its commercial clients, and thus no special assistance was required from state organs. This also fit the founders' policy of "staying under the radar" and this is why, when "hard-to-get" certificates (like the "high-tech tax status) were required, BIT preferred to pay for an "Agent" who has the *guanxi*, rather than cultivate their own *guanxi*. The one exception is the tax bureau, which every company must be in frequent contact with. In this regard, B-IT used to be in good relations with the tax supervising department, including having tasty banquets together, providing coupons for holidays and/or other occasions, and thus they usually achieved a compromise regarding the annual tax assessments. However in recent years things have changed. B-IT is no longer providing coupons and most interactions are straight forward via online communication and without banquets. S-IT still provide gift coupon of 1,000-3,000 Yuan to each tax inspector, usually before the spring festival and middle-autumn festival. S-IT also fixing the computers of the local tax bureau for free, as part of "building" the relations. But they also emphasize that the relations with the tax bureau are more professional and there are much less "negotiations" over the tax assessments.

AIB Group: As we mentioned before, the CEO of AIB claims that all the assistance and relations with the government are based on transparent local policies and regulations that applied to every company in an equal manner, and no *guanxi* is used to obtain assistance or permits that AIB needs. In addition, the CEO of AIB downplayed the significance of his public relations and government relations departments, though he admitted that they have "a small meals' budget" to host guests.

However, if we examine the media publications about AIB and its CEO, we can see wide coverage of "connected" company and a very photogenic CEO. In the media publication AIB often obtain awards from government ministries, government institutions and industrial associations. In the last three years AIB won prizes for "Outstanding Artificial Intelligence Enterprise"; "Road Transport Industry award for fighting the Epidemic"; "Golden Great Wall Smart Logistics Service Technology Enterprise of the Year"; "Cloud Native Technology of the Year"; and "Data security compliance governance practice excellent case". In addition, AIB has big logistics and data projects with major SOEs, ministries and local governments (e.g. one of the big cities in Hebei province). The CEO of AIB is also very popular in China's

¹⁹⁰ During that period, I was working as a director in BIT and I was told about all these social activities by the founders.

business circles. He is an expert consultant of the Logistics Planning Institute (which belongs to China Federation of Logistics & Purchasing); he is also expert member of China Federation of Commerce, and he is a logistics professional arbitrator of China Maritime Arbitration Commission. About 20 years ago he was nominated in the Chinese media as one of the top ten figures in China's logistics industry, and in recent years he was chosen as “Person of the Year in China's Logistics Industry”.¹⁹¹ Such publicity, with so many awards from government related organizations, and very important projects with governments and “National Champions” (some are SOEs and some are “considered” private public companies) implies that AIB has very good “connections” with some state organs. If we wish to believe the CEO statement that AIB does not use *guanxi*, we need to find additional explanation for the good “connections” beside the superior technology and the excellent management. In this respect, we may consider the identity of AIB shareholders as important and dominant factor.

Chapter II(1) described the “Mixed Ownership” nature of AIB,¹⁹² which has a distinguished and diversified list of investors (i.e. shareholders), including central SOEs. This fact may raise the possibility of indirect *guanxi*, and paint the statement of the CEO in a different light. Let’s begin with the SOEs that are shareholders of AIB; Bank of China (BOC), China Development Bank Capital (CDBC) and State Development & Investment Corporation (SDIC) 国家开发投资公司, which is the largest state-owned investment company in China. These are very important SOEs that are controlled by the central government. Such SOEs usually invest only in companies that their technology and/or operation align with the central government industrial policy or other strategic interests. Thus, when AIB group needs some assistance from the central or a local government, it is quite convenient for the CEO to talk with SDIC/BOC/CDBC, which can talk with the relevant government departments, and convince them that any permit or benefit for AIB is actually an advantage and benefit for SDIC/BOC/CDBC, which actually benefit the government and China as a whole. Moreover, other shareholders of AIB like Tencent and Alibaba also have tight relations with the local and central government. Any legal request for a local government by such giants will receive the most cooperative attitude due to the potential impact of these companies on the local economy. Another way to understand the relations of AIB with state organs is what I termed as “Image of *guanxi*”; When a company with a strong public image (e.g. technology leader, big and impressive customer base, etc.) applies for certain permit/benefit, and when it is known to the local government that powerful SOEs and National Champions are shareholders of this company, there is high chance that the local government will give its best assistance without a need for direct *guanxi*, gifts or any other form of incentive.¹⁹³

¹⁹¹ All the references to AIB and its CEO, awards, titles and projects are elaborated in the confidential Annex B.

¹⁹² For further discussion of the “Mixed Ownership” definition, history and effects see Chapter IV, section 4.5

¹⁹³ Such “Image of *guanxi*” exist all over the world including in Israel. I was a witness when the brother of an ex-prime minister of Israel, was bragging that during the time that his brother had been prime minister, he never had to ask him for help. He explained that since the family name is the same, almost every legal request that he made to any of the ministries was quickly accepted because they realized that he his was brother of the prime minister (sometimes they verified it with the help of google).

4. Extra-legal Measures of Controlling Private Firms

In Chapter III(4), we described various extra-legal measures and mechanisms that the Chinese government and its organs can use, in theory, to supervise, control and direct the operation of Chinese private companies. As we shall see, some of the mechanisms that exist in JMC and HJV, are absent in the case of BIT and AIB Groups, and vice versa.

4.1 Industrial Associations and Chambers of Commerce

In the BIT Group, S-IT joined the local Chamber of Commerce in Pudong District in Shanghai, and actually got significant assistance in one occasion. B-IT is not a member of any organization. The AIB Group and its CEO are well connected with various associations including, China Federation of Logistics & Purchasing, China Federation of Commerce, and probably some more. We assume that as a leader in the industry and as a member of the relevant organizations, AIB can influence some professional decisions related to its scope of business, which include the sensitive and dynamic fields of AI and autonomous driving. However, AIB may also be restricted by some state organs that supervise closely these sensitive fields.

4.2 Labor Unions

The BIT Group does have a labor union at its Beijing subsidiary (B-IT) due to the demand of the local ACFTU. The labor union is passive and the lady who head the labor union committee was “appointed” by the management due to her loyalty to the management. No elections were done and no elections are planned in the future. The S-IT subsidiary never had a labor union and the Shanghai ACFTU never approach S-IT and demanded the establishment of a labor union. The labor union members in Beijing receive free fruits, rice and other food products that are offered by the district ACFTU. In addition, the money that the ACFTU gives back to the labor union is held in a dedicated bank account and it is used for social activities such as; annual medical check for the employees, birthday cakes, holiday coupons and team building activities. According to its CEO, the AIB Group does not have a labor union and the ACFTU at the various locations, where AIB operates, never demanded the establishment of such union.

4.3 Party Cells and Party Members in Private Companies

The BIT Group does not have a Party Cell and it was never requested by the CPC to establish a Party Cell. They do not know how many CPC members are employed by the group. The CEO of S-IT claims that there are POES in Shanghai that have a clear policy not to hire Party members, in order to prevent the establishment of Party Cells. According to the CEO of AIB, they do not have Party Cell in any of the subsidiaries and it was never requested by the CPC to establish such Party Cells. The CEO also claims that he doesn’t know how many CPC members are employed by AIB, though he assumes that some are Party members.

4.4 Informal Policy Requests by State Organs

In Chapter III (3.1-3.4) we described various requests that state organs and officials asked from JMC Group and HJV. In contrast, BIT Group claims that in recent years they received no special requests.¹⁹⁴

¹⁹⁴ The B-IT company received a request to hire handicap employees, which is based on local regulations. But by paying a special “waiver fee” according to the law, they could avoid hiring such employees.

