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# Why can't China clean up its act?

By **Purseu Heugens**

**Winston Churchill once described the Soviet Union as 'a riddle wrapped in a mystery inside an enigma.' Modern China is a very different story. By definition, the workings of the world's largest economy (by purchasing power parity) can't really be hidden from view nearly as easily. However, the sheer scale means that certain aspects of that vast market's workings are still not all that easy to understand.**

One such aspect is the dynamic of environmental regulation. China's gross domestic product has grown by more than 500 per cent since 1980, advancing from an economy a little larger than Canada's to an economic superpower. However, but this progress has come at the expense of the environment: in 2006, the country became the world's largest emitter of greenhouse gases, and in 2009, the leading consumer of non-renewable energy. At the same time, despite the fact that the government now has some tough environmental regulations on the books and controls up to 80 per cent of all businesses, it's made relatively little environmental progress.

How can the government be the controlling shareholder and yet not exercise much control over its own companies' conduct? To find out, we analysed quantitative data collected on Chinese firms between 2008 and 2012 (specifically the 1,425 companies listed on the Shenzhen Stock Exchange and the Shanghai Stock Exchange, both of which since 2008 have mandated environmental records), as well as qualitative data on these companies collected in 2013-2014.

We analysed how administrative hierarchical distance (the degree of distance from the central government and the level of government holding the control of the firm) affects the environmental regulation of the firm. Our study identified nine levels of administrative hierarchy in China, and assessed their impact on corporate environmental actions. In addition to state ownership, our metrics included the level of government subsidy for environmental actions weighted against the revenue of the company, the numbers of times the company was reported to have violated an environmental regulation, and the percentage of top managers who also worked for governmental bodies, such as the National People's

Congress or the Chinese People's Political Consultative Conference.

The results were not quite what we expected. Perhaps the biggest surprise, initially, was the extent to which the state is not a monolithic actor. In fact, from a certain perspective, there is no state. Instead, in China – probably as in other countries with federal governments – the government is a patchwork of overlapping jurisdictions and overlapping interests. As a result, governmental bodies operating at different levels can exert different and even conflicting influences on corporate environmental practices.

In general, higher-level agencies are primarily rule makers and lower-level bodies are mostly rule takers. At the mid-level, however, governmental bodies add hardly any environmental regulation of their own, which means that further down, the pressure tends to level off and even weaken. As the ancient saying goes, in the provinces, the mountains are high and the emperor is far away.

## **Selective enforcement**

In the end, when it came to environmental sustainability, our analysis ►

*“...governmental bodies operating at different levels can exert different and even conflicting influences on corporate environmental practices.”*

# Why can't China clean up its act? *(continued)*

By **Pursey Heugens**

suggested that two kinds of companies tended to be the worst: very large national companies, which have some protection from the government, and locally controlled companies, which tend to have their own set of regional protectors.

Not only are the laws enforced more selectively with respect to companies the nearer their ownership is to entities in one of the nine administrative strata we identified, but the government incentives at each of these strata tends to favour companies whose ownerships are rooted at that particular level. At the national level, for instance, the political and economic importance of the success of state champions such as Sinopec, the government oil company, tends to encourage more selective enforcement actions.

only partially rather than pass up the jobs and revenue promised by the growth of the local firm.

Another insight we gained from this study is how environmental protection evolves in a country where civil society is largely undeveloped. In China, the advocacy groups that act as a check on the private sector and government regulators in the West are either weaker or non-existent. In such a context, most of the mature market playbook regarding how to prod companies to pursue environmental goals – such as stakeholder dialogue, and the influence of non-governmental organisations – isn't really applicable.

Instead, the society is extremely hierarchical. Our interviews taught us that individuals, organisations, and society in general are constantly aware of

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At the local level, leaders focus in a similar way on the economic growth of their region, both because they depend on local revenues for economic development, and because most officials see local economic advancement as the key to political promotion. When lower-level governments control firms, officials tend to implement regulations

the power of the administrative hierarchy. For example, Chinese managers and officials strive “to avoid troubles whenever possible” while they show deferential behaviour towards hierarchically superior individuals or organs.

Each time my co-author, who conducted the interviews, was introduced by the CEO's secretary to an interviewee,



he/she would point up and say, ‘she's arranged by the top,’ and nobody would question the interview process anymore. In a more general sense, and in ways unimaginable in the West, Chinese firms consider themselves to be “grandsons” (*sun zi*, also meaning “being very subordinate”) of the government, and therefore subject to its (paternal) authority. Governmental bodies are considered to be like “parents” or even “grandfathers” who have the authority to decide everything for the local area, much as senior members do for a family in a feudal society.

Our interviews similarly suggest that Chinese firms feel they have little influence over the content of new environmental policies by the central government, even though there may be some room to bargain with local governments over the pace and scope of their implementation.

For now, foreign investors committed to making sustainable investments in China should keep in mind



the fact that the companies that tend to be the most compliant tended to be somewhere in the middle – companies that are too far from the central government to win any protection from the highest echelons, but also too far from local and provincial government to be favoured as a home team. These companies in the middle, at the bend of this inverted U, tend to have the best environmental record.

### When will China go green?

Is any of this changing? Yes and no. For the sake of the planet and humankind, I certainly hope so. Certainly, the government is aware of the challenge: the amount of attention that it has paid to environmental issues in recent Five-Year Plans has grown enormously over the past 15 years. In the 13th Five-Year Plan (2016), “Green Development” has been promoted to one of the five crucial development concepts to facilitate building a prosperous society in China. Moreover, almost 12 per cent of the

government’s 2017 annual report focuses on environmental protection, compared to one per cent in 1985. However, although the authorities recognise the environment as an important issue, for now economic growth and combatting corruption remain higher priorities.

Companies too are concerned. As one manager told us, ‘Although we are now more developed, pollution has intensified. Our minds are changing against this backdrop... It is, of course, difficult to fix it immediately... More promising outcomes may materialise in three to five, or even 10, years.’

For what it’s worth, I suspect that the country won’t be able to focus on conservation until China’s next Five-Year Plan and President Xi Jinping or his successor puts a new plan in motion. The good news, however, is that when China puts its foot down, the world trembles. As the success of the “tigers and flies” anti-corruption programme has demonstrated, the government

can move rapidly once it makes a commitment. Once the government starts focusing more on environmental protection, the effects are likely to be felt everywhere.

Overall, I am moderately hopeful that China will do the right thing eventually. Whether that will happen soon enough for polar bears to still be standing on firm ice remains to be seen. ■

**This article draws its inspiration from the working paper *Government’s green grip: multifaceted state influence on corporate environmental actions in China*, written by Ruxi Wang, Frank H. Wijen and Pursey P.M.A.R Heugens.**

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