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**The Evolutionary Dynamics of China's  
Small- and Medium-Sized Enterprises  
in the 1990s**

Laixiang Sun with Edward X. Gu and Robert J. McIntyre



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This study has been prepared within the UNU/WIDER project on Small and Medium Enterprises in Transition: How does Entrepreneurship Develop in Post-Socialist States (Transition from Below: the Role of the New Private Sector), which is directed by Professor Robert J. McIntyre.

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## FOREWORD

The year 1992 saw the introductory start of several diverse, innovative and successful reforms within the ownership and governance structures of China's small and medium enterprises (SMEs). Novel arrangements such as 'joint-stock co-operatives', 'joint-stock partnerships', 'grafted joint ventures' and 'small corporatization' were introduced on a wider scale. This new round of reforms has affected enterprises in both the state sector and the local government enterprise sectors.

This volume gives readers of all backgrounds an up-to-date sense of the dynamic changes going on in the Chinese economic system. While it is known that the TVEs have been successful as a development instrument in remote poverty-stricken areas, it is amazing to discover its dynamic economic success in the highly competitive markets of the rapidly modernizing southern coastal areas where there are several other types of enterprises (private, large marketized SOEs, joint ventures, and so on). Clearly this is a national experience worthy of sustained and serious international attention. Indeed, the TVE model ought to be distilled in detail and possibly replicated, after the due adaptations, in other economies in transition. I am therefore happy to bring to the fore this noteworthy component of UNU/WIDER's research programme on transitional economies for global awareness.

Giovanni Andrea Cornia  
Director, UNU/WIDER  
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## ABSTRACT

Since 1992 a series of radical and successful reforms of their ownership and governance structures have been conducted by China's small and medium enterprises (SMEs). Innovative arrangements such as 'joint-stock co-operatives', 'joint-stock partnerships', 'grafted joint ventures' and 'small corporatization' have been used. This new round of reform has affected SMEs in both the state and non-state sectors and in both urban and rural areas.

Local governments play a significant role in this round of market-facilitating reform. Even in the state sector these reforms has been led by local governments, mainly counties and cities. Since the early 1970s local governments in China have gradually come to control all of the small- and a large proportion of the medium-sized state-owned enterprises (SOEs). The reform of these *local* SOEs has been a response to the present financial and business difficulties.

On the other hand, the simultaneous ownership reform in the township and village enterprise (TVE) sector is an active response to potential or foreseeable future difficulties. The TVE growth miracle has in fact continued, producing 46.3 of total exports and more than 30 percent of GDP by 1997. Private and household-run enterprises have also experienced very rapid growth since the new reform era opened in 1992. Many of these firms have sub-contractor or other affiliated relationships with TVEs or locally controlled SOEs.

Of the TVEs that have adopted the joint-stock co-operative form, most are 'closed co-operatives' with shares that are not tradable by outsiders and local government as the only non-employee shareholder. Many purely private enterprises have been adopting this same form, again often bringing in local government as an equity holder. A complex and in some ways unpredictable 'mixed' system is emerging where 'public' ownership does not mean state ownership and where the term 'private' is commonly used to describe entities that have no conventional private owner.

The Chinese experience indicates that it is desirable to adopt a pragmatic multi-track strategy of building market institutions, which requires active and sustained government policy engagement. The authorities must work to: (a) supply incentives which induce a market-learning evolution of the existing institutions; (b) develop market organizations and institutions in a way that combines new, market-oriented elements with the existing organizational and institutional capital; and (c) encourages and supports the coexistence of diverse organizational and managerial arrangements.

## CHAPTER 1

### INTRODUCTION: QUESTIONS AND ANALYTIC FRAMEWORK

*Laixiang Sun*

#### 1.1 Major research questions

Since 1992, China's small and medium enterprises (SMEs) in all sectors of the state, township and village, and private have conducted a series of radical and successful reforms of their ownership and governance structures. An innovative arrangement, joint-stock cooperative (or joint-stock partnership), has become widespread, supplemented by traditional measures such as selling, leasing, taking over, merging, and restructuring through Sino-foreign joint venture ('grafted' joint venture) and corporatization (or equitization).

The category of SMEs in China includes almost all TVEs (township and village enterprises), private enterprises, and household enterprises, which together produced more than 30 per cent of China's gross domestic product (GDP) in 1995. In the state sector, SMEs have played a major role as well. Urban SMEs provided 75 per cent of employment for the urban labour force in the 1990s.<sup>1</sup> According to the 1995 National Industrial Census, there were 6,416 large and 16,591 medium-sized industrial enterprises. These large- and medium-size enterprises are mainly state-owned enterprises (SOEs) that together produced less than 40 per cent of national industrial value-added and business revenue in 1995.<sup>2</sup>

In the state sector, this new round of reform has been once again initiated and led by local governments—mainly counties and cities with a prefectural- or county-rank in China's administrative hierarchy. Since the early 1970s these county and city governments have gradually come to control all small and a large proportion of medium-sized SOEs. Different from the situation in the former Soviet Union and Eastern Europe, the size distribution of SOEs in China is skewed toward the small and medium ones, and furthermore the distribution is spread across the country rather than geographically concentrated (this volume, Section 3.1; Qian and Xu, 1993). Therefore, in China ownership restructuring of these locally controlled SOEs is equally, if not more, as significant as the restructuring of the large ones that are largely controlled by the central government. Several interesting questions arise here. Why local governments have finally come to have a strong motivation to give up a large set of their *de facto* ownership rights

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<sup>1</sup> *People's Daily*, 9 April 1999.

<sup>2</sup> The official definition of large, medium, and small enterprises varies by industry and takes account of many factors such as fixed capital, business revenue, employment, and so on. For our analysis of institutional change, the details of these definitions are not important. For those readers who are interested in the details of this definition, please refer to Appendix III of China Industrial Economic Statistical Yearbook, 1988. See also *People's Daily*, 19 February 1997.

over their local-run SOEs, after enjoying these rights for several decades during both the pre-reform period (mainly in the 1970s) and the twenty years of reforms? Are the local governments gainers or losers in the reform? What incentives have induced the local SOE managers to accept and in most cases to implement the most radical reform measures, when it is they who are clearly running the risks of losing control rights and job security? Where is the position and what is the attitude of workers in the reform process? What are the consequences of the reform, in terms of economic performance, the relationship between government and enterprises, labour-management relations, and most importantly, ownership and governance structures?

If reform of SME ownership in the state sector is best seen as a relatively *passive response* to the present financial and business difficulties faced by the state SMEs, ownership reform in the township and village enterprise (TVE) sector is an *active response* to potential or foreseeable difficulties TVEs may confront in the near future. During 1992-7, the TVE sector continued its growth miracle. TVE value added increased from 448.1 billion yuan in 1992 to 2,074.0 billion yuan in 1997, implying a real growth rate of 22.2 per cent per annum.<sup>3</sup> The export performance of TVEs has been more impressive. The value of export goods delivery increased from US\$21.68 billion in 1992 to US\$84.6 billion in 1997 and the TVE share in total national exports rose from 25.5 per cent in 1992 to 46.3 per cent in 1997 (sources: same as in Table 4.4). Since 1995, industrial TVEs have produced more than half of the national totals of industrial value-added, profits, and output; the TVE sector as a whole has created more than 30 per cent of China's gross domestic product (GDP) (Ministry of Agriculture, 1997).<sup>4</sup>

In the discussion that follows, TVE and TVEs are understood in the narrower sense of those with dominant community ownership only. When it is necessary to emphasize these TVEs with dominant community ownership, we may also call them 'core TVEs'.

Why did TVEs, the creators of the TVE miracle, need to reform themselves? In addition, similar to the questions arising in the state sector, what has motivated the township and village governments to give up a large set of their *de facto* ownership and control rights over their TVEs? Are they gainers or losers in the reform? What incentives are confronted by the TVE managers and workers in the reform process? What are the consequences of the reform, in terms of economic performance, the relationship between community governments and TVEs, labour-management relations, and most importantly, ownership and governance structures?

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<sup>3</sup> The relevant figures are deflated by the general retail price index. Data sources are State Statistical Bureau, *Statistical Yearbook of China* (Yearbook hereafter) 1998: 302 and 421; *Yearbook of China's Township and Village Enterprises* (TVE Yearbook hereafter), 1996: 102-3.

<sup>4</sup> In this paragraph, accommodating to data limitations, the TVE data is interpreted in the broader sense, to include household-run and jointly-owned private enterprises, which accounted for 41.9 per cent of value added and 55.9 per cent of employment in the broader TVE sector in 1996 and tend to be much smaller in scale than TVEs with dominant community ownership (*TVE Yearbook 1997*: 121). In addition, a large number of household-run and jointly-owned private enterprises are subcontracted subsidiaries of larger TVEs that have dominant community ownership. As a result, TVE exports largely come from TVEs with dominant community ownership. See *People's Daily*, 19 February 1997 and 6 February 1998.