The CEO of B-IT speculated that this might be because the relations now are more professional and more distant using online communication. S-IT emphasized that the relations with the local government in Shanghai are minimal, except for the relations with the tax bureau, and this may explain why they did not receive any “policy requests”.¹⁹⁵ The CEO of AIB did not mention to us any requests by local governments or officials, but since the company in its publications prides itself to support ESG and CSR activities, we assume that they also participated in various CSR activities that were requested by local governments. It is also likely that relevant state organs handed AIB “requests” and “advices” related to its sensitive fields of operation (AI, Data Security, Surveillance, etc.). Some of this “requests” may be backed-up by specific laws that applied to these fields,¹⁹⁶ but even without legal support, there are strong incentives to cooperate with the state request as the CEO of SOGOU explained.¹⁹⁷

4.5 “Mixed Ownership” Mechanism as a Control Measure

In previous sections we described the complicated legal structure of AIB and called it “Mixed Ownership” (MOE). The term “Mixed Ownership” became popular in 2013, when the CPC Third Plenum (18th Central Committee) designated it as one of the policy tools to reform the SOEs. The idea was that “Mixed Ownership” will improve and revitalize some of the less productive and less efficient SOEs.¹⁹⁸ The original mechanism of the policy was to “inject” private shareholders into existing SOEs, in order to bring the advantage of entrepreneurial culture into the state-owned dogmatic and inefficient culture. However, in February 2016, the Chinese government added a new mechanism and initiated a pilot of two new “state-owned capital investment enterprises”, which manage multiple investment funds. By the end of 2018, there had been additional 18 central SOEs with such structure, which designed to: “Promote the rational flow of state-owned capital, optimizing the investment of state-owned capital, concentrating on *key industries, key areas and advantageous enterprises*” in “good service of national strategy needs”.¹⁹⁹ [My emphasis].

This later mechanism, which we may call “state-owned investment funds” (SOF), gave different meaning to the term “Mixed Ownership”, because in this mechanism the state culture and state interests are “injected” into private companies. The research of Chen and Rithmire found that by the end of 2017, China had 716 SOFs (counting only SOFs with total assets above one billion Yuan). Among them, 106 were controlled by the central government and 610 controlled by local governments.²⁰⁰ So, to be clear, in this section, when we talk about “MOE” as an extra-legal measure to control POEs, we refer only to companies invested by the SOF mechanism. This is why Chen and Rithmire describe the SOF as follow: “For business, state investment challenges the distinction between private and ‘state’ sectors, and introduces a new means through which the state can monitor, influence, and discipline business actors and activities that take on particular importance in authoritarian regimes.”²⁰¹

¹⁹⁵ However, the PSB contacted S-IT in regard to one employee that published sensitive political views in the internet.

¹⁹⁶ See, note 177. Regarding various Chinese tech laws (e.g. Cyber Law) that require companies to cooperate with the state.

¹⁹⁷ See the statement of the CEO of SOGOU, note 183.

¹⁹⁸ Curtis Milhaupt and Wentong Zheng, “Why Mixed-Ownership Reforms Cannot Fix China’s State Sector”, *Paulson Policy Memorandum*, Vol. 5, No. 11 (Jan’ 2016), p. 2.

¹⁹⁹ Hao Chen and Meg Rithmire, “The Rise of the Investor State: State Capital in the Chinese Economy”, *Studies in Comparative International Development*, Vol. 55 (2020), p. 263.

²⁰⁰ Chen and Rithmire, *Ibid*, pp. 265-266.

²⁰¹ Chen and Rithmire, p. 259.

The SOFs, usually operate as minority shareholders, often in a multi-layer pyramidal structure, and usually they have only around 3% of the shares (in the case of public companies).²⁰² Most scholars focus on SOFs that invest in public companies, probably because it's easier to obtain data. However, the SOFs also invest in non-public unicorns (like AIB) and "gazelle" companies.²⁰³ For example, in 2022 one of the top Venture Capital firms in China, measured by the scale of investments, was China International Capital Corporation (CICC),²⁰⁴ which is controlled ultimately by one of the SOFs.

The SOFs nature of investment creates analytical taxonomy problem. Where is the "borderline" between POE and MOE? Do we accept the definition of Huang, Véron, and Xu that only companies with more than 10% state ownership are MOEs?²⁰⁵ Or do we define a different borderline of 3% or less? And if AIB is a MOE, why we include it in our research, which focuses on "private" companies? The answer to these questions is not easy, and as we argued in our introduction that the borderline between SOEs and POEs is blurred and not dichotomist, then naturally the same is true for defining the borderlines between POEs, MOEs and SOEs (as Chen and Rithmire argue).

In our view, 10% threshold, suggested by Huang, Véron and Xu has some logic, but it doesn't reflect the full powers of the state, which beside its legal rights as a shareholder, also has other legal and extra-legal tools to enforce its goals. For example, Meyer and Wu, as well as Pearson et al., argue that the state can use legal tools to retain ultimate control via indirect ownership with controlling equity in the entity that control the firm (pyramid structure), or it can retain contractual control, via "Golden" or "Management" shares.²⁰⁶ These kinds of contracts to retain control, are often hidden, and are also a common practice in China, like the VIE structure, which is used in sensitive industries (e.g. Internet).²⁰⁷ Moreover, if we stick to the 10% or 5% definition, most of those private companies invested by SOFs shall be classified as "Private" rather than "MOE" and thus the definition will miss very important aspects of the corporate nature and governance structure of such companies.

The academic discussion of the exact definition and borderlines of MOEs is interesting, but for our purpose it is more important to examine the case of AIB, and whether the SOEs investments in AIB, actually established certain control over AIB operations. Unfortunately, the CEO of AIB did not provide us enough information and we can only speculate based on some circumstantial evidences.

We do know that at least three central SOEs are invested in AIB; the investment branch of BOC, CDCB, which is a special policy investment fund, but ultimately controlled by SOF, and SDIC, which is the

²⁰² Pearson et al., p. 153.

²⁰³ A gazelle company is a high-growth company that has been increasing its revenues by at least 20% annually for four years or more, starting from a revenue base of at least \$100,000.

²⁰⁴ See: <https://www.china-briefing.com/news/china-startup-landscape-industries-investment-and-incentive-policies/>

²⁰⁵ Some scholars use the 10% state shareholding in a private company as a threshold to define the border line between POEs and SOEs/MOEs. See for example: Tianlei Huang, Nicolas Véron, and David Xu, "The Private Sector Advances in China: The Evolving Ownership Structures of the Largest Companies in the Xi Jinping Era", *Peterson Institute for International Economics Working Paper*, 22-3 (2022), p. 7. The State shareholding is often divided between different SOEs and the percentage is calculated by counting all the SOES shares together.

²⁰⁶ Marshall Meyer and Changqi Wu, "Making Ownership Matter: Prospects for China's Mixed Ownership Economy", *Paulson Policy Memorandum*, (September 2014), http://www.paulsoninstitute.org/wp-content/uploads/2015/04/PPM_Making-Ownership-Matter_Meyer-and-Wu_English.pdf. See also: Pearson et al., p. 153.

²⁰⁷ Our law firm in China drafted many VIE contracts, in which the actual controlling entity was not the registered shareholder.

largest SOF in China. They all invested in the later rounds of investments (from 2017 onward), when AIB was already big and successful. We do not know how much percentage they hold together, but based on the average of 3% (found by Pearson et al.), they probably have together around 10%. Since we know that the three major shareholders have around 10% each, than the combined shares of the SOEs is quite significant, and it meet the 10% threshold defined by Huang Véron and Xu. In addition, 10% and also 3% of the voting power grant certain rights according to the Chinese law.²⁰⁸ On the other hand, the fact that AIB has 20 shareholders, including heavy-weight foreign entities like GLP and Temasek, can moderate the influence of the state, *as a shareholder*. But, considering the inside information that the SOEs are exposed to as shareholders, I assume that they can use the state powers as the regulator of logistics, AI, autonomous driving and data security fields (which are highly regulated fields), to direct or restrict the company's operation if they wish to. The fact that AIB seems to align very nicely with the state industrial policies and the CSR/ESG trend, as we discussed in sections 3.2 and-4.4, implies that AIB knows to listen to the government "requests" and "incentives". It seems that AIB internalized the advice of the CEO of SOGOU, which we mentioned before in Chapter III(4.4), "you really can resonate together with the state. You can receive massive support".

