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PERSPECTIVES

Theories of the (state-owned) firm

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Abstract State-owned enterprises (SOEs) contribute approximately 10% of the world's GDP. SOEs at one time were predicted to disappear from the economic landscape of the world, but today SOEs are growing more prevalent in the world economy. The current theories of the firm that form the pillars of the management discipline largely ignore the theoretical differences that SOEs introduce into the conceptualization of the firm. Therefore, we extend four core theories of the firm by incorporating SOEs as a mainstream (not special or marginal) organizational form into these theories. We focus specifically on property rights theory, transaction cost theory, agency theory, and resource-based theory, culminating in a research agenda with 12 testable propositions.

Keywords State-owned enterprise · Theory of the firm · Property rights theory · Transaction cost theory · Agency theory · Resource-based theory

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> Economic institutions are always means and never ends. Rarely does any mode of organization dominate another in all relevant performance respects.
>
> —Oliver E. Williamson (1985: 408)

What is the nature of the firm? Why do firms exist? How are they established? How do they behave, compete, and perform? Leading scholars in management and economics have addressed these fundamental questions (Barney, 2001; Coase, 1937; Cyert & March, 1963; North, 1990; Penrose, 1959; Williamson, 1975, 1985). Their work has established a number of theories of the firm that have become pillars of the management discipline (Conner, 1991). These theories of the firm can be broadly grouped as (1) property rights, (2) transaction cost, (3) agency, and (4) resource-based theories (Kim & Mahoney, 2005; Mahoney, 2005).

Insightful as these theories are, we argue that they fall short in terms of *comprehensiveness*. In these theories the archetypical firm is a private firm. But the focus on private firms misses a significant component of the global economy: state-owned enterprises (SOEs) (La Porta, Lopez-de-Silanes, & Shleifer, 1999). SOEs are firms that are (wholly or partially) owned and controlled by the state (government). SOEs represent a crucial aspect of the world economy, producing approximately 10% of global GDP (Bruton, Peng, Ahlstrom, Stan, & Xu, 2015). Scholars have recognized the need to adapt theory in regard to entities other than private firms, such as non-profit organizations (Arellano-Gault, Demortain, Rouillard, & Thoenig, 2013). However, SOEs, despite their large impact on the world economy, have not seen theory contextualized in a manner that addresses their uniqueness. Thus, from a theory-of-the-firm perspective questions remain: Why do SOEs exist? How do SOEs behave? What problems do SOEs solve better or worse than private firms? These are nontrivial, theoretical questions that call for answers. Not paying attention to SOEs, existing theories of the firm miss a significant part of the global economy (Carney & Child, 2013; Whittington, 2012; Young, Tsai, Wang, Liu, & Ahlstrom, 2014).

In the 20th century, the SOE experienced both its rise and fall. More recently, this organizational form has risen again on a worldwide basis—thanks in part to the massive state bailouts since 2008. Of course, SOE research has its own literature (Aharoni, 1986; Goldberg, Grunfeld, & Benito, 2008; Kornai, 1992; Peng & Heath, 1996; Toninelli, 2000). However, it is limited and less influential than the "mainstream" literature. Moreover, SOE research tends to be overlooked by scholars working on "mainstream" theories of the firm. Two decades ago, SOEs were widely regarded as a marginal, special case, which was expected to eventually disappear. SOE researchers themselves seldom endeavor to develop a "theory of the SOE," and even rarer are efforts to incorporate SOE research into any "mainstream" theory of the firm.[1] Therefore, the two literatures, one on theories of the (non-SOE) firm and another on the SOE firm, have developed in parallel, with relatively little cross-fertilization between them (Whittington, 2012).[2]

[1] For exceptions, see Hafsi, Kiggundu, and Jorgensen (1987); Peng and Heath (1996); Perry and Rainey (1988); Ramamurti (1987); and Ralston et al. (2006).

[2] For example, SOEs are not mentioned in two recent review papers explicitly dealing with "ownership issues" (Connelly et al., 2010; Johnson et al., 2010).

Far from being a purely academic debate, the debate on SOEs—or more generally, on state ownership[3] versus private ownership—has profound political, economic, and social ramifications affecting billions of people worldwide (Bremmer, 2010). Clearly, any theory of the firm aspiring to remain relevant will need to incorporate SOEs to address this large and enduring segment of the global economy. In this article we neither take an ideologically driven, one-sided approach by viewing state ownership to be inferior to private ownership (as in Shleifer, 1998), nor do we claim SOEs to be superior (as in Ralston, Terpstra-Tong, Terpstra, Wang, & Egri, 2006). The new SOEs of the 21st century are not necessarily the same as the SOEs of the 20th century (Bremmer, 2010; *Economist*, 2012b). In other words, while most SOEs of the 20th century were the classic, "state-owned *and state-controlled*" firms, in the 21st century tremendous diversity exists among the SOE population (Bruton et al., 2015; Cuervo-Cazurra, Inkpen, Musacchio, & Ramaswamy, 2014; Musacchio, Lazzarini, & Aguilera, 2015). Some of the new SOEs have substantial private participation in management and shareholding (Jiang, Peng, Yang, & Mutlu, 2015). Overall, we argue (1) that given the importance of SOEs in the global economy, theories of the firm in the 21st century can be expanded by incorporating SOEs as a mainstream (not special or marginal) organizational form, and (2) that a focus on SOEs can propel theories of the firm to new and exciting theoretical frontiers. Focusing on such theoretical extensions and frontiers, our contributions lie in our efforts to sketch the contours of such expanded theories of the firm that *explicitly* incorporate SOEs and leverage the SOE context for further development.

Theories of the firm

The literature on theories of the firm includes some of the best known classics in the field (Conner, 1991; Kim & Mahoney, 2005, 2010; Mahoney, 2005; Young et al., 2014). While there is no particular order of importance among these four major theories, since ownership represents the "O" in "SOE," we start here with property rights theory (Table 1).

Property rights theory of the firm

Property rights are the "rights individuals appropriate over their own labor and the goods and services they possess" (North, 1990: 33). Property rights theory argues that ownership matters (Cheung, 1983). It contends that firms arise in situations where independent economic players cannot write complete contracts and where the allocation of control is important. Therefore, firms can be conceptualized as a place where owners exercise ownership control rights through asset utilization. Firm boundaries are chosen to optimally allocate ownership control rights among various parties to a transaction (Grossman & Hart, 1986).

[3] Another term for "state ownership" is "public ownership." However, "public ownership" can be confused with "publicly listed but privately owned firms." To minimize confusion, we use the term "state ownership."