The private and household-run enterprise sector has experienced very rapid growth since 1992, thanks to the needed improvements in the ideological environment and concrete policy treatment following the renewed impulse for reform. The number of private firms increased from 139,000 in 1992 to 961,000 in 1997, of which about 60 per cent are in the urban areas and the remaining 40 per cent in the rural areas, and their average employment size dropped slightly from 17 in 1992 to 14 in 1997. The number of household-run firms rose from 15.3 million in 1992 to 28.5 million in 1997, of which about 65 per cent are in the rural areas. Of the total number of private and household-run firms, more than half have engaged in wholesale and retail trade and in catering services, and about 20 per cent are industrial firms. From 1992 to 1997, the share of these industrial firms in the national total industrial output increased from about 6 per cent to 18 per cent (*Yearbook 1993*: 113-4, 409, 590; *1998*: 152-3, 431-3, 581).

Two specific characteristics of this sector are of great interest to this research. First, private and household-run production firms in general and those in rural areas in particular have operated in tandem with community authorities such as village governments and with community-run TVEs. Second, an increasing number of the production firms in this sector are adopting the ownership form of joint-stock co-operative or joint-stock partnership and some of them have grown out of joint-stock co-operatives and become limited liability companies. Why do these small private firms prefer 'co-operation' when their legal status as purely private entities has been constitutionally recognized and the policy discriminations against them have been substantially diminished?

This research intends to give a preliminary answer to the three sets of questions listed above. Among these questions, the one of great theoretical interest is how the organization of government matters in providing government itself with incentives for reform. The existing theories on government-owned firms and privatization (see, e.g. Shleifer and Vishny, 1994; Boycko *et al.*, 1996) cannot answer this question (Qian and Roland, 1999). New insights into the discussion would be provided if we adopt a new theoretical framework that integrates general property rights theory with the dual perspectives that competition induces ownership restructuring, but that organizational and social capital are crucial as well for the transition.

The argument that ownership restructuring has been induced by competition suggests that the introduction of competition mechanism is more fundamental for the success of transition than privatization within an environment where there is an absence of competition. The perspective that stresses the importance of organizational and social capital indicates that whether governments in the transition economies functioning as a market promoter or a rent grabber generates essentially different consequences. In other words, when transition has started in an environment where there is a lack of independent market intermediaries and dispute settling institutions, governments in general and local governments in particular are typically the only available institutions with the capability to mediate transactions and with the authority to settle disputes. Under these conditions, a proper transformation of the role of government from a rent grabber to a market promoter is critical for the emergence and development of professional market intermediaries and dispute settling institutions, and thus for the success of transition. Of course, competition, particularly inter-jurisdictional competition, induces and prompts the proper transformation of the role of government as well.

These three points—namely competition-inducing ownership restructuring, the significant role of organizational and social capital, and inter-jurisdictional competition prompting the proper transformation of the role of government—may be the fundamental lessons that China's reform has offered.

## **1.2 Two forms of competition and ownership restructuring**

### *1.2.1 Competition as rivalry behaviour*

There are two different concepts of competition in the economics literature. The first one is linked with the concept of 'perfect competition', in which competition is understood as a seemingly tranquil equilibrium state. The theory established around this concept mainly deals with the allocative efficiency of resources, and it suggests that under the competitive equilibrium state, well-informed agents treat prices parametrically. The second concept defines competition as rivalry behaviour with respect to prices, market shares, corporate control, survival and other variables in a world characterized by flux, uncertainty, and disequilibrium (Stigler, 1987; Vickers, 1995). Since the second definition follows the tradition of Hayek and Schumpeter and pays main attention to productive and dynamic efficiency, it is more relevant to our study of the evolutionary dynamics of firms in the transition economies.

Following the rivalry behaviour definition of competition, 'more competition' will be induced by (a) greater freedom of rivals, such as more freedom to enter an industry; (b) an increase in the number of rivals; (c) a move away from collusion among rivals; and (d) introduction of or increase in the rewards for success and the penalty for failure (Vickers, 1995).

The significance of competition emphasized in the literature can be sketched out as follows. First, competition sharpens incentives for managers. An increase in the number of players in the market enhances the possibilities of performance comparison between managers. Competition in product markets alone may make profits more sensitive to the effort of managers, and thus the owners can relate managerial remuneration to profits so as to stimulate managerial effort. Competition by comparison also brings in reputation building efforts of the managers and reduces moral hazard because a manager's effort can be estimated with greater precision (Hay and Liu, 1997; Vickers, 1995). Second, competition can play a major role in selecting more efficient firms from less efficient ones. When firms' costs differ, the lowest cost firm will certainly win the competition and the highest cost firm may have to exit due to its losses or due to an increase in the number of competitors. In order to win the competition or survive in a competitive environment, firms have to develop themselves by capital accumulation, improving technology and management, and innovation (Liu and Li, 1998; Vickers, 1995). Third, dispersed imperfect information can be aggregated in the competitive process (Hayek, 1949: 96; Grossman, 1989; Vickers, 1995). Firms or other organizations can discover their desired information through the process of competition and comparison. For example, they can evaluate the opportunity costs of alternative choices of technologies and management modes through performance comparison and learning from rivals.

### 1.2.2 *Inter-jurisdictional competition*

In transitional China, apart from the market competition that has put pressure on and stimulated the efforts of firms and local governments, another kind of competition, named 'inter-jurisdictional competition' across provinces, cities, counties, and rural communities (i.e. township and villages), has played perhaps a more important role in the areas of promoting markets, stimulating reform initiatives and inducing ownership restructuring (Montinola, *et al.*, 1995; Qian and Roland, 1998; Qian and Weingast, 1997).

In a country with a federal system like the United States, inter-jurisdictional competition among local governments increases efficiency mainly through sorting and matching. In other words, it allows citizens to sort themselves and to match their preferences with a specified menu of local public goods. This kind of sorting and matching forms implicit pressure and incentive for local governments to further the interests of the local citizens (Tiebout, 1956). In a transition economy like China, inter-jurisdictional competition functions in a somewhat different manner due to the fact that local governments typically control a large number of firms and citizen mobility is quite limited. First, inter-jurisdictional competition induces local governments to provide a hospitable environment for attracting scarce production factors such as capital and skilled labour. Local governments are induced to establish a basis for secure rights of factor owners, to provide infrastructure, utilities, and access to markets. For example, an increasing number of local governments in China have formulated and revised local regulations to promote foreign investment and non-state sector development, often acting in ways that are much bolder than expected by the central government and out of line with the official ideology (Gu, 1998). Because those jurisdictions that fail to provide these local public goods find that the urgently needed factors move to other jurisdictions, and consequently, this causes their local economic activities and tax revenues to stagnate or even decline (Montinola *et al.*, 1995).

Second, inter-jurisdictional competition induces the endogenous emergence of harder budget constraints for lower level governments. Although the mobility of already existing 'stock' resources may be limited in China, the mobility of incremental resources in general and non-state capital investment in particular raises the opportunity costs to local governments of bailing out inefficient firms or spending on wasteful public consumption (Jefferson, 1998; Qian and Roland, 1998). Local governments that persistently make inefficient expenditures will not only fail to attract investment and skilled labour to their jurisdictions but also find that their own resources and skilled labour have moved away from their jurisdictions. As a consequence, competition endogenously hardens budget constraint of lower level governments given the limited capacity of the higher level governments to provide fiscal subsidies (Qian and Weingast, 1997).

Third, inter-jurisdictional competition helps limit government's predatory behaviour against local firms. Furthermore, it leads to a reduction of restrictions on local firms and induces the local governments to look for better ownership and governance structures for their firms. When a particular local government insists on imposing an onerous restriction on its local firms, local firms in this jurisdiction are confronted with a competitive disadvantage compared with competing firms from other jurisdictions that are not bound

by the restriction (Montinola *et al.*, 1995). These competition-induced effects are certainly market-promoting and reform-oriented.

Once our understanding of competition extends to the inclusion of inter-jurisdictional competition among local governments, we can better understand why the pace and outcomes of reform in China have been to a great extent determined by the competition specific to localities and enterprises. Market competition was introduced and gradually enhanced by opening the state monopolized industrial sector to new entrants and by the consequent TVE miracle. The inter-jurisdictional competition was put in place by the revenue-sharing contract between central and provincial governments and between provincial and city or county governments. The revenue-sharing contract system introduced in the early years of reform was likened as 'eating in your own kitchen' (*fenzao chifan*). It delegated the basic responsibility of balancing local revenue and expenditure to local governments.

### *1.2.3 Competition can induce ownership restructuring*

Confronted with an increasingly competitive environment, profits are much more sensitive to the competitive ability of firms. Low or declining profits lead directly to low or declining bonuses and fringe benefits, poor reputations, and even to survival crises—thus motivating enterprise managers and employees to seek alternatives which enhance their competitive position. Among local governments, particularly those at lower levels with fewer enterprises under their jurisdictions, the erosion of enterprise profits that are the major source of local revenues causes immediate fiscal distress. This distress alone may destabilize the distribution of fiscal revenues among regions and administrative organs, hurt the reputations of local officials and reduce the bonuses and benefits of local government employees. In order to generate more revenue and reduce expenditure pressure, local governments are induced to reform their local enterprises rather than continuously to bail out inefficient firms. It is in this sense we claim that competition induces enterprise reform and ownership restructuring.