5. State Organs Motivation for Assistance and Companies Motivation for Proximity

Another comparison that we did among the people that we interviewed, was to understand their perception regarding the motivations of state organs to assist POEs. We asked our interviewees to provide a score between 1 and 5, regarding the importance of the following 5 factors (but they could also add more):

1. Economic Development - of the district / county / province / state
2. Technology and High-Tech
3. Social stability (e.g. reducing unemployment, social unrest, social gaps, reducing poverty)
4. Environmental and Pollution' Considerations.
5. Helping Friends / Family / Party Members (*guanxi*)

These are the results:

Motivation	Ofakim Official	Owner of JMC Group	HJV GM	BIT Group		AIB CEO
				B-IT CEO	S-IT CEO	
Economy (GDP)	5	5	4	5	5	5
Technology	4	4	4	4	4	4
Social Stability	5	5	3	5	1	3
Environment	3	3	4	3	5	1
<i>guanxi</i>	1	4	3	4	3	1
Others		-----	----		Taxation	Taxation

The results of this survey show that there is almost consensus opinion on the importance of the economic factor (5 points) and the technology factor (4 points). The dominance of the economic factor is also

²⁰⁸ The Company Law grants different rights for minority shareholders, including the right of 10% of shareholders to convene interim shareholders' assembly (Article 100), the right of 3% of shareholders to request the board of directors to add topics for discussion at the shareholders' assembly (Article 102) and the right of 1% of shareholders that can request the supervisor of the company to initiate a lawsuit in the people's court against director, supervisor or senior manager that violates laws, regulations or bylaws. Additional rights granted to minority shareholders of listed companies.

reinforced by those participants who emphasized that taxation revenues are extremely important for the local officials in their districts. However, there were diverse rating for the other factors.

Regarding the social stability factor there are significantly different replies; The CEO of S-IT, who gave the lowest score, explained it by the good employments situation in Shanghai, so it is not high on the agenda of the local officials. This might also explains the medium score given by the CEO of AIB, but does not explain the medium score that HJV from Ofakim gave for this factor. Another possible explanation that fits both HJV and AIB is that these are the most successful companies in our survey, and therefore local governments do not pressure them in this respect. In this regard AIB had to dismiss almost 1,000 employees in recent years (due to a big merger) and, according to the CEO, the local district government in Beijing did not care and did not interfere with that. However the majority of the participants believe that this factor is high on the local government agenda, and we also experienced it first hand in other cases we dealt with.²⁰⁹

Regarding the environment factor; while most participants gave it a score of 3-4, AIB gave it the lowest score and S-IT gave it the highest score. S-IT explained that in their district in Shanghai, nobody mention environment or pollution, because the local government has a total ban on polluting companies, and about 10 years ago they had kicked out the last polluting company from the district. Regarding the score that AIB gave we can assume that since the company doesn't pollute the environment and it is located in a clean and green AI park, then local officials never bother them with environmental issues. However, the score they gave does not fit with recent publication of AIB about joining "green initiatives". Does it mean that AIB believe that in other locations the environment is an important factor?

Regarding the *guanxi* factor; we can also see that most participants gave a score of 3-4. Some of them told me that it is actually very important, but nowadays it is harder to use, and that is why they gave it a score of 3 rather than 4. It is also important to add, that in spite of the sensitivity of this factor, the reply of JMC, HJV and BIT Group, seems sincere, because I have personal relations with all of them and "they know that I know", since I worked with them in the past and was exposed to the relations with the state organs. The lowest score given by the official in Ofakim is expected, because his position requires him to deny it. The score of 1 given by the CEO of AIB is interesting and I can find two possible explanations. The first is that he did not give an honest reply because he doesn't know me well and does not want to be exposed (if you give high score you may be suspected of using *guanxi*). The second explanation is that AIB success relies on its professional skills (technology, management, etc.), and since it already gained what we described earlier as "Image of *guanxi*" (identity of shareholder plus business recognition). So, the CEO actually does not need and does not use direct *guanxi* in the traditional sense.

Another reason for the government assistance, that we didn't include in our questionnaire, but it came up in the interviews with the people in Ofakim, is a mix of "responsibility", "duty" and "pride", that some of the officials feel and exhibit. In our opinion, these emotions reflect the Confucian holistic approach of governance, as well as renewed CPC approach to "serve the people". Those officials, especially those who manage the Ofakim EDZ, see the companies under their jurisdiction, as their "children" and themselves as the "parents", in the Confucian sense. Or if you prefer, as "emperor-subject" relations. Thus, according to Confucianism, these unequal relations burden the superior (Emperor, Official, Parent) with responsibilities,

²⁰⁹ We had such cases mostly in peripheral areas, such as Panzhihua (in Sichuan) in ChiFeng (Inner Mongolia) and Hubei.

duties and obligations towards their inferior (subject, company, child). Simultaneously, as Aleksandra Kubat says: "The pledge to serve the masses is regularly renewed by the Party [...] Paradoxically, in this new cultural narrative of the CCP, the societal considerations embedded in Maoism and Confucianism are brought together in mutually strengthening interactions, which lead to the enrichment and reappraisal of these respective theories."²¹⁰ We personally felt these emotions and heard it in the rhetoric of those officials that we met. And as we already mentioned, the CEO of AIB described it as "the local government feels that it is the holding company of all the companies under its jurisdiction".

In their book *Corporate Political Strategies of Private Chinese Firms*, Ma et al. divide the Chinese officials to "rank-seeking" and "rent-seeking". They argue that "rank seeking" officials are those who have fair chance for promotion, so they care more about the government policies (economic development, etc.), while the less-promotable officials are likely to become rent-seeking and look for personal gains.²¹¹ Seeking personal gains means that these officials will need to facilitate *guanxi* with the businessmen in their jurisdiction. These findings make sense, but they were collected before 2012. Our impression is that due to the Anti-Corruption Campaign that began in 2012, "rent-seeking" officials are very careful, and the usage of *guanxi* for personal gains, or as the major factor in the government decision, become much less common.

Unlike the diverse motives for the government assistance, the motives of SMEs and businessmen to seek state organs proximity are more trivial and expected, and they are as old as the history of humans. If we need to summarize it in a simple way it will be money and power, on the one hand and pain and sanctions on the other. In other words carrots and sticks, which is actually the essence of Wang Xiaochuan statement that we quoted earlier. However, the interesting question is whether this phenomenon is more prominent compared with other countries and why. The answer of Milhaupt and Zheng is as follow:

The point is that where a government routinely chooses to enforce its policies by extra-legal means, the added degree of autonomy from government influence that ordinarily follows from private, as compared to government, ownership of enterprise may be illusory. Of course, this is a principal reason why politically connected entrepreneurs are so prevalent in China: If private entrepreneurship does not bring added autonomy from the state, better to seek the benefits of affiliation with the government. Simply put, if you can't beat 'em, join 'em.²¹²

Beside the common sense, there is ample empirical evidence to support the view that political *guanxi* assists in a wide range of business activities, which some of them Lin and Milhaupt described earlier.²¹³ Thus, it is not surprising that in his survey Dickson found that 75% of the entrepreneurs, were either CPC members or wanted to be.²¹⁴

As Cheng and Wu explain; in countries like China, where formal institutions are weak, including weak legal system; weak protection of private property rights; weak enforcement of contracts; frequent

²¹⁰ Aleksandra Kubat, "Morality as Legitimacy Under Xi Jinping: The Political Functionality of Traditional Culture for the Chinese Communist Party." *Journal of Current Chinese Affairs*, Vol. 47, No. 3 (2018), p. 79.

²¹¹ Hao Ma, Shu Lin and Neng Liang, *Corporate Political Strategies of Private Chinese Firms*, New York: Routledge, 2012, p. 10.

²¹² Milhaupt and Zheng, p. 688. See also: Ma et al., *Ibid*, p. 11, where they show that this is much more common in China compared with Western countries.

²¹³ See note 37, and the quotation in that page.