Table 1 Four theories of the firm (areas of emphasis: √)

	Property rights theory	Transaction cost theory	Agency theory	Resource-based theory
Representative literature	Cheung (1983); Grossman and Hart (1986); North (1990); Hart (1995)	Coase (1937); Williamson (1975, 1985); Jones and Hill (1988)	Jensen and Meckling (1976); Fama and Jensen (1983)	Penrose (1959); Conner (1991); Kogut and Zander (1993); Teece et al. (1997) Barney (2001)
Why do firms exist?	√	√		√
How are firms established?	√			
How do firms behave?		√	√	√
What determines firms' scale and scope?	√	√	√	√

Transaction cost theory of the firm

Transaction cost theory assumes that "in the beginning there were markets" (Williamson, 1975: 20). Firms emerge because, under certain circumstances (such as a high level of uncertainty and opportunism), firms are more efficient at solving transaction cost problems than market transactions (Coase, 1937; Williamson, 1985). Holding technology constant, firms strive to economize on transaction costs. Firm growth is constrained by the comparison between the additional economic benefits and the additional bureaucratic costs associated with the expanded scale and scope (Jones & Hill, 1988).

Agency theory of the firm

Agency theory views the firm as a nexus of contracts between principals (such as owners) and agents (such as managers and employees). Because agents do not completely share owners' goals and because agents tend to have better information about the tasks, agents may have both motivation and opportunity to behave in a way that maximizes agents' own utility at the expense of principals (Jensen & Meckling, 1976). Agency theory argues that firms led by self-interested managers may grow to a point with diminishing returns to owners unless there are proper corporate governance mechanisms to rein in the managers.

Resource-based theory of the firm

The resource-based theory defines a firm as a collection of various resources and capabilities (Barney, 2001).[4] Its development has benefited from the insights from

[4] We are aware of the debates within the resources and capabilities literature on whether these two terms can be used interchangeably. Since joining these debates is outside the scope of our article, we have decided to use these two terms interchangeably. Also, we acknowledge there are debates on whether the resource-based view is merely a "view" but not a "theory" (Barney, 2001; Priem & Butler, 2001). We do not intend to join these debates and have followed Conner (1991) to label the resource-based view a "theory."

transaction cost and agency theories (Conner, 1991) as well as property rights theory (Foss & Foss, 2005; Kim & Mahoney, 2005, 2010). The resource-based theory challenges transaction cost, agency, and property rights theories for their (over) emphasis on the *negative* aspects, such as the focus on curbing opportunism, on solving agency problems, and on getting property rights "right" (Conner, 1991; Kogut & Zander, 1993). Instead, the resource-based theory concentrates on the *positive* aspects of the firm: the dynamic creation, acquisition, and deployment of resources and capabilities that are valuable, rare, and hard-to-imitate (Teece, Pisano, & Shuen, 1997).

Synthesis

Through these four leading theories of the firm, our understanding of the nature of the firm has evolved from seeing the firm as a property rights player to being a transaction cost and agency cost minimizer, and, more recently, to a collection of resources and capabilities (Conner, 1991; Foss & Foss, 2005; Kim & Mahoney, 2005, 2010; Zenger, Felin, & Bigelow, 2011). Despite the differences, they overlap considerably and are often complementary to each other (Mahoney, 2005). In addition, these theories share one important commonality: they are based almost exclusively on the experience of the private, non-state-owned firm and have missed an important aspect of the "firm": SOEs. An interesting question is: Why?

Why are SOEs not featured in existing theories of the firm?

There are two fundamental issues that underlie the lack of coverage on SOEs in the existing theories of the firm. First, theorists and the theories they develop are naturally influenced by their own environment. Most existing theories of the firm historically have been developed in the United States. The result is that they have naturally emphasized organizational attributes salient to the US economy, which historically does not have a sizable SOE sector.[5] Given the focus on private firms, the underlying assumption of most theories of the firm is that the firm is profit maximizing. This assumption obviously does not always hold in SOEs. Thus, not surprisingly, SOEs have been largely outside the scope of existing theories of the firm.

Second, the ideological nature of the debate on state ownership has resulted in the difficulties of incorporating SOEs into theories of the firm. Some scholars have framed the debate as socialism versus capitalism, which has made it politically and ideologically difficult for Western scholars to openly advocate the potential merits of SOEs, especially in postwar decades. Among most scholars and policymakers in the West, it has become an "article of faith" that SOEs are less efficient than private firms (Dewenter & Malatesta, 2001: 320). Thus, instead of being studied on their own, SOEs only deserve to be privatized (Filatotchev, Buck, & Zhukov, 2000; Megginson & Netter, 2001; Vickers & Yarrow, 1991). The privatization movement throughout the world since the 1980s seems to suggest that SOEs are a *transitional* organizational form

[5] See Galambos (2000) and Kole and Mulherin (1997) for SOEs in the United States. While this point is outside the scope of our article, one can argue that the very first colony that settled in today's United States, the Virginia Company that founded Jamestown in 1607, was an SOE.

destined to become relics of history (Spicer, McDermott, & Kogut, 2000). Thus, scholars commonly label formerly socialist economies featuring numerous SOEs and undergoing large-scale privatization since the 1990s as "*transition* economies" (Peng, 2000). As a result, conventional thought was that theories of the firm did not need to incorporate this organizational creature, which in any case was being privatized to resemble the traditional (Western) private firm.

However, SOEs have been stubborn in remaining on the global stage. Since the 2008 bailouts, instead of being phased out by history, SOEs have *expanded* their worldwide presence (Carney & Child, 2013; *Economist*, 2012b). Some of them have engaged in significant international expansion (Bass & Chakrabarty, 2014; Chen & Young, 2010; Cui & Jiang, 2012; Hoskisson, Wright, Filatotchev, & Peng, 2013; Lebedev, Peng, Xie, & Stevens, 2015; Ma, Yiu, & Zhou, 2014; Meyer, Ding, Li, & Zhang, 2014; Xie, Huang, Peng, & Zhuang, 2016). Thus, scholars need to ensure that theories of the firm can address this crucial organizational form.

The new state-owned enterprises

Table 2 summarizes a number of key differences between firms with private and state ownership (Kornai, 1992; Peng, 2000). While these differences are well known, a key new development since the late 20th century is that ownership boundaries are not fixed. Rather, they can be penetrated from either direction: (1) SOEs can be privatized, and (2) private firms can be nationalized to become SOEs. The result of these changes is that SOEs today are not necessarily "state-owned and state-controlled." Instead, there can be substantial separation of ownership and control in SOEs in the sense that these firms may become "state-owned and *manager-controlled*" (if managers enjoy significant autonomy) or "state-owned but *private-controlled*" (if control rights are leased to private firms) (Cuervo-Cazurra et al., 2014; Jiang et al., 2015). The line between SOEs and non-SOEs—and among various kinds of SOEs—has blurred considerably (Bruton et al., 2015). Globally, four important sets of events necessitate increasing research attention on SOEs.