By the mid-1990s, competition had gradually exhausted the monopoly profits of most state-owned industries, the traditional primary sources of government revenues. According to a World Bank (1997) report, about half of the industrial SOEs made a loss in 1996, up from one-third just two years earlier. Among loss-making SOEs about 90 per cent were small and controlled by city and county governments (Zhou and Shen, 1997). One simple reason for this is that small SOEs hold too small a market share to retain monopoly profits longer. As a consequence, the most radical ownership reform seemed inevitable for small SOEs by the mid-1990s.

### *1.2.4 Ownership restructuring improves the framework for competition: a virtuous circle*

On the one hand, competition induces ownership restructuring, and on the other, ownership restructuring induced by competition further improves the framework for competition and opens up more areas to competition. In the 1980s, the reassignment of SOE property rights and increased SOE autonomy not only enhanced entrepreneurial responses to market-determined supply and demand signals, but also extended product markets from the secondary component to the dominant one in the dual track economy with both planned and market components. SOE property rights reform and TVE development further led to



the emergence of capital and labour markets in China (Sun, 1997). The role of governments was transformed as well from the direct management of SOEs to one more like that of a market intermediary. While the independent market intermediaries are largely absent in a transition economy like China, the role played by governments, particularly lower level governments, in mediating transactions and resolving disputes is of fundamental importance for the transition (Stiglitz, 1998; Oi, 1992). One may worry about the negative effect of such government-business collusion based on the experiences of market economies. However, it seems necessary for a successful transition and furthermore, in the context of China, the intensive inter-jurisdictional competition seems to have kept this collusion in check while generating positive net benefits (Li, 1998).

The ownership restructuring conducted since, 1992 has prompted further a functional transformation of the role of the various layers of government in China. In those cities and counties where most of enterprises have waved farewell to *de facto* government ownership, the local governments have started to function more like a market regulator, although they have continued to mediate transactions and resolve disputes. Government assets are managed in the forms of share holding and venture capital. This progress has improved and is likely to continue to improve the framework for market competition. In Chapters 3 and 5 a more detailed development of this perspective is provided.

### **1.3 Market intermediation, organizational capital and social capital**

A well functioning market needs not only autonomous enterprises with well-defined property rights, but also market intermediaries to mediate transactions and other institutions to supply strategic services, preserve competition, and resolve disputes. A simple list would include: commercial banks and other financial institutions; healthy securities exchanges and their monitoring commissions; rigorous accounting standards and their enforcement agencies; professional accounting and auditing services; well-developed financial press; antitrust agencies; procedural rules and services facilitating shareholder litigation; sustainable social security nets; and so on (Hall and Jones, 1999; La Porta, *et al.*, 1998; Rask *et al.*, 1998). These institutions took root and have developed themselves in the developed market economies over a period of several generations if not several centuries.

However, for most economies at the beginning of the transition, there were no such market organizations and institutions at all. Instead there was a universal government which controlled almost everything in the economy. Market organizations and institutions cannot emerge from scratch. Organizational and institutional capital are needed for their emergence and development.<sup>5</sup> Two consequent questions arise here: can the organizational and social capital embedded within the old universal government system be used to facilitate market development in general and to set up new bases for the emergence of new market organizations and institutions in particular? If the answer is positive, then what is the basic mechanism to induce such a transformation?

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<sup>5</sup> Rask *et al.* (1998) presents a detailed case study to document and examine the market-learning evolution of China's accounting system. As in the other socialist economies, the traditional accounting system in China was an uniform one designed to report aggregate statistics regarding plan fulfilment and to provide average cost data for central planners. Following the evolution of China's enterprises and economy, a multidimensional accounting system, which includes management accounting, financial accounting and increasing adoption of international financial reporting standards, has gradually developed out of the traditional one.

Based on China's experiences, the answer to the first question is 'yes', and for the second one, the basic mechanism may be the introduction of horizontal inter-jurisdictional competition and a harder budget constraint for lower level governments (Section 1.2). The evolutionary transformation of the role of government in China has passed several stages: from the universal manager of the economy to the controller of the planned component and the co-ordinator of the market component of the dual track economy; to the one of mediating market transitions and settling disputes; and finally close to becoming the market regulator. This transformation is certainly dramatic and may have occurred beyond any *ex ante* imagination. As mentioned in Li (1998), forty years ago, the same bureaucratic system under the control of the same Communist Party imposed a massive campaign under the name of the Great Leap Forward, causing the loss of tens of millions of lives. Thirty-two years ago, the same regime launched the Cultural Revolution, denouncing any traces of economic incentives. Although a significant legacy of the Cultural Revolution disaster may be that it left China with a weakened bureaucracy and thus made reform easier, the deeper lesson indicated by the transformation would appear to be that the existing organizational and social capital can be used for opposite purposes. They can be used in a value-destructive way as well as in a value-constructive way, dependent on what kind of incentives they face.

A possible problem for any large-scale social transition is that due to the bad role these existing organizational and institutional capital played in the old system, there might be a social consensus to destroy them first, leaving the economy bereft of the necessary institutional infrastructure for normal functioning (Stiglitz, 1998). The cost of such destruction may be enormous, as manifested in the transition of Russia.

The Chinese experiences indicate that it is desirable to adopt a dual-track market institutional building strategy. That is: (a) supply incentives to induce a market-learning evolution of the existing institutions; and (b) develop new market organizations and institutions in a way that combines new and market-oriented elements with the existing organizational and institutional capital. In this process, the role played by government and the proper transformation of the government role are two critical determinants of the success.

#### **1.4 Organization of the volume**

In the introductory chapter, we have highlighted three sets of interesting questions arising from the evolutionary process of China's SME ownership reform in the 1990s. They include: What incentives have induced the relevant actors, particularly local governments, to conduct the 'pragmatic denationalization' in the state sector? Why do TVEs, the creators of TVE miracle, now find that they need to reform their ownership structure? Why do small private firms prefer 'co-operation' when their legal status has been constitutionally recognized? In order to conduct an insightful investigation to these major research questions, an integrated theoretical framework is introduced. This integrated framework places emphasis on: the interaction between competition and ownership restructuring; the incentive structure of ownership restructuring; and the significant role of organizational and institutional capital, and of inter-jurisdictional competition among local governments.

Chapter 2 conducts a detailed and thoroughgoing discussion of the theoretical issues of the incentive structure of ownership restructuring in a transition economy. It starts from a general comparison between market contracting and ownership assignment, and argues that a non-private firm in a transition economy typically possesses a large set of relationships beyond those suggested by the conventional categories of ownership and market contracting. It then analyses how the introduction of market transactions and principles to more areas of the firm's transactions can facilitate the clarification of ownership rights and the reduction of ownership costs, and further reviews the major components of ownership costs.

Finally this chapter will present stylized features of the joint-stock co-operatives, compare these features with those of other ownership types, and evaluate the comparative advantages and disadvantages of joint-stock co-operatives from several complementary perspectives. This comparison suggests that for small and medium community firms that have little chance to capture a net benefit from capital and managerial labour markets and have to depend on market intermediaries for financing and marketing, the ownership form of joint-stock co-operatives may be a suitable choice. Under such an ownership arrangement, community governments have the chance to play a positive role like an inside venture capitalist; community members as share-holders can hold shares in several community firms and thus diversify their portfolio risk; information problems can be internalized; competition pressure and community democratization can help to avoid political failure within a community or a community firm.

Chapter 3 focuses on the dynamics of local SOE ownership restructuring and on the determinant role that is played by local governments in the radical ownership reform. The chapter first presents an up-to-date assessment of models, pace, and efficiency and welfare gains of local SOE ownership restructuring during the 1990s. It then examines the reform-incentives of local governments and officials, SOE managers, and SOE workers, respectively. Consequently, the ownership-reform-induced transformation of the role of local governments will be discussed, and the remaining bottlenecks and impediments to the ownership reform will be pointed out. Finally, this chapter will try to explore general implications of this round of reform. The dynamics of local SOE ownership restructuring in the 1990s offers an excellent case for analysing the evolutionary process of competition-inducing ownership restructuring and the role of ownership restructuring in improving the framework for competition.

In Chapter 4, we examine the dynamics of ownership reform in the TVE sector. Sections 4.1 and 4.2 review the dynamics of TVE development and TVE miracle, describe the shifting industrial composition of TVE output and employment, and summarize the reasons for TVE success based on an up-to-date survey of the TVE literature. Section 4.3 discusses the emerging debt problems faced by TVE and the urgent need for capitalization. Other problems that have been labelled as 'TVE mechanism degeneration' will be analysed as well. Both capitalization urge and mechanism degeneration justifies why TVEs need ownership restructuring. In Section 4.4, we present the stylized features and models of joint-stock co-operatives emerging in the TVE sector and investigate the reasons why joint-stock co-operatives are preferred. Although it is now at the very beginning, we will also analyse the evolutionary implications of the preliminary equity democratization for

the political democratization in the communities where TVEs are located. Finally Section 4.5 highlights the remaining challenges to TVE development and reform.