²¹⁴ Bruce Dickson, "Integrating Wealth and Power in China: The Communist Party's Embrace of the Private Sector", *The China Quarterly*, Vol. 192 (2007), p. 838.

change of government policies; and discrimination against private firms, there is a tendency of POEs' owners to look for non-formal institutions as a substitute to formal institutions, so close relations with state organs are a major tool in business development.²¹⁵

It is also worth mentioning that, when Milhaupt and Zheng emphasize that "government routinely chooses to enforce its policies by *extra-legal means*",²¹⁶ [my emphasis] it is also quite easy for the government to enforce its policies via the legal system, and in spite of some improvements of the Chinese legal system, it is still very hard to win a case in court against any state organ or SOEs.²¹⁷

Chapter V. Analysis and Discussion of Research Findings

1. Vertical Comparison Analysis

The vertical comparison of the state-companies relations in Ofakim exposed a significant shift between the pre 2013 period and today. The approach of the local government and its officials became more systematic, professional, technical, and less corrupted. It is a "rule-by-law" approach, which is more transparent, but also more bureaucratic and more autocratic. Examples for this approach are the evolution of the local investment regulations, rules that forbid loans by SOEs and the rules that restrict fancy banquets and gifts. This approach is also supported by the major technological move to online rather than face to face communication.²¹⁸ This approach use the old and new mechanisms to supervise, direct and mobilize the POEs in the direction of the government policies, while reducing corruption and inefficiency among the officials. This new approach, which is seen clearly in Ofakim, is also corroborated by the evidence from the cases of B-IT and S-IT in Beijing and Shanghai.

However, in spite of the major shift, which most interviewees see as a healthy change in the right direction, it is clear that both the officials and the POEs found ways to adjust and circumvent this approach in order to mitigate some of its restrictions. These "adjustments" also enable them to keep the culture of reciprocal personal relations alive and follow Confucian values and CPC terminology of "harmonious society".

The "adjustments" taken on the ground by the POEs and the officials in Ofakim, reflect the limitations of the CPC to supervise and control the private sector. As we described in Chapter III(4) and Chapter IV(4), the establishment of labor unions and Party Cells within the POEs are often circumvented by appointing confidants of the management, while the higher level of the Party and the unions do not seem to care, as long as the "decor" and the organization exist on paper. The EDZ in Ofakim, established "rule-based" policy that enabled legitimate banquets with the companies in its zone, and CSR policies, which the government promotes, are often perceived by both sides as a mere public relation gimmick.²¹⁹ These examples, and others, which we described in this thesis, expose the "cat and mice" game that the CPC plays with the

²¹⁵ Cheng and Wu, p. 245.

²¹⁶ Milhaupt and Zheng, p. 688.

²¹⁷ Regarding civil disputes, see: Haitian Lu, Hongbo Pan and Chenying Zhang, "Political Connectedness and Court Outcomes: Evidence from Chinese Corporate Lawsuits", *The Journal of Law and Economics*, Vol. 58, No. 4 (2015), p. 830.

Regarding administrative disputes, see: Ji Li, "Dare You Sue the Tax Collector? An Empirical Study of Administrative Lawsuits Against Tax Agencies in China", *Pacific Rim Law & Policy Journal*, Vol. 23 (2014), p. 58.

²¹⁸ As a telling anecdote; during my recent visit (summer 2023) in a remote mountainous village in Shanxi, and as a foreigner, I was interviewed, identified and registered online by the local police officer, via the computer system in my very poor guesthouse.

²¹⁹ This is in contrast to some of the findings by Yao, Zhang and Ma.

private sector. Yet, although the POEs and local officials manage to circumvent some of the restrictions, the general tendency seems to increase scrutiny, to rely more on rule-based procedures and reduce corruption. On the other hand, this approach seems also to increase dogmatic thinking and reduce the enthusiasm of officials to support private / or government initiatives that are out of the mainstream.

Due to the above shift, there are various side effects and I shall mention two of these changes; First, all interviewees confirmed that there are less “personal” requests by officials but there are much more CSR requests, which are used by all sides as a PR benefit. Second, land benefits become the dominant tool that local governments can use to assist POEs/SMEs, while financial tools are less effective.

2. Horizontal Comparison Analysis

The Horizontal comparison of the SMEs relations with state organs exposes diverse types of relations that can be attributed to the location, the sector and the economic significance of the companies. The differences between locations and sectors also demonstrate the flexibility of the state organs in using different mechanisms to supervise and control the private companies. They also demonstrate that the level of supervision and control can vary a lot between different types of private companies. So let’s unpack this generalization into specific insights.

JMC Group and HJV are both located in Ofakim, which is a small peripheral town. In spite of the policy changes and developments that we discussed in Chapter III, the traditional values and the relations between people still play an important role and they are tighter than in Beijing and Shanghai. The officials of the town, literally know every owner and GM of every company. They celebrate with them birthdays and holidays, assist the companies in various ways (land and finance), help solving commercial and other disputes and treat the whole ecosystem as one big family, or as one big company. This is why they expect the companies to reciprocate and fulfil the requests of the government as well as some personal requests of the officials.

The formal mechanisms of labor unions, Party Cells and industrial associations exist nominally, but in practice they only used as another tool to nurture the social relations, rather than monitor or effect the SMEs. This social environment is in contrast with BIT Group that declared a policy of staying under the radar, and minimize its relations with the government (except for the tax bureau in Shanghai). Based on our research it seems that many private SMEs in Beijing and Shanghai, can interact with state organs by relying on transparent rules and online procedures without the need for tight personal relations, and with minimal, or without any supervision of Party Cells and labor unions.

The case of AIB is somehow more complicated and falls between the two edges. On the one hand, AIB does not have Party Cell and labor union, but due to its size, leadership position in sensitive industries, media exposure and its shareholders’ identity, AIB seems to align much closer with government policies and receive major assistance like a National Champion. In this sense, and this is something we discovered only during our research, AIB does not fit into the SME category in spite of its modest number of employees. Another observation is that although HJV and JMC are located in the same ecosystem, the relations of HJV with state organs in Ofakim are more professional and more independent. This can be attributed to two factors; first, foreign ownership, which local officials respect and also understanding that they can’t project

their Chinese values (e.g. *guanxi*) on the foreign shareholder; second, the relative economic success of HJV, which gives it leverage in every negotiation with the local government.

Based on our research we can make the following generalized deductions regarding the relations between private SMEs and the state organs:

- The general tendency in all the locations is to move from state assistance based on personal relations to rules-based assistance, with clear and transparent policies, procedures and regulations.
- SMEs in the periphery will have closer social relations with state organs, compared with big developed municipalities. These relations encompass traditional values with CPC terminology, and the assistance provided by state organs at the periphery will be more comprehensive and flexible. In this regard, SMEs (or POEs) have more chance to influence government policies for their benefits (“State Capture”), the way that HJV did in few cases (such as fast return to work during COVID).
- SMEs in big urban cities shall rely more on rules-based procedures and policies, while using “legitimate agents” to cut red-tapes, rather than using their personal *guanxi*. The assistance by state organs in the big developed cities shall usually be rules-based, less comprehensive and less flexible.
- SMEs with foreign investment (FIE) have more independence in their relations with state organs (although they are also required to adhere more strictly to the laws and may be scrutinized more).
- SMEs with proven technology and/or commercial success in strategic industries, will have tighter relations with state organs, but the mechanism of supervision and control may be more flexible. Such SMEs will also be more prone for government investments (Mixed Ownership).
- The economic contribution of SMEs, or the potential of it, is the most important factor in receiving assistance from local state organs. The economic contribution is measured in local perspective, within the zone / district / city / province, and taxation revenues are an important measurement.
- The initiative to establish reciprocal relations is mutual and both sides yearn for it.

3. Traditional Values Effects on the Relations of State Organs and POEs

Our research pointed out to various conducts of state organs and officials that reflect the importance of traditional Chinese values in the existing governance system, and especially in the peripheral regions, where the community sense is stronger and Western values penetrated less. We believe that these values include a holistic worldview, which sees all the companies and all individuals as subjects of a unified (monist) hierarchical governance structure. This worldview is naturally prioritizing the collective over the individual, because the individual person or the company, are only one small atom in the big unified structure. Not surprisingly, the PRC and the CPC have similar organizational structure,²²⁰ and thus the CPC adopted elements and terminology of this traditional worldview, such as “harmonious society”, “rule by virtue”, “rule by law”, etc.²²¹ Therefore, it is quite natural that this worldview exists in the relations that we explored in our research. Below is a summary of the conducts that reveal these traditional values and worldview:

²²⁰ Christopher Ford, pp. 1037, 1045.