First, since the 1980s, China has been the world's fastest growing major economy. It has not undertaken large scale privatization among its most significant SOEs in the same manner as in the former Soviet Union and Central and Eastern Europe (CEE). Most Chinese SOEs have been transformed. They employ more market-oriented managers, list part of their shares for sale to the public, and collaborate with foreign multinationals. While some have labeled these moves "partial privatization" (Gupta, 2005), fundamentally these firms are still SOEs (Peng, 2000; Ma, Yao, & Xi, 2006; Ralston et al., 2006). SOEs currently account for approximately 80% of China's stock market capitalization (*Economist*, 2012b: 4). Even leading privatization experts such as Megginson and Netter (2001: 380) concede that the China experience "suggests that *non*-privatizing reform measures, such as price deregulation, market liberalization, and increased use of incentives, can improve the efficiency of SOEs."

Second, SOEs necessitate our attention because in settings where the most aggressive privatization has taken place, such as CEE, the efficiency gains from privatization are mixed (Meyer & Peng, 2005). Western advisors, armed with the traditional theories of the firm and with little research of their own on SOEs, often advised the state in these

Table 2 Private ownership versus state ownership

	Private ownership	State ownership
Objective of the firm	Maximize profits for private owners who are capitalists (and maximize shareholder value for shareholders if the firm is publicly listed).	Optimal balance for a "fair" deal for all stakeholders. Maximizing profits is not the sole objective of the firm. Protecting jobs and minimizing social unrest are legitimate goals.
Establishment of the firm	Entry is determined by entrepreneurs, owners, and investors.	Entry is determined by state officials and bureaucrats.
Financing of the firm	Financing is from private sources (and public shareholders if the firm is publicly traded)	Financing is from state sources (such as direct subsidiaries or banks owned by the state).
Liquidation of the firm	Exit is forced by competition. A firm has to declare bankruptcy or be acquired if it becomes financially insolvent.	Exit is determined by state officials and bureaucrats. Firms deemed "too big to fail" may be supported by taxpayer dollars indefinitely.
Appointment and dismissal of management	Management appointments are made by owners and investors largely based on merit.	Management appointments are made by state officials and bureaucrats who may also use non-economic criteria
Compensation of management	Managers' compensation is determined by competitive market forces. Managers tend to be paid more under private ownership.	Managers' compensation is determined politically. Managers tend to be paid less under state ownership.
Ownership boundaries	Privately owned firms can be nationalized and turned into SOEs.	SOEs can be privatized. Even for SOEs in which state ownership is unchanged, they are not necessarily "state-owned and state-controlled."

transition economies to construct the "ideal" private firm, which is often modeled after the typical large US firm with diffused private ownership. However, the institutional and political realities in transition economies often resulted in the SOEs being privatized to insiders (managers and employees), who enjoy concentrated ownership (Filatotchev et al., 2000). Unfortunately, evidence now shows that such privatization to insiders tends to result in poor firm performance (Djankov & Murrell, 2002). In contrast, incomplete privatization in CEE—a euphemism for the SOEs to remain "SOEs" with some private participation—"is surprisingly effective" (Djankov & Murrell, 2002: 741).[6] The outcome has been that many countries, such as Russia, are now shifting toward significant revival of state control of firms (Puffer & McCarthy, 2007). In Russia, 62% of the stock market capitalization is now contributed by SOEs (*Economist*, 2012b: 4).

Third, our focus is drawn back to SOEs since in developed economies (specifically, OECD members), where privatization is supposed to have the least political resistance and where markets are the most advanced, the state still retains control of nearly two-thirds of the so-called "privatized" firms (Bortolotti & Faccio, 2009: 2907). In other words, these privatized firms may be "privately run," but are still very much "state

[6] Similarly, in India, partial (not full) privatization is found to *enhance* profitability and productivity (Gupta, 2005).

controlled." Approximately 5% of OECD member countries' GDP ($2 trillion) still comes from SOEs (*Economist*, 2012b: 5).

Finally, the 2008 bailouts throughout developed economies that rescued ailing firms reversed the direction of three decades of the privatization movement. To be sure, the times were challenging, with financial markets melting down, banks failing, and consumer and investor confidence reaching all-time low. State bailouts often turned firms receiving rescue funds into SOEs.[7] This action was at odds with the "free market" (and anti-SOE) tradition in much of the developed world.

If there was a significant gap between the (private) "firm" portrayed in various theories of the firm and the stereotypical SOE of the 20th century that resulted in the SOE being outside the radar screen of these theories, the gap has now narrowed. In the 21st century, it is time to *bridge* the gap (Mahoney, 2005: 219). In the next four sections, we argue that the four major existing theories of the firm can be extended and pushed to new frontiers when used to shed light on SOEs (see Table 3 for a summary).

The SOE as a set of property rights

Karl Marx may be regarded as the forerunner of the modern property rights theory of the firm, which emerged approximately 100 years after he first published his treatise *Capital* (Marx, 1967 [1867]). Marx regarded private ownership as a "sin" of capitalism that contributed to the "greed" of private owners—otherwise known as capitalists, who "exploited" workers. A remedy would be to convert private property to the public domain. The end result is the SOE, which would represent a different set of property rights.

Given the complexity of the concept of "property rights," it is useful to break the concept down into three smaller and analytically more manageable sets (Monteiro & Zylbersztajn, 2012):

(1) *Rights to income generated from the property*: In theory, the owners of SOEs are citizens of a country. In practice, the state has rights to income generated by SOEs (Kornai, 1992). For example, Corporación Nacional del Cobre de Chile (CODELCO—the National Copper Corporation of Chile) is the largest copper firm in Chile. This SOE provides an estimated $7 billion a year to the Chilean state, as all excess profits must go to the state (Mantse & Streda, 2006).

(2) *Rights to control and use the property*: Often labeled ministries, agencies, and commissions, the bureaucracy determines the key dimensions associated with SOEs such as financing, appointment, compensation, and/or dismissal of key managers. For instance, Gazprom is a gas producer in Russia that typically generates each year over 15% of the world's natural gas production. The SOE is a joint stock company in which the state owns 50.002% of the stock. The CEO is Alexey Miller, who at one stage worked for Vladimir Putin when Putin was mayor of St. Petersburg. Prior to becoming the CEO of Gazprom, Miller had no prior experience in fossil fuels—he was appointed by the state despite his lack of direct knowledge of the industry.