Chapter 5 reviews the general development pattern of the private sector and investigates the emergence and dynamics of joint-stock co-operatives in the private sector. One representative model, Wenzhou model, is selected and examined in details, because this prefecture-level city with a population of more than six million in Zhejiang Province is the first prefecture to become economically dominated by the private sector in China.<sup>6</sup> The incentives for private entrepreneurs to adopt and for local governments to promote joint-stock co-operatives in the private sector will be analysed. This chapter will also examine the unique Chinese phenomenon of *xiaohai*, which refers to the fact that an increasing number of government officials quit their government positions and establish their own private enterprises, and analyse the benefits and costs linked with the dependence of private enterprises on local governments for social and institutional capital.

Chapter 6 explores further the general implications of China's SME evolution and ownership restructuring for Russia and other Eastern European transition economies. Five implications are highlighted. The application of all of these logical and practical steps may presuppose the re-establishment of normal monetary circulation and payments mechanism and an improving overall macroeconomic environment.

First, a large part of the so-called 'hidden' economy can grow out of hiding and become the engine of economic growth, as indicated by the 'Wenzhou Model of China'.

Second, there are two key vehicles for informal SMEs to grow out of hiding and for general SME development: The protection and support by local government, particularly by community government or institutions; and voluntary co-operation of individuals and households in the form of joint-stock co-operatives or joint-stock partnership.

Third, proper transformation of the role of governments in general and local governments in particular are critical for SME development. There are two key vehicles for providing local government itself with the incentive to reform: Creating inter-jurisdictional competition; and changing the incentive structure of local government through creditable revenue-sharing and subsidy-reduction contracts between supervisory and subordinate level governments. The purpose of such a transformation is to induce local governments to act as a market promoter rather than a rent grabber.

Fourth, although the classical period core-TVE is being transformed/replaced in China now, it may well be a plausible 'next step model' for many of the countries where the transition thus far has provided to be a disaster. A build up of activity and experience under TVE-like forms may be desirable in these cases, before considering another round of ownership restructuring. A variety of organizational forms may be expected to quickly develop there as well, but the classical TVE is a proven tool that fits the real circumstances of many parts of other transitional economies.

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<sup>6</sup> Joint stock co-operatives in Wenzhou are not a result of ownership restructuring of original collective firms, but are directly established by private entrepreneurs and households.

Fifth, the ownership arrangement of joint-stock co-operatives may have cost-benefit advantages in other transition economies as well. The joint-stock form (usually closely held) creates economies of scales in terms of capital, production and marketing for the firm. The co-operative structure will bring in more reliable business partners and a set of extended social and economic connections to the firm, thus increasing business security, for which the firms in the individual or household form are having to pay a high and increasing price. Moreover, the enlarged business scale and social/economic network will bring in the much needed institutional and social trust to the firm as well.

In this closing chapter we will also suggest that for an individual firm, the flexibility of the ownership arrangement of joint-stock co-operative allow it easily to transform into a limited liability company or publicly listed stock company along with the expansion of the firm. However, for the majority of small and medium-sized firms, which have little chance to become an openly held company, joint-stock co-operatives may not be a transitional ownership arrangement and may be going to play a significant role in the development of the SME sector in transition economies, particularly in China. In brief, with regard to the SME development and evolution, other transition economies may move along a somewhat similar path, making the evolutionary analyses of the Chinese precedent's experience particularly important.

## CHAPTER 2

### INCENTIVE STRUCTURE OF OWNERSHIP RESTRUCTURING: A GENERAL DISCUSSION

*Laixiang Sun*

#### **2.1. The transitional firm as a political institution**

##### *2.1.1 Market contracting versus ownership in the west*

Following the recent development of the ownership theory of the firm in developed market economies (cf. among others, Hansmann, 1996; Putterman and Kroszner, 1996; Blair, 1995), the firm can be considered as a nexus of contracts, within which, two types of transactional relationships can be distinguished. The first is 'market contracting', which is more closely linked with the daily business operations of the firm. For example, the firm may have signed contracts with vendors of supplies or services that the firm uses as inputs; it may have contracts with individuals who provide labour inputs to the firm; it may have signed loan agreements with banks, bondholders, and other suppliers of capital; the firm may also have sales contracts with purchasers of the firm's products. The second category involves the so-called 'ownership relationships'. By means of ownership, an owner, or a group of owners, exercises the discretion and other residual control rights over the firm left after exercise of the 'market contracting'.

The persons or parties linked with the firm by market contracting can check the firm's behaviour only by seeking enforcement of their contract with the firm or by threatening to cease contracting with the firm. Whereas the persons or parties holding ownership rights have the additional option of seeking to control the behaviour of the firm directly through internal governance mechanisms.

Using this terminology, we may stylize the difference among the major ownership forms that appear in developed market economies in a more intuitive and precise way. In an investor-owned firm, the transactions between the firm and its capital suppliers occur in the form of ownership, but other transactions with workers, material input suppliers, and customers all take the form of market contracting. In an employee-owned firm, the transactions between the firm and its workers occur in the context of ownership, while other transactions with outside capital investors, material suppliers, and customers are conducted through market contracting. In a consumer co-operative, the transactions between the firm and its customers, namely selling the goods or services it produces, take the form of ownership, whereas other transactions for obtaining capital, labour, and material inputs are carried out by market contracting. The transaction forms in a producer co-operative, such as agricultural marketing and processing co-operatives, are similar to

the consumer one, where the position of customers as owners are replaced by major producers and suppliers of material inputs. A representative example of producer co-operatives is a dairy farmers' cheese co-operative in the west, in which a cheese factory is owned by the farmers who supply the factory with raw milk (Hansmann, 1996: 13-20).

If the market is perfect and there is complete information, a firm may be fully specified by market contracting. In other words, in such an ideal market, the parties involving in setting up a firm could write well-elaborated, comprehensive, long-term contracts governing their relationship and specifying everything that matters economically. Thus there is nothing left to ownership. However, in reality the market is far from perfect and information problems are everywhere. These inconvenient realities make ideal and complete market contracting impossible and general market contracting costly. In order to minimize the total cost of transactions between the firm and all of the parties engaging in the transactions, the assignment of ownership becomes desirable. All other things equal, transaction costs will be minimized if ownership is assigned to those persons or parties for whom the problems of market contracting, namely the costs of market imperfections, are most severe. Of course, ownership itself also involves costs, which mainly include the costs of monitoring managers, the costs of collective decision-making among the owners, and the costs of risk bearing. Moreover, the costs of ownership can vary greatly across the different parties involved in the transaction. Therefore, the least costly assignment of ownership would minimize the sum of the costs of market contracting and the costs of ownership (Hansmann, 1996: 20-2; Putterman, 1993).

### *2.1.2 Political structure of non-private firms in China*

Now let us deal with a non-private firm in a transition economy like China following the conceptual framework of market contracting versus ownership. While the transactions occurring between the firm and its customers and material suppliers can be approximately classified as market contracting for the reform period, other transactions involved by the firm can hardly be classified as simply ownership or market contracting. This includes the transactions between the firm and its employees, between the firm and government agencies concerned, and between the firm and state banks. The latter set of relationships is ambiguous between, or even beyond, the categories of ownership and market contracting.

First, let us discuss the relationship between workers and the firm. Workers are in part nominal owners of the firm. A large proportion of workers join the firm by way of local government assignment rather than market contracting. They have made and some of them continue to make contributions to the capital accumulation of the firm through past acceptance of low wage rates and other sacrifices of income and welfare in the name of the nominal owners (particularly in TVEs). They also have to make firm-specific investment in the maintenance and development of both human capital and social capital because the very limited labour market offers them almost no alternatives. If these specific relationships between workers and the firm were ignored and workers were simply treated as employees as in a typical capitalist firm in the west, the restructuring of ownership would become incentive-destructive rather than incentive-strengthening, and in the worst case, may even induce social unrest and production collapse.

The relationship between the firm and its supervisory government bodies has many dimensions as well. For SOEs, governments have directly provided capital investment and continue to provide financial support in the forms of soft credit, soft taxation, and direct subsidies. Although the government bodies have largely withdrawn from daily management of the firm's business, they are still crucial in the area of mediating credits between banks and the firm. Banks need the information advantage of government bodies to justify lending decisions and to exercise monitoring over the loans. SOEs need the support and guarantee of the supervisory government bodies to compete for bank loans (Sun, 1999). Once the governments, particularly local governments, find that many local SOEs have become large consumers rather than creators of local wealth they may want to get rid of the unlimited liability they hold for their local SOEs. However, they are constrained by the possibility of production interruptions, large-scale layoffs, and social unrest that may be induced by an unfair redistribution of SOE assets.