²²¹ The difference between “Rule by Law” vs. “Rule of law” was explained earlier. See: note 92.

3.1 Intervention in Civil Disputes:

In democracies civil disputes between private parties are normally resolved by an independent legal system. But in China, the traditional unified (monist) and hierarchical structure, sees the legal system as just another arm of the government, and subject to the government orders. Accordingly, Chinese officials, sitting high in the hierarchy structure, feel that ultimately it is their duty and obligation to solve significant civil disputes and contribute to social harmony. Thus, the local governments in Ofakim, and other regions (including the less traditional Shanghai),²²² can intervene and resolve civil disputes, in those cases that are important enough and where its “mediation” can add-value to resolve it. We exemplify it in Chapter III (4.2) and Chapter IV (2) – regarding BIT Group. These interventions can happen even when the case is already dealt and handled by the court, because from the officials’ perspective the court is just another arm of the government.

3.2 Cultivating Social Relations

Cultivating the social relations is a major aspect of the unified and hierarchical worldview, in which an official should know and take care of each individual or company under his jurisdiction, reflecting the “emperor-subject” (or parent-child) relations.²²³ Such relations require the subject to respect and obey his superior, but also impose responsibilities and duties on the superior. As Yi-Huah Jiang phrased it “the legitimacy of the Confucian political order is based on a ‘service conception of authority’, and an authoritative political relation is marked by a ‘mutual commitment’ of both the ruler and the ruled, namely, the rulers are committed to serve the people and the ruled willingly submit themselves to the rulers.”²²⁴ In addition, by cultivating these relations and taking care of his constituents the official also facilitates the goal of harmonious society. We exemplified the various ways that this is done, mainly in Ofakim, in Chapter III(3.5) and Chapter IV(3.3).

3.3 "Reciprocal Benefits" of State Organs and Companies

The importance of social relations, discussed above, also explains the concept of reciprocal benefits, or “give and take” principle, which naturally exists in all cultures, but in the Chinese society it is more prominent. Whether it is an official-subject relations, or the equal relations between friends, the logic of harmonious society deserves that a party shall return a favor for another party’s assistance. If an official requested a “personal” favor from a company, or if the company requested the official, it is only natural and logical to expect a gratitude. If it is a “policy” request by a state organ, the company should respond positively, not only due to the logic, which is embedded in “personal” requests, but also because the “policy” request is for the benefit of the collective society. In Chapters III(2-3) and IV(2-3) we described various cases where HJV, JMC and S-IT received government support, but also returned the favors in various ways including, aligning with government policies; support of the government and officials public relations; and providing various types of gifts and personal benefits (like financing trips, jobs for relatives, or fixing the computes of the tax bureau in Shanghai).

²²² We also encounter such attitude by local officials in Chifeng (Inner Mongolia), Panzhihua (Sichuan) and Shandong province.

²²³ See Chapter III, sections 2.2.8 and 2.5.3, where we mentioned how the official we interviewed was proud of assisting the companies to receive “good” loans, and the personal care of the companies and GMs in the EDZ district.

²²⁴ See Jiang, p. 158-159.

Reciprocal benefits that are spread along an extended period and without direct causal relationships to specific actions, are a natural phenomenon that will always exist. However, when there is a direct causal relationships between a benefit and an official's action, it can be classified into two extremes. On the one hand, it may reflect a legitimate incentive defined by regulations or public policy, such as the tax incentive that HJV received for its contribution to the local economy. On the other hand, when it is a personal benefit that an individual official receives due to his actions, for the benefit of the company, it may be regarded as "gratitude gift" in the better case, or an illegal gift, in the worst case.

Our research demonstrated many examples where SMEs had reciprocal relations with state organs and/or officials. They include legitimate alignment with government policies (especially AIB, HJV), which are explained by modern economic theories. But they also include less legitimate activities, such as gratitude money gifts to officials (HJV), seasonal gifts by HJV, JMC and BIT (in the past), employing relatives of officials (HJV and JMC), etc. These reciprocal relations, which may be against the law or the official policy of the central government, prove the strength of the traditional values.

3.4 Priority of Policy over the Law

Prioritizing policy over the rule of law (actually, rule by law) can reflect pragmatism over dogmatism, but it also can reflect that the collective is superior to the individual. The conscious policy of the labor bureaus to violate the laws on social benefit deductions and establish unwritten regional policy, which promote economic development, is a good example. This policy prioritize the collective good of the region over imposing a specific regulations that reward certain individuals, but harm the collective society. This policy also prevents grievances of companies and workers, which may harm social stability and thus it facilitates the value of harmonious society.

3.5 Importance of Family Values

The importance of family values is part of cultivating social relations (section 3.2 above), but it is the inner core of social relations, with the nuclear family in the center. As mentioned earlier, most of Chinese private firms in history were family businesses, but this phenomenon continue also today. In his recent edition about the Chinese economy Naughton emphasizes how unique is this phenomenon, and he points out that 85% of private companies in China are family controlled (especially in small firms).²²⁵ Family control means that most of the senior management of the firm will be family members, relatives, or friends of family members. In our research, JMC Group and its subsidiaries is the perfect example of a family run firm, that was controlled by Mr. Long. Mr. Long not only held 100% of the shares, but he also was the actual GM and he appointed his relatives in various positions, including his son (Xiaoli) that replaced him after his death. Even in HJV (which used to be a joint venture before AVL took control), Mr. Long appointed 4-5 relatives in key positions, including deputy-manger, finance department, purchasing manager and storage manager. BIT also shows a tendency toward this structure and thus in B-IT the husband of the GM / founder joined the company in a senior position, and S-IT is run by the two founders who are a married couple. The children of the BIT management are still young, but I will not be surprised if they will join the company when the time is due.

²²⁵ Barry J. Naughton, *The Chinese Economy: Adaptation and Growth*. Cambridge: MIT Press, 2018. p. 318.

To summarize: Our empirical findings show the influence of Chinese traditional values on the relations between state organs and the SMEs that we researched. These results are also obtained by Oppen and Anderson, and they summarize it as follow: “Conceptually, culture has long been perceived as a factor pertaining to cross-national and interregional differences in economic activity and firm management [...] culture as a factor likely explaining some of the differences in economic activities and new venture creation, both across countries [...] and regions. [...], differences in regional cultures have recently also gained recognition in research on China’s economic and business development.”²²⁶

The assumption that there are “differences in regional cultures (and values) in China and that these differences influence the economy and business activity,” is not surprising due to China’s enormous size and diversity. Our research suggests that traditional values are stronger in peripheral towns like Ofakim, in comparison with urban metropolises like Beijing and Shanghai. Similar results were obtained by Kwon (2012), who compared coastal Shenzhen (in the south-east) with inland Taiyuan (central-north) and found significant differences in work-related values. In his research, workers in modern, entrepreneurial and tech-oriented Shenzhen, showed more individualism, compared with the workers of the more traditional industrial Taiyuan, which were more collectivist.²²⁷

In October 2022, during the 20th National Congress of the Communist Party, Xi Jinping gave a two hours long speech in which he emphasized that “to uphold and develop Marxism, we must integrate it with China’s fine traditional culture” and he also listed some of the traditional values that should be cherished, including:

Pursuing common good for all; regarding the people as the foundation of the state; governing by virtue; discarding the outdated in favor of the new; selecting officials on the basis of merit; promoting harmony between humanity and nature; ceaselessly pursuing self-improvement; embracing the world with virtue; acting in good faith and being friendly to others; and fostering neighborliness.²²⁸

This speech of Xi Jinping was very unique and it shows how important it is for the CPC to add the traditional values to the governance system in China. Some scholars believe that the traditional values are only a tool to strengthen the legitimacy of the CPC, but others, like Professor Yuri Pines, argue that this is a real ideological turning point, and it may put China on a different trajectory.²²⁹ I would like to summarize this section with the words of Zhao Wei that quote McNally and says: “McNally also noticed that there is a deep historical institutional reservoir and traditional value system that have shaped Sino-Capitalism (MCNALLY, C., 2011). Chinese society is ruled by social relations rather than by explicit laws.”²³⁰

²²⁶ Oppen and Anderson, p. 1168. Oppen & Anderson support this quotation by many empirical researches.