[7] The official US government jargon for such SOEs is "government-sponsored enterprises (GSEs)."

Table 3 How SOE research contributes to four theories of the firm

	Extensions	Frontiers
Property rights theory	Proposition 1: SOEs will outperform privately owned firms. Proposition 2: SOEs will underperform privately owned firms.	Proposition 3: When incentives to innovate are weak, imperatives to contain costs are moderate, and performance criteria are more long-term and non-economically oriented, SOEs will outperform private firms. Proposition 4: When incentives to innovate are strong, imperatives to contain costs are compelling, and performance criteria are more short-term and economically oriented, SOEs will underperform private firms.
Transaction cost theory	Proposition 5: In underdeveloped economies infested by severe market failure, SOEs are likely to arise.	Proposition 6: The boundaries of SOEs are determined by the tradeoffs between the transaction cost savings brought by state control, and the additional bureaucratic costs brought by state agencies and units involved in the management of SOEs.
Agency theory	Proposition 7: SOE managers and employees (as agents) are likely to experience incentive problems that do not sufficiently motivate them to strive for a high level of economic performance. Proposition 8: State owners (principals) of SOEs are likely to experience monitoring problems that lead to SOEs' deviation from the goals of state owners.	Proposition 9: When conflicts arise between state owners (controlling shareholders) and citizens (minority shareholders), SOE managers—and the SOEs themselves—are likely to make decisions to advance the interest of state owners at the expense of citizens. Proposition 10: The presence of additional blockholder(s) may provide a constraint on the behavior of the controlling shareholders (which are state agencies) and SOE managers.
Resource-based theory	Proposition 11: Driven by their interest to enhance the value, rarity, and inimitability of resources and capabilities, SOEs are likely to develop and leverage nonmarket-based, political ties—especially in industries with strong state influence.	Proposition 12: The economic performance of SOEs is likely to improve when they leverage both market-based, competitive capabilities and nonmarket-based, political capabilities.

(3) *Rights to transfer or sell the property.* Although belonging to all citizens in theory, these rights, again, belong to the bureaucracy in practice. While transferring one SOE from the jurisdiction of one agency to another is frequent, the rights to sell (or not to sell) the SOE are not necessarily available to the average citizens. For example, in 2011 the Greek state sold various SOEs such as airports, seaports, defense companies, and even the national lottery, despite public outcry against these measures (*Wall Street Journal*, 2011).

The key outcome from property rights will principally be the economic performance of the firm (Ma et al., 2006). While there can be a rich set of other outcomes such as employment, sustainability, and social justice, the one most commonly focused on is economic performance. Thus, from the standpoint of property rights theory, those who support state ownership would argue:

Proposition 1 SOEs will economically outperform private firms.

While proponents of state ownership stress the proposition above, it is clearly contestable from both the theoretical arguments made by Hayek (1945) and the weight of evidence from worldwide experiments with SOEs (Megginson & Netter, 2001; Shleifer, 1998; Vickers & Yarrow, 1991). In general, the economic performance of SOEs has been lackluster. This is especially the case for SOEs under central planning—SOEs in the former Soviet Union and CEE, pre-reform China and Vietnam, and current-day Cuba and North Korea. Thus, proponents of private ownership argue:

Proposition 2 SOEs will economically underperform private firms.

Although crude, these two competing propositions have served as baselines that underpin much of the debate that has flowed from the property rights perspective that is concerned with state ownership (Ramamurti, 1992; Vickers & Yarrow, 1991). Advocates of each proposition can point to a body of supportive evidence. A new generation of research needs to investigate *under what conditions* and *according to what economic performance criteria* SOEs are likely to outperform their privately owned counterparts or vice versa. Consequently, we develop Fig. 1 to clarify these conditions.

Building further on the property rights perspective, global evidence has informed us that neither SOEs nor private firms are likely to uniformly outperform each other under all circumstances. In other words, both Propositions 1 and 2 are *underspecified*. Proposition 1 suggests that SOEs in the upper row (Cells 1 and 3) will outperform private firms in the lower row (Cells 2 and 4). Likewise, Proposition 2 is also underspecified by positing that SOEs (Cells 1 and 3) will underperform private firms (Cells 2 and 4). This figure helps us understand why evidence is so mixed, because

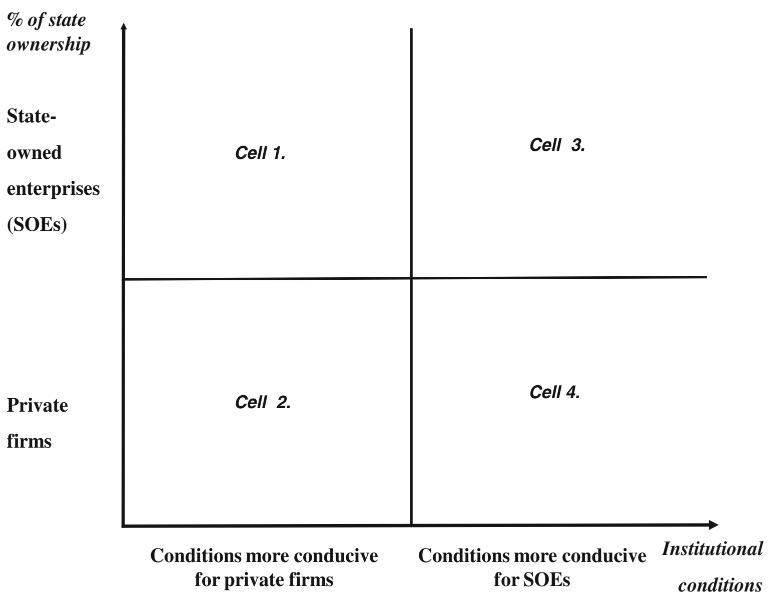

Fig. 1 Does ownership make a difference?

findings on SOEs in Cell 1 underperforming private firms in Cell 2 (which would support Proposition 2) do not necessarily refute Proposition 1. Instead, Proposition 2 can be supported when SOEs in Cell 3 outperform private firms in Cell 4.

The conditions under which private and state firms will excel in each cell can be addressed. Specifically, when the incentives to innovate are strong, when the imperatives to contain costs are compelling, and when performance criteria are more short-term, private ownership—which tends to be more economically oriented—can deliver better performance (Shleifer, 1998). Schumpeter (1942) has long maintained that the incentives to innovate are the tremendous engine behind capitalism, which fuels private firms. In competitive product markets, the imperatives to contain costs are a must. Firms unable to contain costs are selected out of markets. Finally, when performance criteria contain measurable proxies that are more short-term and economically oriented, private firms often excel in their abilities to meet such performance criteria (Peng, 2000; Shleifer, 1998).