The relationship between TVEs and their local governments is essentially the same as that of SOEs (Jefferson *et al.*, 1998; Sun, 1997). In addition, there is a question of who should be entitled to the benefits from the preferential policies of the state toward them, such as repayment of loans before taxes and tax exemptions? Township and village governments have typically monitored their TVEs much more closely due to the much harder budget constraint and much smaller information problems. While township and village governments want to maintain their TVEs' competence, they are frustrated by the increasingly high debt-asset ratios of many of their TVEs and by the *de facto* unlimited liability they bear for their TVEs.

As we already noted, banks in China have depended heavily on local government bodies for credit planning, concrete lending, decision-making, and loan monitoring. It makes local governments function like a financial intermediary between local firms and banks. While partly reflecting the legacy of the original bureaucratic co-ordination system, this dependence is really the least-costly arrangement for the banks at the present and may continue to be so in the near future.

The above analysis suggests that we need to view the firm in a transition economy like China as a political institution. There are many political and economic actors inside and outside the firm. On one hand, the effort and contributions of these actors are essential for the survival and development of the firm, and on the other hand, they are also stakeholders in (or compensation-seekers from) the firm with ambiguously defined stake specification. There is no group among them whose interests can be simply ignored in the process of ownership restructuring. Because this process will not only change the distributive rules for current income flows, but also redistribute the accumulated wealth of the society, injustice occurring in this process will have long-term, severe adverse consequences for the society. The ownership restructuring of the firm is not simply a process to identify or find a group of individuals as owners. It is intended to establish a better incentive structure toward all stakeholders, so that the ownership reform will remain compatible with economic growth and social stability. The direct purpose of the restructuring is to significantly reduce the cost of decision-making, monitoring, risk-bearing, and market-contracting and to induce greater efforts by managers, workers, and other relevant actors, subject to the existing market, technology and knowledge constraints.



## **2.2 Reducing the costs of ownership and governance**

### *2.2.1 Opening up more areas to market co-ordination*

The analysis in the previous section indicates that ownership arrangements result from the cost-minimizing trade-off between market contracting and ownership. If market and competition do not exist or are very limited, ownership or ownership-like relationships will spread over every aspect of the firm's transactions, inducing high ownership and political costs inside and outside the firm. That was the situation in the pre-reform period where inefficient bureaucratic co-ordination dominated the daily life of China's state firms.

The introduction of product markets and competition since the early 1980s has brought market contracting to the areas of product sales and inputs purchases of firms, and induced a progressive clarification and reassignment of various property rights among different levels of governments, between government and firms, and among parties within the firms (Sun, 1997). The ownership restructuring of China's SMEs since 1992 has continuously followed these two tracks: (a) introducing market contracting and market principles to more areas of the firm's transactions, based on cost-reduction considerations; and (b) directly reducing the cost of ownership. Of course (a) and (b) are not independent but complementary.

At the same time, private firms in transitional China have shown the tendency to spread their ownership, reflecting the two major challenges they face. First, they need to attract sufficient assets or cash flow to buffer fluctuations in their own earnings, thus reduce the cost of risk bearing. Second, for some types of transactions market contracting is too costly or even impossible. As a result, they need a reasonably shared ownership to establish social trust within their own firm and to mitigate the cost of marketing contracting. This tendency appears consistent with theoretical analysis conducted in Hansmann (1996).

For non-private firms in China, opening up more areas of their transactions to market competition offers the advantage of total cost-reduction. First, many components of government financing can be opened up to market co-ordination. These components include: (a) strict separation of credit financing from other government financing and letting credit financing follow market principles; (b) replacing implicit subsidies such as interest rate subsidies, tax exemption, and others by explicit equity investment or venture capital investment; and (c) to transform government property rights in the firm into shareholding or venture capital rights. These opening up efforts will induce the firms to clearly observe financial discipline, and to face a hard budget constraint. At the same time these efforts will essentially simplify and clarify the relationship between the government and the firms it owns, and lead the government as one of the owners to act more like a shareholder or venture capitalist. The government may reorganize itself in such a way as to replace industrial bureaux with an independent government assets management agency and this agency can act as a shareholder or venture capitalist to manage government assets in local firms. When the government owner acts as a shareholder or venture capitalist, its governmental rights over residual benefits and residual control can be better and more clearly defined in forms of concrete share numbers and capital proportions. The homogeneity of interests among the owners of the firm will increase and this increased

homogeneity will in turn reduce the extent of conflicts of interests among owners, thus lowering the cost of collective decision-making.

The dual role of workers in a non-private firm can be separated and then opened up to market competition as well. A worker's role as one of the owners of a firm can be defined by their equity investment (in terms of share or venture capital), and thus is separated from the role of an employee of the firm. Other services such as housing provision that the firm committed to its employees can be separated from market contracting of employees as well. These separations would induce workers to clearly observe labour market disciplines as well as opportunities appearing in the market. While the rights as an owner are measurable and clearly defined, the worker can make a better trade-off between their dual role (when the trade-off is needed) and will also have opportunity to follow market signals and to make risk diversification decisions. These separations would bring the firm more disciplined workers and clearly defined employee-owners (or 'inside venture capitalists'). Although the interest as an owner may be different from that as an employee, once the owner's self-interests becomes measurable, a voting rule for collective decision-making of all owners can be designed and implemented. This could result in a reduction of ownership cost.

### *2.2.2 Reducing the costs of collective decision-making*

We now focus on several components of ownership costs and examine the possibilities of cost-reduction for each of them. First let us analyse the cost of collective decision-making. If all owners had identical interests in connection with the firm, there would be no cost of collective decision-making. Costs of collective decision-making result from interest heterogeneity or interest conflicts among the owners. For the firm in a transition economy, because ownership rights are largely ambiguous, even one class of owners (e.g. the government owner) has diversified interests in connection with the firm. Highly diversified interests among owners will bring not only contradictory criteria but also the cost of 'political failure' to the firm, with the result that the firm has to diversify its scarce resources to satisfy contradictory criteria and to struggle with the recurring interest conflicts (Perotti *et al.*, 1999). Therefore, the efforts to reduce the costs of collective decision-making should focus on two measures: (a) increasing interest homogeneity among the owners; and (b) setting up some simple and salient criteria for balancing those heterogeneous interests among the owners.

As examined before, if ambiguous ownership rights are transferred into measurable equity shares or venture capital, no matter who holds them, the owners' interest relative to the firm will become much more homogeneous. The simple and salient criteria can be set up around the core interest of all owners—to maximize the net worth of the firm. In some cooperative or partnership firms, the total value of such a firm may be hardly divided among members or each individual owner's transactions with the firm may be difficult to measure. In this case a rule of equal division may serve as a natural point of agreement, this rule can minimize the process cost of reaching a collective decision, though perhaps creating some inefficient incentives (Hansmann, 1996: 42; Schelling, 1960).

### 2.2.3 *What mechanisms police the insider control in US public companies?*

The second major component of ownership costs is the cost of monitoring managers and the cost of managerial opportunism. Both result from the failure to monitor managers with perfect effectiveness. For example, in the typically publicly traded US business corporation, shareholders are frequently in a poor position to discipline management because of the dispersion of shareholdings (Roe, 1994; Black, 1990). The key roles in keeping the agency costs of dispersed shareholdings in US corporations to a reasonable level are played by competitive capital and managerial labour markets and various institutions. Shareholders can vote by selling or buying or holding the shares of a specific corporation. Performance comparison may be informative for both shareholders and managers themselves. The desire to maintain or establish a favourable managerial reputation and the threat of take-over by investors with the incentive, power, and knowledge may serve as a sound surrogate for the direct shareholder monitoring in keeping corporate management in line. The restraint mechanisms based on institutional and social capital include rigorous accounting standards; extensive mandated disclosure, prohibitions on inside self-dealing, procedural rules facilitating shareholder litigation, and a well-developed financial press. These institutional and social restraint mechanisms enforce the fiduciary duties of managers toward the shareholders of their corporations (cf. Hansmann, 1996, Chapter 4; Roe, 1990; Shleifer and Vishny, 1997).

### 2.2.4 *Insiders controlling the firm versus the party controlling personnel in China*

Because of the specific institutional background and the absence of competitive capital and managerial labour markets, the agency problem and the corresponding checking mechanism in transitional China have had quite different manifestations from those in the west (cf. e.g. Jefferson, 1998; Perotti *et al.*, 1999; Qian, 1996). To highlight the distinguishing features of the agency problem in China we present the case of the SOE sector here. The difference in these features between SOEs and TVEs is not in essence but in extent, with TVEs appearing to enjoy lower costs in all of these respects (Jefferson *et al.*, 1998).

First, the contract responsibility system promoted in 1987 and enhanced in 1992 has granted SOEs effective rights to use state assets and to distribute and enjoy incomes so generated. The nominal rights to dispose of all state assets are held by the government but the real rights to dispose of SOE assets are partly exercised by SOE insiders as well. Because there is great difficulties within the framework of the contract responsibility system to set up congruence between allocations of effective control rights and financial risks, privatizing incomes by insiders and socializing losses through soft credits and tax exemptions have become commonplace in the 1990s. Spontaneous privatization and state-assets stripping have been frequently reported as well.