²²⁷ Jong-Wook Kwon, “Does China Have More Than One Culture? Exploring Regional Differences of Work Values in China”, *Asia Pacific Journal of Management*, Vol. 29 (2012), p. 92.

²²⁸ “President Xi Jinping’s Report to China’s 2022 Party Congress” *Nikkei Asia* (18 October, 2022).
<https://asia.nikkei.com/Politics/China-s-party-congress/Transcript-President-Xi-Jinping-s-report-to-China-s-2022-party-congress>

²²⁹ Yuri Pines, “The Future in the Past? The Ideological Swing of the CPC and its Potential Implications”, HUJI Lecture (7 Feb’, 2024).

²³⁰ Wei Zhao, “What is Capitalism with Chinese Characteristics? Perspective on State, Market, and Society”, *Colloque international*, Vol. 10 (2015), p. 4.

4. Other Specific Observations

Below are some additional specific observations that came up in our research:

4.1 The Limited Powers of Industrial Associations, Labor Unions and Party Cells:

Milhaupt and Zheng argue that the Party-State is using extra-legal measures, including industrial associations, to monitor, control and direct the operations of POEs. This point is emphasized by many scholars and politicians because of its practical consequences, and the FBI director, Christopher Wray, testified recently (July 2023), in front of the house judiciary committee, that China demands foreign companies (FIE) to host the Party Cells that monitor their compliance with CPC views, and also attempt to obtain technology secrets and information of these companies.²³¹ In a new paper, Milhaupt argues that the usage of Party Cells is effective in big tech POEs and SOEs.²³²

In contrast, with Milhaupt and Zheng thesis and the fears of many scholars and politicians, including Christopher Wray, our research found that the usage and capabilities of the labor unions, the Party Cells and the industrial associations to monitor, control and direct the operation and policies of SMEs, seems overrated. The exceptions may be SMEs like AIB, which are operating in a highly monitored and regulated sector, and thus, the industrial association of that sector may have powers to direct the firm's operation by defining policies, quotas, and also direct "requests". In the cases of S-IT (Chamber of Commerce) and HJV (Industrial Association) they claim that they pay symbolic fees but receive real assistance and value without any interference in their operation.

In the case of labor unions and Party Cells that we studied, those organizations were either totally absent, or functioned merely as social clubs under the control of the management. As such, they were without any powers to interfere or intervene in the SMEs operation and policies. On the contrary, in many cases the management used the organizations for the benefit of the company, such as organizing social activities that management wanted (using the money of the labor union), or using the Party Cell to distribute the management's message and goals to the workers.

Based on the case of Walmart, that we discussed in Chapter III(4.2), it seems that even labor unions in big POEs, and even when it is an FIE (like Walmart or HJV), have very limited ability to influence the POEs and they are no more than paper tigers. Milhaupt argues that the situation is different in big high-tech POEs and SOEs, and especially among those that have outsized influence in the Internet sphere, like Alibaba, Tencent (Wechat), ByteDance (TikTok), etc.,²³³ so one cannot exclude the potential of the Party-State to use these organizations, under suitable circumstances, to monitor, control or steal technology and commercial secrets of the SMEs. Yet, the Party-State has so many other tools to achieve such goals, that using these organizations is usually not necessary and less efficient.

It is also interesting to see, that even the legal obligation to establish a nominal labor union or a Party Cell is not enforced systematically. While B-IT was requested by the ACFTU to establish the union, AIB, located in the same district in Beijing (Haidian), was not requested to do so. S-IT in Shanghai also was

²³¹ "Communist Party Cells Influencing U.S. Companies' China Operations, FBI Director Wray Says", *CNBC News* (23 July, 2023). <https://www.cnbc.com/2023/07/12/communist-cells-influence-companies-in-china-fbi-director.html>

²³² Curtis Milhaupt, "The (Geo) Politics of Controlling Shareholders." *European Corporate Governance Institute-Law*, Working Paper 696 (2023), p. 10.

²³³ Milhaupt quotes *The Economist* that describes the CPC moving to "detycoonify" the domestic internet industry, pp. 5, 10.

not requested to establish a union. AIB, B-IT and S-IT were also not requested to establish Party Cells. We don't know if these examples are the result of some regional conscious policy, or just an arbitrary and negligence of the local ACFTU and the local CPC. But judging from the negligent supervision of the labor unions at HJV, JMC Group and B-IT, we tend to believe the latter option.

4.2 Government Assistance Tools:

The research shows that currently the main financial assistance that local governments provide to POEs is via real-estate. It can be sale of land plots (in the case of JMC and HJV), it can be a discounted lease fee, or free lease of office and storage space (in the case of AIB, BIT and HJV). Financial assistance via discounted local taxation is limited due to the relatively small amount of local tax that authorities collect (most tax transferred to the central government) and the new regulations are comprehensive but strict, so there is less room for manipulation. The usage of land as the most important resource of local governments in China is well documented, and now that the economy is slowing down, it creates serious deficit for local governments, as well as major headache for the central government.²³⁴

4.3 Government Consideration of Economic Development and Social Stability:

In comparison with the developed big urban municipalities, state organs in peripheral regions care more about social stability, including unemployment and labor disputes. They also care more for workers in blue-collar industries, compared with white-collar and high-tech. The possible explanations are that, first, unemployed workers at peripheral regions have less alternative options for work, especially if they are non-skilled workers (i.e. blue-collar). Thus, the potential for unemployment unrest in peripheral regions is bigger; secondly, in peripheral regions social relations are tighter and officials will often know the dismissed employees or their relatives. Thus they have more direct pressure and moral emotional obligation compared with officials in big urban regions.

Regarding the relations between the goals of economic development (including taxation revenues) and social stability, in all the regions we examined (Ofakim, Beijing, Shanghai), and also in other regions that I worked on in the past,²³⁵ the local labor bureaus accept that companies with average salaries above the average in the region, will deduct the social benefits based on the average salary rather than follow the law, which requires deduction based on the actual salary. This phenomenon, that benefits the rich companies and the high-earners employees, also increases the wealth gap and shows how important is the economic development compared with the wealth-gap and social stability goals.

²³⁴ See for example: Tianlei Huang, "Local Governments in China Rely Heavily on Land Revenue", *Peterson Institute for International Economics* (5 July 2023). <https://www.piie.com/research/piie-charts/local-governments-china-rely-heavily-land-revenue>

²³⁵ Including Wuxi (in Jiangsu province) and some localities in Shandong province.

Chapter VI. SMEs within the State Capitalism Discussion

In our horizontal comparison analysis we discovered that the relations between the state organs and SMEs include diverse types of interactions, which are correlated mainly with the location, the industrial sector and the economic significance of the company (and to a lesser extent also to foreign identity). We also noticed the flexibility of the state organs in using different mechanisms, for different type of SMEs, in order to achieve the goals of the local/central government and especially the goal of economic development. However, when we examine and compare our research findings regarding SMEs with the thesis and model of Milhaupt and Zheng, we can see some important differences.