Conversely, when the incentives to innovate are not strong, when the imperatives to contain costs are moderate, and when performance criteria are more long-term and non-economically oriented (such as socially-oriented performance criteria), SOEs may outperform private firms. Examples would include firms in domains such as postal delivery, power generation and distribution, and local water utilities. In each of these areas, the need for radical innovation is not necessarily strong, and the reliable and affordable delivery of services to all citizens is typically more critical than controlling costs or obtaining short-term, economic goals. As a result, both Propositions 1 and 2 can be rewritten in a more precise way. Thus:

Proposition 3 When incentives to innovate are weak, imperatives to contain costs are moderate, and performance criteria are more long-term and non-economically oriented, SOEs (in Cell 3 in Fig. 1) will outperform private firms (in Cell 4).

Proposition 4 When incentives to innovate are strong, imperatives to contain costs are compelling, and performance criteria are more short-term and economically oriented, SOEs (in Cell 1 in Fig. 1) will underperform private firms (in Cell 2).

The SOE as a transaction cost minimizer

Although transaction cost theorists such as Williamson (1975, 1985) have always advocated a "comparative institutional" approach, the actual development of transaction cost theory has taken on a microanalytical flavor. This flavor has resulted in the theory's insightful focus on the important micro attributes such as asset specificity and uncertainty, and its relative lack of attention on the more macro, truly "comparative institutional" aspects brought by SOEs.[8] However, Williamson (1985: 408) suggests a direction for future research: to study SOEs as an alternative mode of economic organization vis-à-vis various forms of private firms. Williamson's (1991) more recent work has discussed some aspects of socialist economic organization. It is in this spirit that we endeavor to further extend this theory.

[8] Neither Williamson (1975) nor Williamson (1985) has an entry of "SOEs" in their index.

A paradigmatic question of transaction cost theory is: "Why do firms exist?" Consequently, an extension becomes: "Why do SOEs exist?" The answer, from transaction cost theory, is that firms exist to economize on transaction costs in a more efficient way than markets can (Coase, 1937). Extending this logic, we can argue that SOEs, despite their imperfections, exist to economize on transaction costs in a more efficient way than markets can.

It is important to note that even in countries with well-developed markets, it is market failure that gives rise to private firms in the first place (Williamson, 1975, 1985). In numerous other countries where markets either do not exist or dysfunction, market failure is likely to be more severe. The most severe market failure may force SOEs to be the only viable mode of organization. In economies infested with severe market failure, private firms simply do not exist or may not have sufficient capabilities to promote economic development (Rajan, 2010). Therefore, SOEs often arise in underdeveloped economies (such as the Soviet Union in the 1930s). Despite SOEs' many imperfections, one of their often unacknowledged *benefits* is that they reduce transaction costs in economies infested with severe market failure. Thus:

Proposition 5 In economies characterized by severe market failure, SOEs are likely to arise.

Mature economies in which severe problems arise can also give rise to SOEs. The 2009 US efforts to rescue GM and Chrysler illustrate this argument. When both private firms were collapsing, to the extent that another private firm (or "white knight") can be found—in the case of Chrysler, Fiat, a foreign private firm—there was no need to turn Chrysler into an SOE. The market (which in this case can be labeled as the strategic factor market, the acquisition market, or the market for buying and selling companies) worked. However, when no private firm—domestic or foreign—emerged as a willing acquirer of GM, the US government was forced to bail out GM.[9] In other words, when the market failed, an SOE was born. Unlike the establishment of SOEs in the Soviet bloc 60 years ago, there was no supportive political ideology to turn failing firms such as GM into SOEs. Instead, the US government *reluctantly* turned GM into an SOE, and recently reduced its holdings (from 61% stake in 2009 to 19% in 2013) (*Economist*, 2013). We argue that from the standpoint of transaction cost theory, it was compelling transaction cost logic that necessitated the government's bailout of GM when the market failed.

Having noted the transaction cost benefits of firms over markets, Coase (1937) and Williamson (1975, 1985) go on to discuss firm boundaries. Specifically, firms cannot grow their boundaries indefinitely due to diminishing benefits of transaction cost savings (Argyres & Zenger, 2012). In other words, firms with an expanding scale and scope will have to shoulder the correspondingly higher bureaucratic costs of internal management (Jones & Hill, 1988). Otherwise, the economy eventually may have one large firm left.

The record of SOEs throughout the world supports this argument. Despite the politically loaded descriptions of "USSR, Inc." and "China, Inc." (by Western analysts), there are thousands of SOEs in such environments—not just one gigantic firm. Consolidating all economic functions in the hands of one gigantic SOE is simply not manageable or feasible even during the heyday of communism (Kornai, 1992). The

9 In addition to the US government taking 61% of GM's equity, the Canadian government took 8%.

reason, in part, is that the excessive bureaucratic costs required to internally coordinate everything would wipe out any possible transaction cost savings by completely replacing external markets (Coase, 1937). In general, the more state agencies and units are involved in the management of SOEs, the higher the bureaucratic costs (Kornai, 1992). Thus:

Proposition 6 The boundaries of SOEs are determined by the tradeoffs between the transaction cost savings brought by state control, and the additional bureaucratic costs brought by state agencies and units involved in the management of SOEs.

The SOE as a nexus of agency contracts

With the state being the de facto owner and SOE employees being agents working for the state, the conflicts of interests between principals and agents at the heart of agency theory become highly relevant to SOEs (Jensen & Meckling, 1976). In other words, a new nexus of contracts, centered on the agency relationship between the state and SOE employees, has replaced the traditional nexus of contracts between private owners and employees (Wright et al., 2005).

Unfortunately, relative to the traditional nexus of contracts that is subject to agency problems, the new nexus of contracts is spelled out less clearly, incentive problems are more severe, and economic efficiency loss is more pronounced (Shleifer, 1998; Young et al., 2014). Upon discovering these problems, in Soviet bloc SOEs, it was customary to invoke the ideological call to instill “a sense of ownership” and for employees “to work like proprietors” (Peng, 2000). However, as long as there are *inherent* conflicts of interests between principals and agents no matter who those principals may be (Jensen & Meckling, 1976), it is practically impossible for a true proprietary motivation to develop (Kornai, 1992). In other words, because agents by definition are *not* principals, simply asking agents, who do not have the corresponding incentives coupled with responsibilities, to behave like principals is doomed to fail.