Second, there is no clearly accountable representative of the major owner, the state. There are typically several government agencies that have authority over a specific SOE, but none of them is able to exercise effective monitoring. The monitoring through branch ministries and bureaux involves large bureaucratic costs as well, which has induced growing dissatisfaction in the society, though this monitoring role is diminishing as enterprise autonomy expands.

Third, the authority of the committee of the communist party to appoint and dismiss SOE managers has been maintained and may have served as a major counterbalance against complete managerial discretion.<sup>7</sup> Though promotion within the bureaucratic hierarchy has become less attractive than before, disciplinary actions and dismissal by the party will bring severe damage to the reputation, position benefits and control rents of managers. This has effectively restrained SOE managers from going beyond the limitations indicated by the party. The fact that the party holds the residual control rights to appoint and dismiss SOE managers may be the major reason why delegating authority to SOE managers in China does not result in almost complete insider control as quickly appeared in Russia. However, the party control of personnel involves significant costs as well, because it continues to cause political interference in SOE businesses and distorts the incentives of SOE managers.

The above listed three features indicate that the agency problems is much worse in China than in the west, and that the previous enterprise reform seems to be trapped in the dilemma—expansion of enterprise autonomy induces high agency costs but checking the agency costs through the party and government control entails high political and bureaucratic costs. In order to reduce the costs of insider self-dealing (particularly managerial self-dealing) and the costs of political and bureaucratic interference, ownership restructuring and government reorganization become desirable. Ownership restructuring helps to separate the government role of being a regulator and administrator from that of being an asset owner. After the ownership restructuring, the party's authority over personnel can be reasonably limited to political consultancy and the affairs of qualification examination and certification of personnel, if its full elimination leaves a power vacuum or is simply not feasible in the near future.

### *2.2.5 Reducing risk-bearing costs*

The discussion of risk-bearing costs in the west usually focuses on the advantage of investor ownership. Because of the divisibility of financial capital, the owners of financial capital are in a better position to eliminate firm-specific risk through diversification of their financial portfolio. Other parties, particularly employees, often face high costs in spreading their transactions across different firms in different industries. As a consequence, investor ownership will lead to low costs of risk bearing (Hansmann, 1996; Putterman, 1993).

For enterprises with a soft budget constraint, however, the problem related to risk bearing is that the managers typically take too much risk and too little effort in their business but transfer the costs of risk bearing to the society through soft budget constraint (Zou and Sun, 1996). In order to correct this mismatch, in addition to hardening the budget constraint, such measures as letting managers hold shares or stock options that link the present value of the firm to their efforts, profit sharing rule, and opening firms to outside plural investors become desirable.

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<sup>7</sup> The so-called new economic mechanism (NEM) in Hungary after the 1968 reform had a similar mixture of market-driven firms managed by party committee appointed professional managers. However, in the case of Hungary there was no real market, only a simulated market (Berend, 1990; Kornai, 1986).

## 2.3 Joint-stock co-operative: its stylized features and functioning mechanisms

Although many forms of ownership restructuring have emerged in the 1990s, the form of joint-stock co-operative (*gufen hezuozhi*) has dominated. Joint-stock co-operatives are not only emerging in the TVE sector, but also in the SOE and private sectors. By the end of 1996, of all collectively owned TVEs, about 42 per cent in Shandong Province, 33 per cent in Jiangsu Province, 26 per cent in Zhejiang Province and 20 per cent in Guangdong Province had been transformed into joint-stock co-operatives (*TVE Yearbook 1997: 299*). At the national level, about 33.5 per cent of collectively owned TVEs had conducted various forms of ownership restructuring by the end of 1997; and 63.4 per cent of the restructured TVEs adopted the joint-stock co-operative form.<sup>8</sup> Of small SOEs, about 50 per cent in Shandong, 60 per cent in Jiangsu, 40 per cent in Jilin and 30 per cent in Henan had been transformed into joint-stock co-operatives (Institute of Economic System Reform, 1997; You and Wang, 1997).<sup>9</sup> As has been noted in Chapter 1 and will be further discussed in Chapters 3 and 4, the restructuring has generally been based on local government initiatives.

### 2.3.1 Stylized features of joint-stock co-operatives

Joint-stock co-operatives are not uniform as well. Even in China's official statistics, the various forms of joint-stock co-operatives have not yet been clearly brought together in a single category. Some of them may appear in the category of 'limited liability companies', some in that of 'joint-stock companies', but the majority of them have remained in their original category, namely 'SOEs' or 'collective TVEs'. However, the stylized features of joint-stock co-operatives can be spelled out as follows:

- (a) managers and employees own a majority of the total share of the firm and shareholdings among them differ on the basis of paid subscriptions;
- (b) the firm is closely held, implying that ownership shares are typically not freely marketable, although subscribed shares can be transferred within the community;
- (c) the local government may hold a large part of shares in the name of community (city, county, township, and village) citizens;
- (d) in addition to the shares held by the insiders and local government, there usually exist some (or even large) shares of outside equity which carry one vote per share;
- (e) a representative form of governance is usually employed based on 'one-person-one-vote' or 'one-share-one-vote' or a combination of both voting principles; and
- (f) the firm is small or medium-sized.

There are typically different types of shares. One of them, for example, may be similar to a trust fund for employee pensions, the fund is owned by employees as a whole and benefits from the fund are distributed mainly according to seniority. Shares that confer the greatest ownership rights are those that have been subscribed by employees as individuals, which we call the most *active shares*. However, because of the smallness of the firms, these most

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<sup>8</sup> *People's Daily*, 25 July 1998; table 4.8.

<sup>9</sup> There is no official statistical data on the pace of adoption and distribution of new ownership forms across regions and years. Figures given in this paragraph are based on some official surveys and research reports. The ownership restructuring process is led by the coastal provinces and TVEs are largely concentrated in these provinces as well.

active shares are not freely marketable. This makes these individually subscribed shares much closer to a venture capital investment with a simple profit sharing scheme than to the shares of western public companies. The profit sharing scheme is typically that: a fixed proportion of total profits (after taxes) is earmarked as the shareholding fund for the distribution of dividends.

The local government has continued to be involved in the governance of the restructured enterprises via its state or collective assets administration body and financial bureau instead of the original industrial bureaux. Its role in governance has been increasingly transformed from sole owner and supervisor of the firm to one more similar to that of a major venture capitalist. A typical venture capitalist often serves on the board of directors, provides help in recruiting and compensating key individuals, works with suppliers and customers, gets involved in establishing business strategies, and most importantly plays a major role in raising additional capital (Admati and Pfleiderer, 1994; Dasgupta and Tao, 1998). At present, however, the local government seems to play a stronger role than a pure venture capitalist even in situations where the only capital provided by the government is the land. This reality may be partly attributed to the need by all parties concerned for more time to live up to the letter and spirit of their newly defined roles. But more evidence suggests that this involvement is mutually beneficial during the transition when well-functioning market intermediaries and dispute-settling institutions are still in their infancy, and that it serves to promote a smooth institutional transition with lower social costs. We will present this evidence in Chapters 3 and 4.

The fact that managers and employees hold a majority of the shares makes the joint-stock co-operative quite similar to those firms with employee ownership. The performance characteristics of employee-owned firms have been hotly debated and an enormous literature has developed.<sup>10</sup> The western theoretical and empirical literature suggests that while employee ownership arrangements may bring both advantages and disadvantages for the performance of the firm, on balance in most circumstance the disadvantages seem to outweigh the advantages. The recent literature dealing with employee ownership in the former Soviet Union and Eastern Europe seems to further alter the balance toward the disadvantages (Blanchard *et al.*, 1991; Earle and Estrin, 1996). However, the conclusions in both western and transition literature rely on the implicit assumption that the employee-owned firm has rents or other sources of firm-specific surpluses in one way or another. This assumption is hardly applicable to the case of China's joint-stock co-operatives that face highly competitive product markets and an increasingly competitive labour market, and have little political power to maintain some kind of firm-specific rents.

Because of these important differences, a better understanding of how China's joint-stock co-operatives actually work will bring new insights into the ongoing debate over the advantages and disadvantages of employee ownership. In the rest of this section, we will examine the general mechanisms that function in the joint-stock co-operatives in China. The mechanisms are grouped under three headings: mechanisms which check insider control; structures to avoid high costs of collective decision-making; and risk diversification channels and the flexibility to evolve.

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<sup>10</sup> For an excellent survey of the literature on employee ownership, see Earle and Estrin (1996).

### 2.3.2 *Mechanisms which constrain and limit insider control*

In order to highlight the restraint mechanisms to insider control in China's joint-stock co-operatives, we present a sharp comparison among SOEs with autonomy in the transition, large public companies in USA, and joint-stock co-operatives in China (Table 2.1). As we noted in the previous section, SOEs under the contract responsibility system obtain effective *usus fructus* – the rights to control state assets and to enjoy the incomes so generated, but do not carry the downside risk borne by state assets. In order to restrain opportunistic behaviour and self-dealing of the SOE insiders, the government agencies have reasons to intervene in SOE operations and party organizations have the reasons as well to control personnel; but this in turn brings high bureaucratic and political costs. This dilemma results in the inefficiency of the state sector as a whole.