Milhaupt and Zheng's main thesis is that in China SOEs and Large POEs with "potential economic growth" are similar.²³⁶ They explain it as follow:

China's weak institutional setting gives the Party-State fairly extensive informal control rights over privately owned enterprises (POEs), even in the absence of state ownership. Because many Chinese firms, regardless of ownership, succeed by fostering connections to the Chinese Communist Party (CPC) and obtaining state-generated rents, *large firms* [my emphasis] in China exhibit substantial similarities in their relationship with the state that distinctions based on corporate ownership simply do not pick up.²³⁷

However, in our research we found that not all the SMEs that we explored wanted to foster connections with the CPC or other state organs, and some SMEs, like S-IT and B-IT prefer to stay below the radar and minimize connections with the Party-State. It is also hard to evaluate the strength / proximity with state organs, and how useful they are. For example, the JMC Group has strong relations with the local government due to personal relations (when Mr. Long was alive they even had "Institutional Bridging"), historical sentiments, and a partnership with big SOE, but in practice it receives mild support. In contrast, AIB denies any personal relationships with any officials and it does not have labor union and Party Cell, so these control mechanisms can't be used to monitor or influence AIB. At the same time, the Party-State has invested in AIB via its SOEs and it is a significant shareholder. The Party-State is also the regulator of the sensitive fields of AIB operation (AI, Data Security, etc.), and these fields are also generously subsidized. Thus, and based on the examples provided in Chapter IV(3.3), it is probable that the relations of AIB with the government, as a regulator, are very tight and beneficial. Therefore, and in spite of AIB weak *guanxi*, the alignment with the government's goals in the AI sector, plus the state indirect ownership, makes AIB more controlled and more aligned with the Party-State. Milhaupt refer to technology firms like AIB, and he provides a good explanation to the situation of AIB:

Controllers of Chinese technology firms benefit from the support and protection of the government, and the government relies upon the private firms as sources of innovation and to provide the military and public sector with advanced technology, data, and security. But the symbiosis is even more critical in China given the nature of the regime. The Party-State relies on data and technology as a vital means of modern behavioral control and regime protection [...] At the most fundamental level, the Chinese Communist Party needs innovation to fuel the economic growth and social stability essential to its

²³⁶ Milhaupt and Zheng, p. 696

²³⁷ Lin and Milhaupt, p. 188.

legitimacy, while the tech firm controllers' personal liberty and security depends upon the continued support of the Party-State.²³⁸

The parameters that Milhaupt and Zheng are using to compare SOEs and big POEs are listed below and we shall examine how they match with the specific SMEs that we researched:

- (1) "Institutional Bridging", or "proximity" to state organs.²³⁹
- (2) Government financial support via subsidies, tax refunds, soft loans, etc.
- (3) Alignment with industrial policies and CSR.
- (4) Extra-legal control via industrial associations, labor unions, Party Cells (or "mixed-ownership").
- (5) Extra-legal control via policy advice / requests.
- (6) "State Capture", which is the mechanism that the firm acquires state-generated rents (like soft loans), due to non-material reasons (such as political loyalty, personal relation of family and friends, or due to corruption), or due to policy legitimate reasons, such as "potential for economic growth".²⁴⁰

When we look at the above parameters, we can see that many of them do not apply to the SMEs that we examined. On the one hand, we have the BIT Group that does not match most of the parameters. On the other hand we have JMC Group and HJV during the 2003-2005 period, when Mr. Long was managing the companies using his strong "Institutional Bridging" and the alignment of the companies with the policies of the local government at that time. In fact, when the companies were in poor financial situation, Mr. Long used his power to acquire state-generated rents, for non-material reasons (i.e. State Capture). Due to all these factors JMC Group and HJV received massive financial support, and in many ways the local government in Ofakim treated JMC and HJV as SOEs (another influential factor may be that most employees were x-employees of the state-owned HBB and high percentage of them were CPC members).

On the other side, B-IT and S-IT operate almost like a private company in the west. They prefer the policy of "staying under the radar"; minimize their relations with government officials; and do not seek "Institutional Bridging". Thus, they do not encounter extra-legal advice or requests from state organs. All the government support that they receive is based on transparent regulations and policies. B-IT has a labor union on paper, which is controlled by the management, and S-IT is a member of the chamber of commerce. But these organizations do not control or monitor the companies. On the contrary, they are used for the benefit of the companies. B-IT and S-IT do align themselves with some public policies and regulations that benefit them, but this is not different than any high-tech company in the West that is doing the same.

The current relations of HJV with the local government in Ofakim are warm and cooperative due to various reasons, but also due to the local "family" culture in Ofakim, and especially in the EDZ. However, HJV has very little "Institutional Bridging" since Mr. Long lost the control of the company (in 2009), and much less since he became sick and died (2021). The respect and cooperation that the company receives from the local government is related mainly to the economic contribution that HJV provides to the city, and to a lesser extent to the prestige that it brings to the city as a foreign brand with advance technology. Thus, and due to the alignment with industrial policies and officials requests, as we elaborated in Chapter III(3.1-3.4), and due to the "potential for

²³⁸ Milhaupt, p. 13.

²³⁹ See Chapter III(1)

²⁴⁰ Milhaupt and Zheng, pp. 694-695

economic growth”, the company can acquire legitimate state-generated rents (such as the new land plot at 25% of the original cost) and the treatment of HJV by the local government is somewhere in the middle between SOE and POE (maybe the historical relations with the JMC Group and Mr. Long also contribute to this attitude).

The JMC Group, at its current state, is one step closer to SOE on the spectrum between SOE and POE. On the one hand, its “Institutional Bridging” is weaker than it used to be when Mr. Long was alive, but on the other hand, Mr. Long’s wife and her son, Xiaoli, still have personal relations with Mr. Long friends. Moreover, the recent restructure of JMC Caps, which partnered with the state-owned HBB, strengthen the cooperation with the local government and increased the political power of the JMC Group. However, the industrial sectors that JMC Caps and JMC Packing operate in, are not attractive for the government.²⁴¹ Thus, JMC group has strong “Institutional Bridging” and a historical origin as an SOE spin-off, with 30% CPC members, which helps to perceive the group and its workers as a semi-SOE, but it has limited chance to receive significant financial assistance and acquire other state-generated rents, because the sectors in which the companies operate do not align with state policies. It seems that the inherent value of JMC Group to the local government is very low, but thanks to the good personal relations, it still receives a favorable treatment, but with no meaningful financial support. Due to its size and alignment with the government (mainly small CSR activities) it is considered loyal, and thus the labor union and the Party Cell within the JMC group are practically virtual and meaningless (and the supervising organs don’t care).

The most interesting company in our research is AIB. On the surface it is the company which is very independent from the state organs and with “Western Style” management. Without “Institutional Bridging”, with no direct interface with the government (according to the CEO), without a labor union and without a Party Cell. All the financial support that was received from the state is based on public policies and regulations, like any other private company around the world. However, as we delve deeper, we could see that due to its distinguished shareholders, including three powerful SOEs, and due to the sector and leading technology that it has, AIB receives major state attention and support (government projects, real-estate expenses, taxation). Moreover, since the technology fields of AIB are highly regulated, it is actually supervised and monitored closely by state organs. Honestly, we don’t know enough about the degree to which AIB needs to obey government directives and how the powerful shareholders influence the company’s operations and policies. Based on our limited knowledge and experience in other cases, we can evaluate that AIB is the most “independent” company in daily operation, but it is the most controlled by the Chinese state organs when it concerns the core technologies, security and cyber, commercial monopoly in China, global expansion, etc.

In summary, and based on our limited research, it seems that Milhaupt and Zheng thesis regarding big POEs does not fit most private SMEs. It can fit mainly SMEs in leading technology sectors that also have proven technology that dominates their fields (like AIB). In such a case, the company size is less important, as we can see in the case of AIB, which currently has only around 1,500 employees. Beside the technology factor, and dominance in a specific niche market, there are other parameters that can be relevant for SMEs in order to be treated as SOEs. Among these parameters, we can presume that “Mixed Ownership” firms will be under higher scrutiny and supervision by the state organs (although, in most cases they will become “Mixed Ownership” due to their proven and successful technology). Another parameter can be a regional dominance of the SME, which would probably attract the local government attention. Finally, we can also assume that private SMEs in other

²⁴¹ The Cherry orchard of JMC is actually supported by the local government, but it is not comparable to tech oriented companies.

sensitive sectors, such as mining, financial and fintech, etc., will also be more influenced and monitored by the state organs. These three presumptions are based on common sense and personal experience, but are not part of my research and require further research.

Regarding the theoretical framework of State Capitalism, our research reveal that in our small sample, most of the SMEs are not subject to strict control, supervision and intervention by the local state organs. Our research also identified different types of SMEs, which we may be classified as “Privatized” (JMC Group), “Tech Leader” (AIB), Industrial Leader” (HJV) and “Private Clients Service” (BIT Group). The names I give to these categories intend to emphasize the dominant factor in the relations with the state organs. This factor, and other factors that we discussed above, can help us to position the company in the right location along the spectrum between SOE and POE, which was one of the main questions that we raised in our research.