The failure of the state to employ “spiritual” or “moral” incentives so that the employees feel like owners typically leads to the use of material incentives (such as bonuses) to give SOE employees a measure of interest in raising economic efficiency. In practice, such incentive schemes in SOEs are typically insignificant, resulting in little motivational benefits (Wang & Judge, 2012). There was a widespread saying in SOEs in the former Soviet bloc: “They pretend to pay us, and we pretend to work.” In contemporary Cuba, SOE employees have pointed out an advantage in working for SOEs: plenty of opportunities to pilfer (steal) supplies from the workplace. The logic goes like this: SOEs belong to the state, which belongs to the people—that is, according to employees, “us.” Since SOE wages are so low, many Cuban SOE employees feel entitled to help themselves (*Economist*, 2012a). While SOEs in Cuba may be an extreme case, the larger point is that SOEs typically suffer from agency problems. Thus:

Proposition 7 SOE managers and employees (as agents) are likely to experience incentive problems that do not sufficiently motivate them to strive for a high level of economic performance.

In addition, the sheer number of so many SOEs can also lead to monitoring problems experienced by the state bureaucracy (Wang & Judge, 2012).[10] The monitoring of SOEs is further accentuated by the fact that these bureaucrats often do not have the business skills that private businesspeople do, and often do not have enough resources to monitor and control every SOE. As a result, information asymmetries are aggravated. Since local authorities also have little resources to focus on individual SOEs, decentralization by delegating SOEs' jurisdiction to local authorities only partially solves such problems. Not surprisingly, SOEs are characterized by significant slack, waste, and, in the worst case, abuse (Ju & Zhao, 2009; Stan, Peng, & Bruton, 2014; Tan & Peng, 2003; Xu, Yang, Quan, & Lu, 2015).[11] Because of such monitoring problems, some SOEs may pursue their own interests, which deviate from the goals of state owners. Thus:

Proposition 8 State owners (principals) of SOEs are likely to experience monitoring problems that lead to SOEs' deviation from the goals of state owners.

According to agency theory, the key to performance is the proper design of the incentive structure for agents and the enhancement of monitoring capabilities for principals (North, 1990). The rise of some of the new SOEs in China, despite the lack of large scale privatization, suggests that it is possible to incentivize SOE employees (including managers) to strive for goal congruence with state owners (Peng, Sun, & Markóczy, 2015; Ralston et al., 2006; Wang & Judge, 2012). The principals' monitoring capabilities can also be enhanced by reducing their scope and focusing their attention on a smaller number of SOEs under control (Lin & Germain, 2003).

Recent research in agency theory suggests that greater contextualization of the theory must be considered. For example, private equity (PE) is well recognized for generating high performance in firms (Bruton, Filatotchev, Chahine, & Wright, 2010). One of the keys to PE's success is the tight leash between principals and shareholders. Yet, from a contextualization standpoint, as the PE industry moves around the world, often the activities performed may look similar, while the dominant logic among private equity investors on how to operate changes differs dramatically (Bruton, Ahlstrom, & Puky, 2009). Similarly, some have noted not only principal-agent conflicts, but also *principal-principal* conflicts between controlling shareholders and minority shareholders as two classes of principals (Chen & Young, 2010; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008).

When principal-principal conflicts arise between the state and its employees as controlling shareholders on the one hand and average citizens as minority shareholders on the other hand, SOE managers can be expected to make decisions to advance the interests of controlling shareholders at the expense of average citizens (Fig. 2). A case in point is China's state-owned cigarette monopoly, China National Tobacco. This SOE has sponsored more than 100 elementary schools throughout rural China. On the gates of some schools, it paints slogans such as "Genius comes from hard work—tobacco

[10] The US Treasury Department now manages US government holdings in *hundreds* of SOEs. On the day when GM's IPO went well in November 2010, the official in charge shared with *BusinessWeek* (2010: 35): "We have responsibility for almost $200 billion of assets and only one of those, which is very important, is GM. While it would have been nice to spend the day watching and feeling good about it, there was other business to attend to."

[11] Of course, not all slack is bad for performance (Cyert & March, 1963; Stan et al., 2014; Tan & Peng, 2003; Xu et al., 2015).

helps you become talented" (*BusinessWeek*, 2011: 29). Such blatant efforts in marketing tobacco to young students are clearly against the interest of a majority of Chinese citizens.[12] But the dominant logic of the SOE is to do what is best for the state. The tobacco industry is one of the largest tax-paying industries in the country, contributing about 7% of overall central government revenue (and a higher percentage for local government revenue in tobacco growing regions). Ultimately, the promotion of cigarettes has grave consequences to most citizens—a million of them die every year of tobacco-related illness. Principal-principal conflicts like this are certainly not isolated (Jiang & Peng, 2011; Young et al., 2008). Thus:

Proposition 9 When conflicts arise between state owners (controlling shareholders) and citizens (minority shareholders), SOE managers—and the SOEs themselves—are likely to make decisions to advance the interest of state owners at the expense of citizens.

The remedies to alleviate principal-principal conflicts are different from those to alleviate principal-agent conflicts. Increasing ownership concentration is typically advocated to combat principal-agent conflicts, but in SOEs experiencing principal-principal conflicts, such a solution would not work. This is because giving more control to already powerful controlling shareholders—in our case, state agencies—may further intensify such conflicts (Young et al., 2008: 210). Abolishing concentrated state ownership via mass privatization, with the aim of distributing shares to all citizens, is challenging, as indicated by the CEE experience in the 1990s (Djankov & Murrell, 2002; Meyer & Peng, 2005, 2016).

One solution is the presence of multiple blockholders, instead of having just one controlling shareholder and numerous small shareholders (Faccio, Lang, & Young, 2001). In SOEs, this means having at least one more blockholder as the second largest shareholder, whose holding is sufficiently large to constrain the controlling shareholder. Such an additional blockholder can be another domestic or foreign firm, fund, or individual. One additional blockholder can provide some checks and balances, and multiple blockholders may form a coalition to take action against the controlling shareholder, thus providing some internal safeguards to curb principal-principal conflicts (Jiang & Peng, 2011). Thus:

Proposition 10 The presence of additional blockholder(s) may provide a constraint on the behavior of the controlling shareholders (which are state agencies) and SOE managers.