In American publicly held corporations, insiders, particularly managers, have effective rights to control the assets of outside shareholders. Because of the dispersion of shareholdings in US, the managers of many large public companies have long been essentially self-appointing and self-policing. The mechanisms which function in keeping the accountability of the managers to their company's owners are mainly competitive capital, product, and managerial labour markets and well-established legal and institutional constraints as listed in Table 2.1. Although shareholders have a chance to vote in the shareholders conference, a more effective and less expensive way for them to exercise ownership rights is to sell or keep their holdings, or buy new shares in the market.

Compared with both SOEs operating under 'transitional' conditions and the normal times in large American public corporations, insider control in China's joint-stock co-operatives is less problematic. Highly competitive product markets and hard budget constraints have constantly put the 'survival urge' before them and forced them to reduce various costs and improve their efficiency. Both groups of inside and outside shareholders have had long-term co-operative relations and geographic proximity. Their interests in the firm have now become measurable and clearly defined. When facing tough market competition, the better strategy for them is to acknowledge, safeguard and promote their common interests and to choose co-operation rather than conflict. The local government by acting as a major venture capitalist may become more helpful, because it acts now in a less predatory manner while continuing to mediate market transactions and to resolve disputes among parties involved, particularly between insiders and outsiders.

For China's joint-stock co-operatives, the most challenging issue is deciding who will monitor the monitors in general and the community government in particular. The local government has typically held a large stake in most of joint-stock co-operatives in terms of either financial capital, land or both. In the ownership restructuring process, the local government often plays triple roles of 'coach', 'referee', and 'athlete'. In raising equity capital and mediating credits the role of local government seems irreplaceable at least in the near future. In most of the townships and villages with joint-stock co-operatives, the community government has acted as the *de facto* representative agency of local shareholders in the exercise of shareholders' residual control rights over the local joint-stock co-operatives. Together these patterns indicate that the proper behaviour of local governments has been and will continue to be crucial for the success of the local firms. Although inter-jurisdictional and market competition can function as an alternative

governance mechanism to discipline local officials through putting pressure on and placing survival urge before the community, it cannot replace the internal governance structure within the community. In order to directly promote the most competent persons to the key positions and to prevent some officials from opportunism and corruption, political democratization within the community becomes equally, if not more, important than the equity democratization promoted by joint-stock co-operatives.

### *2.3.3 Structures to avoid high costs of collective decision-making*

In comparison with the state ownership of SOEs and community ownership of TVEs before the current restructuring wave, the ownership form of joint-stock co-operatives reduces the costs of both monitoring and collective decision-making. Investing part of personal savings in the firm and in exchange for getting some control rights will certainly increase employee commitment to the firm. This may encourage self-monitoring and peer-group monitoring. Since employees now have a measurable and larger personal stake in the fortunes of the firm from which most of their income comes, they can be more easily assembled for consolidated collective actions when facing market competition. Employees already know a great deal about the firm simply as a by-product of their employment and moreover they now have a stronger incentive to acquire information about the effectiveness of management. The improved flow of information and communication between workers and managers may avoid needless conflict. They can appoint and hold accountable representatives who in turn act to monitor management accountability for the fortunes of the firm. This will reduce the costs of managerial opportunism. The reduction of government intervention will enable the firm to focus on its business criteria, which will contribute to the reduction of the costs induced by conflicted criteria.

However, because workers act as both equity owners and employees in exercising their control rights over the joint-stock co-operatives, the interest differences induced by the dual role may bring high costs of collective decision-making if desired mechanisms for resolving interest conflicts are not put in place. Generally speaking, employees may disagree about their relative wages. They may have quite different opinion about the distribution of firm's earning between capital and labour because they may differ substantially in the amount of equity capital they have invested in the firm. They may fail to reach agreement on the firm's investment decisions due to their different stakes in the investment projects. There may be different attitudes toward technical updating between unskilled, skilled, and white-collar workers, and between younger and older workers. In order to avoid some of these conflicts appearing in the decision-making processes and limit other costs to a tolerable level, some institutional and social mechanisms need to be put in place.

The institutional and social mechanisms which facilitate avoidance or limitation of the costs of interest conflicts that are emerging in China's joint-stock co-operatives include representative form of governance, formal charter limitations on voting procedures and voting outcomes, review by outside agencies, and the shared norms and survival urge imposed by competition.

The representative form of governance is analogous to that employed in large corporations with dispersed shareholdings and also in large co-operatives such as Mondragon in Spain



(Hansmann, 1996: 98-103). Under this form both inside and outside owners elect representatives to a board of directors. The board, in turn, is responsible for appointing, overseeing and dismissing the firm's managers. The direct employee participation in governance is largely confined to annual meetings and to major 'constitutional' changes such as mergers or splits of the firm, changing the firm's statutes (e.g. to a limited liability company), issuance of bonds, and increasing or decreasing the number of shares. The members in the board of directors and the managers serve for a minimum of three to five years. The members in the board of directors cannot be removed during their term except for cause. This arrangement would serve to secure professional management and to avoid inefficiently biased decisions and high costs induced by a highly participatory governance form.

Formal charter limitations on voting procedures and voting outcomes means that there are formalized limitations on the substantive decisions that may be vulnerable to the conflicts of heterogeneous interests. For example, the distribution of profits is largely defined by the firm's charter that is based on government regulations. According to the regulations issued by the Ministry of Agriculture on 12 January 1990 (article 15), the rural joint-stock co-operatives should retain 60 per cent of their profits after taxes for investment and capital accumulation. The remaining 40 per cent can be used for dividends, bonuses, and employee welfare funds, and the distribution of dividends is suggested to be no more than 20 per cent of the total profits after taxes.<sup>11</sup> Relative wages are largely determined by piece-rate, contracting (for managers) and sub-contracting (for teams in workshops). The wage level is subject to the firm's performance in the previous year and local government approval, and is flexible in order to accommodate the needs of market competition. The strong delegation of decision-making power to management and the charter attenuation of employee's rights to earnings and control have appeared to effectively mute the play of political forces among the firm's employees, pre-empting opportunities for costly conflicts. In fact, criticisms in China have focused on the weak role of employees in controlling management. While agreeing that employees should play a more active role in the exercise of the equity democracy, our analysis suggests that it is better to let employees play more politics in the process of community democratization rather than in the firm.

At present the outside review function is still performed by the agencies of local government, mainly, state asset administration bodies, financial bureaux, and the local branches of state banks at county level and above, and community government itself at township and village levels. Although there continue to be certain bureaucratic and political costs, their review and oversight seem to bring more benefits and less cost than before. In addition to the roles of venture capitalists, market intermediaries, and dispute arbitrators analysed above, another role they play is quite similar to that of the 'social council' in the well known Mondragon area in Spain. The members of the social council are elected by local constituencies and the council serves as a major venue for discussion and negotiation which smooth the relations between employees and management.

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<sup>11</sup> In August 1997, This same norm for profit distribution was adopted for urban joint-stock co-operatives by the State Commission for Restructuring the Economic System, which issued the 'guiding suggestions' (*Zhidao yijian*) for urban joint-stock co-operatives (*Economic Daily*, 7 August 1997).

The effectiveness of above listed mechanisms is subject to a hard budget constraint and the extent of market and inter-jurisdictional competition. Without competitive pressure and a hard budget constraint, they may not function in a positive way. Competition and the hard budget constraint make profits sensitive to the performance of the firm and put the same survival urge before all of the inside and outside owners and managers. As a consequence, profitability and the survival urge may become the shared norms among stakeholders. This competition also disciplines local government agencies to promote and secure better ownership arrangements and to function as a 'helping hand' rather than a 'grabbing hand'.

#### 2.3.4 Risk diversification channels and the flexibility to evolve

Apart from the costs of collective decision-making, theoretical worries over employee-ownership include also the concentration of risks and difficulty of raising capital. The risk concentration argument indicates that when employees invest a significant portion of their wealth in the firm that employs them, they will bear much more risk than that born by pure employees. They not only reduce the diversification of their investment portfolio, but also reduce the diversification between their financial portfolio and their human capital, the source of earning income. If the firm fails in business, they will lose not only their jobs but their savings as well (Hansmann, 1995: 76; Putterman, 1993). The argument about the difficulty of raising capital indicates that because of the asymmetric information and interest differences between employee-owners and outside investors, predominantly employee-owned firms may be less attractive to the outside investors, resulting in under-capitalization (Earle and Estrin, 1996: 11-3).

However, as pointed out by Earle and Estrin (1996: 12), the risk concentration argument ignores the point that human capital risk may be reduced due to reduction in the risks of layoff and in loss of firm-specific investment or rents, once it becomes clear that investing personal savings in the firm also brings employees some control rights. This point is much more relevant for SOEs in transition economies where capital markets are severely underdeveloped, the highest risk for employees is layoff, and for society large-scale layoffs. In addition, if outside funds are rarely available, employee ownership may help to form a modest pool of savings for the firm's survival and capitalization.