We can also say that the dominant factor that decides the level of intervention by state organs is the economic value of the company. This value may be evaluated based on current economic contribution, such as taxation and scale of employment, and/or on the potential for future growth, based on the company’s technology or commercial advantages. It also may be evaluated based on the relative value of the SME in the administrative region in which it operates. In case of conflict with other factors, this dominant factor will usually prevail. We saw it prevailing over the social stability factor in the case of accepting lower social benefits deductions which increase the wealth gap. We also saw it prevailing over the factor of *guanxi* in the case of the dispute in HJV between Mr. Long and AVL (see Chapter III.2.4.4).

Our research also revealed that the relations between the SMEs and the state organs are a two-way street, in which some of the companies, like JMC, HJV (and also probably AIB) facilitate and nurture the relations with the state organs in order to acquire state-generated rents (like discounted land and soft loans). This is the phenomenon that Milhaupt and Zheng define as “State Capture”. Some of the SMEs that we examined acquired the rents due to personal relations (e.g. JMC Group and HJV) and some used legitimate reasons like alignment with government policies (e.g. HJV and AIB). However, due to the Chinese culture, which emphasizes personal relations and reciprocal benefits (including banquets and gift giving), in most cases acquiring the state-rents require also some degree of personal relations and reciprocal benefits. We can see it in the case of S-IT that fixes the computer of the tax bureau, even though it prefers to minimize relations with the state organs.

The two-way street in the relations of the SMEs and state organs, supports the Sino-Capitalism definition of McNally, which observed that in China “the two processes, of state-led development from above and network-based development from below tend to meet.”²⁴² It also supports the SPME theory of Nölke et al. that the economic activity in China “rests on a close relationship between various state and domestic business actors leading to growth alliances at the national and sub-national level”.²⁴³

In other words, I concur with McNally that the Chinese version of Capitalism, is unique enough to be defined separately from other types of Capitalism. This is especially true due to the frequent shifts in the Chinese economic policies, as well as social and technological changes. Due to these frequent changes, scholars are competing in inventing new names for the ever-changing landscape. Thus, McNally called it Sino-Capitalism, Pearson, Rithmire and Tsai call it Party-State Capitalism, and recently it was also called “Surveillance

²⁴² McNally, p. 744

²⁴³ May, Nölke, and Ten Brink, pp. 277-278.

Capitalism” and “High-Tech Surveillance Capitalism”.²⁴⁴ So the names are less important, but the content and the special components (comprehensive networks and reciprocal relations) are the unique part of China’s version of State Capitalism. Wei Zhao chooses another angle to analyze this theoretical question. He assumes that State Capitalism in China exists, but to him the important question is whether it is State-dominated or State-led, or State-guided or State-coordinated market capitalism.²⁴⁵ McNally and Nölke et al. would probably refuse to choose only one of the options that Zhao offered. In paraphrase to their ideas, I would say that Chinese Capitalism is the confluence of state-domination in the strategic sectors (energy, mining, heavy industries, traditional finance) state-guided (especially in the tech fields), and it is led from below by network of private businesses with materialistic and entrepreneurial spirit, in the remaining sectors.

Conclusions and Future Research

Looking back at the hypothesis and the questions that we asked in this thesis, we can conclude that the relations between local state organs and private SMEs, span many dimensions, including economic, political, and anthropological (culture). Different factors play different role and have different weight at different locations and sectors. We also think that the traditional values are not given enough attention when scholars discuss these relations via the prism of political economy and State Capitalism.

We can conclude that the blurred distinction between POEs and SOEs exist also among SMEs and we identified and classified few categories of SMEs that can be stretched along the spectrum between pure POE and Pure SOE. These categories include “Privatized”, “Tech Leader”, “Industrial Leader” and “Private Clients Service”. These categories are not excluding each other, and a “Tech Leader” or “Industrial Leader” may also be a Privatized company.²⁴⁶ The treatment of these categories of SMEs by state organs, shall be influenced significantly by the operation scale of the firms. These categories may also apply to big POEs and help us understand the real nature of the POE and how much it is monitored and controlled by state organs. However, additional research is required to verify the applicability of this classification to the big POEs.

Among the above categories the first two will usually have tight relations with state organs, but with different flavor. The “Privatized” firm shall usually have personal relations with state organs and historical sentiments that will assist the SME to acquire some state rents.²⁴⁷ The “Tech leader” category, will be monitored and regulated better, but also receive significant, mostly legal and legitimate, state rents, due to its potential economic contribution. On the other hand, the “Industrial Leader” and the “Private Clients Service” categories may operate in a manner that resemble the “modus operandi” private companies in the West, as long as their scale remains modest. When such companies will surpass a certain size that will make them big in their region or in their

²⁴⁴ Milhaupt, p. 12.

²⁴⁵ Zhao, p. 3.

²⁴⁶ Huawei and Lenovo can be good examples for such companies.

²⁴⁷ According to the empirical research of Harrison et al.: “Privatized enterprises, which we call ‘former SOEs’, enjoy lower interest rates, larger loan facilities, and more subsidies while suffering poorer performance than never-SOEs” (this results fit perfectly the situation of JMC Group). See: Ann Harrison, , Marshall Meyer, Peichun Wang, Linda Zhao, and Minyuan Zhao, “Can a Tiger Change its Stripes? Reform of Chinese State-Owned Enterprises in the Penumbra of the State” (Jan’ 2019). *NBER Working Paper*, No. w25475. pp. 4-5. [SSRN: https://ssrn.com/abstract=3319806](https://ssrn.com/abstract=3319806)

industry, they may also “show up” on the radar of the local state organs and then they will be monitored and need to cultivate more personal relations with these state organs.

The various parameters of the companies, that we examined and elaborated in Chapter VI, and the classification that we offer, may help scholars, states and business actors, to have better understanding of Chinese POEs that they interact with. Understanding the proximity and the alignment of POEs with Chinese state organs may assist states and business actors to take informed business decisions regarding the interactions with these POEs.

Further research and comparison with SMEs in different sectors, different provinces, and different, but neighboring countries, like Japan and South-Korea can also contribute to the understanding of the intricate relations between SMEs and state organs. The comparison with Japan and South-Korea will be especially interesting due to the similar but different traditional values of these cultures.

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Annex A

Table 1. CPS in transitional China

Type of CPS	Political tactics
Compliance strategies	Reporting firm's work to government officials Inviting government officials attending firm's important occasions Asking instructions from government officials about important issues facing the firm Asking government officials to give opinions in policy discussions organized by trade associations Visiting the government officials regularly Inviting the government officials, congressmen and members of CPPCC to visit the firm regularly
Participation strategies	Being directly the government officials Being elected as the committeeman of Communist Party at various levels Participating in the formulation of government policies and laws Being the officials of trade associations Participating in trade associations to propose the industrial standards or regulations Being members of People's Congress to participate in or discuss the political affairs Being members of the CPPCC to participate in or discuss the political affairs
Association strategies	Making the investments which helps to improve government performance Doing things that the government encourages Being a firm that the government has a pride in and relies on Doing things that the government recommends Doing things suitable for political environment
Lobbying strategies	Paying government officials for their business related travelling Asking government officials attending reception banquets and seminars Providing private services to government officials Providing the financial support for official government activities Influencing government officials through money Giving gifts to government officials Financially supporting advertisement for commonweal projects Donating for programs in education, sports, health care and relieve people from disasters
Prolocutor strategies	Finding government officials through the official's family, townee, classmate, friend, and expecting them to speak for enterprises Finding the non-government officials who participate in policy making-decision, and expecting them speak for enterprises Finding familiar government officials directly and expecting them to speak for enterprises
Challenging strategies	Promoting institutional change by finding the shortcoming of existing institutions, and practicing new institution rules representing the direction of government policy and rule change Entering into the blank field of institution, causing debate and discussion about new institution and establishing it finally Putting forward research reports from industry angle, to government and industry organization Putting forward research reports from firm's own angle to government and industry organization Inquiring policies and regulations information related to their industry or itself Arousing attention of the media, consumers' colony, stockholder or others, to form certain orientation of public opinion and to influence government decision-making indirectly through industrial collective efforts