The SOE as a set of resources and capabilities

As an economic enterprise, the SOE has long been considered a collection of production resources and capabilities (Arend & Levesque, 2010; Kriauciunas & Kale, 2006; Peng & Heath, 1996). However, before the recent market reforms, the archetypical SOE in the Eastern bloc would mostly concern itself with (largely manufacturing)

[12] In China, tobacco advertising is illegal on radio, television, and in newspapers, but there is little restriction on sales and sponsorship activities (*BusinessWeek*, 2011). Sponsoring rural schools and advertising on school gates is legal.

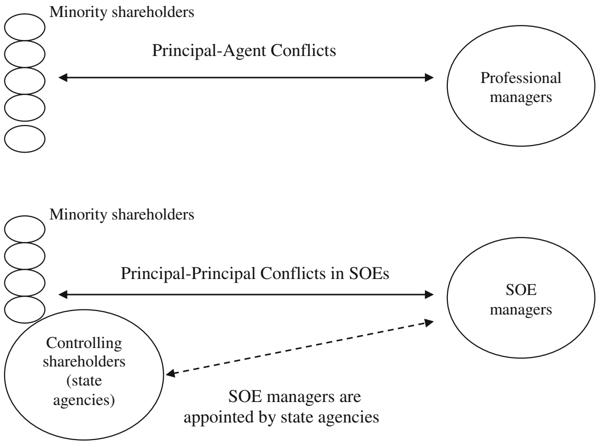

Fig. 2 Principal-agent conflicts in traditional firms and principal-principal conflicts in SOEs

production. Research and development (R&D) was usually undertaken by specialized research institutes outside the boundaries of the firm (White, 2000). Financial resources mainly came from the state, and the firm did not need to raise its own financing or develop financial expertise (Le & O'Brien, 2010). Marketing and branding were essentially nonexistent. Planning, organization, and coordination of production were in the hands of state bureaucracy (Child & Lu, 1996; Kornai, 1992).

Such a narrow view of the firm as a set of production resources is at odds with the resource-based theory that posits that in addition to possessing production resources, a full-fledged firm also needs to encompass technological, financial, and organizational capabilities (Teece et al., 1997). The theory urges firms, in their quest for competitive advantage, to develop valuable, rare, and hard-to-imitate resources and capabilities (Barney, 2001). However, the resource-based theory assumes that the firm operates in a competitive, market-based economy. During the pre-transition era, in many emerging economies this assumption did not hold. During the transition era, market-based competition has been introduced throughout emerging economies, thus necessitating the search for market-based competitive advantage for SOEs (Dixon, Meyer, & Day, 2010; Kriauciunas & Kale, 2006; Mutlu, Wu, Peng, & Lin, 2015). Further, SOEs no longer necessarily occupy the "commanding heights" of the economy because new private start-ups and foreign entrants have joined the game (Mutlu et al., 2015; Peng, 2003). In other words, the assumption of resource-based theory on the nature of the institutional environment underpinning firm behavior has become more relevant to SOEs during transitions (Makhija, 2002).

The resource-based theory has traditionally focused on market-based resources and capabilities, while its recent extension has developed a stream of work based on *nonmarket-based, political* resources and capabilities (Oliver & Holzinger, 2008). In the West, scholars increasingly document the contribution of political resources and capabilities to the performance of private firms (Lux, Crook, & Woehr, 2011). It is, therefore, plausible to argue that political resources and capabilities play a more significant role behind SOEs' performance (Li, Peng, & Macaulay, 2013).

While most firms—regardless of ownership—value political resources and capabilities (Li, He, Lan, & Yiu, 2012; Li & Zhang, 2007; Siegel, 2007), we argue that political resources and capabilities are especially likely to be a source of differentiation for SOEs. Firms not only compete on market-based products, technology, and talents, but also on nonmarket-based political ties (Capron & Chatain, 2008; Carney & Child, 2013; Oliver & Holzinger, 2008). Relative to private start-ups and foreign entrants, SOEs and their executives almost always have strong connections with officials (Okhmatovskiy, 2010; Shi, Markóczy, & Stan, 2014). These ties may promote SOEs' public reputation and legitimacy, and enhance their effectiveness in bargaining with the state or other stakeholders (Peng et al., 2015; Wang, Hong, Kafouros, & Wright, 2012; Xia, Ma, Lu, & Yiu, 2014).

When SOEs compete with private start-ups and foreign entrants on product markets, SOEs' political ties may become valuable, rare, and hard-to-imitate, especially in industries with heavy state influence (such as telecoms, transportation, and construction) (Dieleman & Boddewyn, 2012; Li et al., 2013). The most powerful SOEs are likely to leverage their ties to influence and enact policies acting as entry barriers for competitors (Faccio, 2006; Pearce, de Castro, & Guillen, 2008). Conversely, in deregulated or liberalized "open" industries (such as consumer goods), SOEs' political ties may be less critical. Thus:

Proposition 11 Driven by their interest to enhance the value, rarity, and inimitability of resources and capabilities, SOEs are likely to develop and leverage nonmarket-based political ties—especially in industries with strong state influence.

A key insight of the resource-based theory is that "it may be that not just a few resources and capabilities enable a firm to gain a competitive advantage but that literally thousands of these organizational attributes, bundled together, generate such advantage" (Barney, 1997: 155). Extending this insight, we argue that new SOEs' competitive advantage does not only stem from any single set of the two main categories of resources and capabilities discussed above—market-based or nonmarket-based. Instead, it is the *combination* of market-based and nonmarket-based resources and capabilities that helps sustain some new SOEs' performance and propels their growth in the increasingly competitive global economy (Guillen & Garcia-Canal, 2009; Khanna & Yafeh, 2007; Li et al., 2013).

The combination of both forms of resources and capabilities takes two dimensions. On the one hand, SOEs in the 21st century obviously need to excel in market-based resources and capabilities in their respective domains. Relying on political ties alone will not be sufficient, even domestically. As some of these new SOEs venture abroad, it is imperative that they can compete effectively in product markets (Cui & Jiang, 2012; Lebedev et al., 2015; Meyer et al., 2014; Mutlu et al., 2015; Peng, 2012; Xie et al., 2016). On the other hand, the new SOEs are likely to seek additional benefits from their political ties by enhancing the mutual dependency between these SOEs and officials (Peng et al., 2015). While SOEs rely on officials for resources, officials increasingly also rely on SOEs to accomplish policy goals and advance their personal careers (Shi et al., 2014). Therefore, some SOEs may intentionally grow to become "too big to fail" so that in the event of business failure, they can benefit from (possible) state bailouts (Rajan, 2010). These SOE managers are aware that should officials decide not to bail them out, the resulting job losses and unemployment would be devastating to the economy and to the officials' reputation and careers. As a result, certain SOEs that possess such high-level political ties are likely to outperform non-state-owned firms and other SOEs that do not enjoy such ties. Thus:

Proposition 12 The economic performance of SOEs is likely to improve when they leverage both market-based, competitive capabilities and nonmarket-based, political capabilities.

Discussion

Contributions

Linking and integrating SOE research with theories of the firm, this article makes two broad contributions. First, we demonstrate that existing theories of the firm can be extended to generate a research agenda with testable propositions that focus on SOEs. In Table 3, we have labeled such propositions "extensions." These extensions apply the basic theoretical understanding of the firm to the (relatively) novel context of SOEs. Clearly, extending these theories to cover SOEs, which are a major (not a special or marginal) organizational form in the global economy, makes these theories more comprehensive, more relevant, and more insightful. Supportive evidence derived from tests on these propositions will enhance the explanatory and predictive power of these theories, and non-supportive evidence will help establish their boundaries.

Second, perhaps more critically, we also focus on how research on SOEs can push the frontiers of existing theories of the firm forward. The result is new insights culminating in the propositions that we label "frontiers" in Table 3. In property rights theory, while the two competing "extension" propositions (P1 and P2) essentially replicate the long-standing debate on the superiority of state versus private ownership, the two "frontiers" propositions (P3 and P4) probe deeper into the settings under which state ownership is likely to be superior to private ownership. In transaction cost theory, the "extension" proposition (P5) addresses conditions concerning market failure and the rise of SOEs, while the "frontier" proposition (P6) introduces a transaction cost analysis to understand the boundaries of this theory. In agency theory, the two "extension" propositions (P7 and P8) primarily deal with principal-agent conflicts, while the two "frontier" propositions (P9 and P10) leverage recent work on principal-principal conflicts in an SOE context. Finally, in resource-based theory, the "extension" proposition deals with SOEs' nonmarket-based capabilities (P11), while the "frontier" proposition (P12) focuses on the combination of both market-based and nonmarket-based capabilities. Such a combination is likely to be more valuable, rarer, and harder-to-imitate than the excellent capabilities in either of these two areas. Isolating the link between such a combination and firm performance is not only helpful to SOE research, but can also overcome a major frontier challenge for the resource-based theory.

Limitations and future research directions

Following Conner (1991) and Mahoney (2005), we have focused on the four "classic" economic theories of the firm. How noneconomic (sociological, political, and behavioral) theories of the firm can add to and be enriched by SOE research remains to be explored. Research on theories of the firm is no longer limited to the single pigeonhole of each theory (Conner, 1991). Instead, innovative recent work has sought to combine insights from two or more theories (Young et al., 2014). The complexity and diversity of SOEs call for this combination approach of drawing on and extending more than one theory of the firm (Foss & Foss, 2005; Kim & Mahoney, 2005, 2010; Nickerson & Zenger, 2008).

SOE research can also benefit by integrating with the institution-based view (Ahuja & Yayavaram, 2011; Lawrence, Leca, & Zilber, 2013; Meyer & Peng, 2016; Peng, Sun, Pinkham, & Chen, 2009; Young et al., 2014). Treating institutions as independent variables, the institution-based view “focuses on the dynamic interaction between institutions and organizations and considers strategic choices as the outcome of such an interaction” (Peng et al., 2009: 66). SOEs’ strategic choices can certainly be viewed as the outcome between institutions and organizations (Peng & Heath, 1996). The institution-based view distinguishes between formal institutions and informal institutions (Estrin & Prevezer, 2011; Holmes, Miller, Hitt, & Salmador, 2013; North, 1990; Peng, 2003). Both formal institutions (such as state regulations) and informal institutions (such as historical norms) affect SOEs, making the institution-based view a fertile new ground on which to develop new theoretical understanding (Kostova & Hult, 2016; Meyer & Peng, 2016; Peterson, 2016). This direction is consistent with Mahoney’s (2005: 223) call “far greater attention to the interaction” between institutions and organization-level governance.

SOEs are also a rich context in which corporate social responsibility (CSR) research can be embedded (Xu et al., 2015). Every self-respecting private firm is now embracing some form of CSR. SOEs have inescapable CSR. Yet one of the central constructs within the CSR movement, the triple bottom line, has a clear economic dimension in addition to the social and environmental dimensions. SOEs’ generally lackluster economic performance (and consequently overemphasis on the social dimension) provoked the privatization movement around the world in the first place. Just as private firms need to balance the economic with the social and natural environmental dimensions, determining how SOEs can effectively balance the often conflicting demands from these three dimensions will be a fascinating new ground for CSR research (Marquis & Qian, 2014; McWilliams & Siegel, 2000; Su, Peng, Tan, & Cheung, 2016).

Finally, from a resource dependence perspective (Pfeffer & Salancik, 1978; Xia et al., 2014), scholars need to address both the similarities and differences between previously private Western firms that have received bailout funds from the state and “more traditional” SOEs. Even in China, few “traditional” SOEs currently exist, as many SOEs are now listed publicly and have private (and in many cases foreign) investors who are only interested in economic gains (Ma et al., 2006, 2014). While we can debate the degree of state influence in China (which clearly exists but probably is not as strong as it was three decades ago), it probably is fair to label such SOEs “hybrids.” Likewise, it is also plausible to label post-bailout Western firms such as AIG and GM “hybrids” (Bruton et al., 2015). Overall, our lack of understanding of the nature of such “hybrids” suggests a great window of opportunities for scholars interested in theories of the firm (Young et al., 2014).

Conclusion

Clearly, SOEs are an enduring and evolving organizational form. Beginning in the 20th century, SOEs have experienced the rise, the fall, and the more recent redemption on a worldwide basis. Our central argument is that integrating SOE research with "mainstream" theory building will not only propel SOE research to new heights, but will also extend and enrich existing theories of the firm. To the extent that some management research has been criticized as being "irrelevant," we believe that more complete theories of the firm that place the SOE square and center will make our research more relevant. From a practical standpoint, an enhanced understanding of SOEs will not only help SOE managers and policymakers improve their effectiveness, but will also help *non*-SOE managers and policymakers to better deal with SOEs. No longer limiting themselves domestically, some SOEs are now active internationally and have become a new breed of global competitors. Given the centrality and longevity of SOEs as an organizational form in the global economy, clearly, it is time for theories of the firm not to ignore them anymore. In conclusion, SOEs are neither organizational losers destined to disappear from history, nor fire-breathing dragons that can rock the world. Instead, as scholars interested in developing theories of the firm, we follow Williamson (1985: 407) to conclude that SOEs deserve our *qualified respect*.

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