For joint-stock co-operatives in the TVE sector, there is a mechanism for risk diversification which has existed since the time of the TVE takeoff. From the very beginning, the township and village communities were diversified producers. They engaged in manufacturing, agriculture, commerce, construction, and transportation activities, whether intentionally or not diversifying risk (Sun, 1997).<sup>12</sup> Some of the joint-stock co-operatives are directly based on the *community conglomerate*, meaning that households and employees hold the shares of the community conglomerate rather than in a single firm. For firm-based joint-stock co-operatives, local employees and their households typically hold shares in other community firms as well and in addition they continue to possess contracting rights to use farm land (Table 2.1).

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<sup>12</sup> At the end of 1996, China had about 35,500 townships and 740,000 villages. On average, each township (with a population of about 24,000) possessed 11.5 township-run non-agricultural firms, and each village (with a population of about 1,200) had 1.54 village-run non-agricultural enterprises.

As we will see in Chapters 3 and 4, the establishment of joint-stock co-operatives in both rural and urban China has greatly strengthened capitalization of the firms rather than the opposite. For small and medium-sized firms, even in an economy with well-developed capital markets, the possibility of raising equity capital from markets is usually very low and the cost is often unbearably high. For them, a feasible and efficient way of raising equity capital is to issue shares to the employees of the firm, community members and their relatives and to attract venture capital through the assistance of community governments.

Compared with joint-stock co-operatives in the TVE sector, those emerging from the SOE and private sectors may have disadvantages in terms of risk diversification. To the extent that these disadvantages become a serious obstacle for the firm's development, they may more urgently need to transform their ownership structure to the limited liability form with management ownership or outside investor-ownership. The flexibility of the joint-stock co-operative ownership form may facilitate this type of transformation well, as has already confirmed by the experiences in Wenzhou, which will be presented in Chapter 5.

The above analysis seems to suggest that for numerous small and medium-sized enterprises in the TVE sector at least, there is no *ex ante* reason to assume that the ownership form of joint-stock co-operative will be a transitory arrangement. Some may grow into limited liability and openly held companies, and some may be closed down due to business failure. However, many of them will continue to enjoy the advantages of this ownership arrangement and many new firms will adopt this ownership arrangement due to its cost-benefit advantages.

It should be highlighted that the mixed role of the community government could be transitory. In the near future, the role of venture capitalist could be separated from the role of administration and regulator. In the long run, the role of venture capitalist could be transferred to real financial institutions or intermediaries once they become functioning and mature.

TABLE 2.1 COMPARATIVE MODELS OF INSIDERS' CONTROL: UNDERSTANDING THE FEATURES OF JOINT-STOCK CO-OPERATIVES

Insiders control whose assets	Model identification and performance	Restraint mechanisms
State assets	SOEs in the transition Privatize profits and socialize losses	Government inspection and intervention
Assets of outside shareholders	Large corporations in USA Competitively strong	a). Competitive markets of capital, products, and managerial labour <ul style="list-style-type: none"> <li>• performance comparison and managerial reputation</li> <li>• threats of take-over, bankruptcy, and exit</li> </ul> b). Shareholders' votes (by hands or by feet) c). Legal and institutional constraints <ul style="list-style-type: none"> <li>rigorous accounting standards</li> <li>extensive mandated disclosure</li> <li>prohibitions on insider dealing</li> <li>procedural rules facilitating shareholder litigation</li> <li>a well-developed financial press</li> </ul>
Insiders' assets plus outsiders (insiders hold a majority of the total shares)	Joint-stock co-operatives in the SME sector in China competitively strong	a). Competitive product markets: Continue or exit b). Hard budget constraint: Threats of liquidation, bankruptcy, and exit c). Shareholders vote by hands (both inside and outside shareholders) d). Benefits from smallness: Information problems are largely internalized e). The local government acts as a major venture capitalist f). Revaluation of shares based on book value, profitability, and collective discussion g). Portfolio risks are diversified by share-holdings in other community firms

Source: author's compilation.

## CHAPTER 3

### LOCAL GOVERNMENT AND OWNERSHIP REFORM OF SMALL AND MEDIUM SOES

*Edward X. Gu*

#### 3.1 Introduction

The Chinese economic reform effort has been least successful in the state sector, especially in large state-owned enterprises (SOEs). From 1992 onward, however, nation-wide reforms of small and medium-sized SOEs have been under way. From an institutional point of view, the major content of these reforms has been the restructuring of small and medium-sized SOEs into different types of corporations, joint-stock co-operatives and companies. For the sake of convenience, these reforms are sometimes called 'small corporatization'. Small corporatization also encompasses the restructuring of urban collectively owned enterprises (COEs). For a long time, almost all urban COEs have been affiliated with and administered by local government organs or SOEs, and are commonly called 'semi-SOEs.'

Small corporatization is part of China's ongoing 'share-holding economic reform,' which to a great extent can be seen as a mixture of denationalization and *de facto* privatization. The mixture refers to a process which 'could embrace any increase in private activity, including the creation of brand new ('start-up') private enterprises, without any reduction in the activity of state enterprises' (Bornstein, 1994: 234). The *de facto* privatization involves the transfer of ownership of state assets into private hands. As will be shown below, a significant amount of state assets have been transferred from the state into private hands during the process of small corporatization.

It is useful to begin by outlining the importance of small and medium-sized enterprises to the Chinese urban economy. In China, industrial enterprises which employ fewer than 300 or have registered capital of less than 8 million yuan and non-industrial enterprises which employ fewer than 200 or have registered capital of less than 5 million yuan are categorized as small and medium-sized enterprises. According to a 1994 survey of urban economy, small and medium-sized enterprises accounted for 96.5 per cent of the total number of enterprises, owned 45.6 per cent of total fixed assets, contributed 63.7 per cent of the urban GDP, and employed 62.6 per cent of urban workers (Li and Wei, 1996: 4-5). The vast majority of small and medium-sized SOEs are administered by local government, and are of great importance to local public finance and employment. Table 3.1 reports the importance of small and medium sized SOEs in the state-owned industrial sector, in which the average size of enterprises is relatively much large. It shows that small and medium sized SOEs in this sector produced over one-third of total output value, possessed about one-third of total assets and employed over 70 per cent of workers.

TABLE 3.1 SMALL AND MEDIUM-SIZED SOES IN THE STATE-OWNED INDUSTRIAL SECTOR (PERCENTAGE)

Year	Number	Output Value	Assets	Employment
1993	95.3	43.3	42.7	73.9
1994	95.0	40.5	38.7	73.3
1995	94.7	38.6	37.0	73.4
1996	94.3	36.7	35.1	73.3
1997	93.5	33.8	32.7	72.2

Sources: *China Statistical Yearbook 1994-1998*; and *China Labour Statistical Yearbook 1994-1998*.

As with many economic reforms in China, small corporatization is an institutional transformation from below. It was first initiated as an experimental reform measure in some areas, and then obtained support from the central government. The backing of the central government, in turn, impelled small corporatization to spread around the country. At local levels, however, small corporatization is a kind of imposed institutional change introduced and executed by local government. A basic objective of local government in conducting such reform is, as the effective owners of SOEs, to seek higher benefits from those state assets under their control and to strengthen their rights to the benefits through restructuring of formal property rights.

As no national statistics are available, this article cannot present a macroeconomic image of small corporatization or assess the impact of small corporatization upon the improvement of the economic performance of the state sector. Instead, the article focuses on the institutional aspects of small corporatization. It is divided into five sections. First, we present five major models for small corporatization. Then we discuss the incentive structure for small corporatization, concentrating on how those local governments that initiated the institutional change made rational choices against the evolving institutional and ideological backgrounds. In the third section, we study the role of the state (in particular local government) in the process of re-contracting property rights arrangements during small corporatization. The fourth section focuses on the institutional consequences of small corporatization by analysing the changing relationship between the state and enterprises. Finally, we examine certain institutional impediments to small corporatization.

### 3.2 Five vehicles for small corporatization

The methods used to carry out small corporatization have so far been quite diverse. In brief, five major techniques can be listed as follows:

#### 3.2.1 Corporatization

Corporatization, by which a considerable number of small enterprises have been converted into limited liability share-holding companies. A common procedure is that the net assets of the original enterprises are converted into legal shares held by government organs, and new investors are attracted to join in the companies by issue of new shares. During this process, a certain number of state-owned shares may be offered for placement. In the resulting converted companies the majority of shares are not necessarily held by governmental bodies. In the city of Shunde in Guangdong Province, where small corporatization was launched earlier than in other areas, only 13 per cent of enterprises

were exclusively owned and controlled by governmental bodies after restructuring in 1994 (Lu, 1996: 76).

In China, corporatization with foreign participation is often denoted by a horticultural term 'grafting.' There are two ways of forming these so-called 'grafted joint ventures' (GJVs): (i) Chinese SOEs convert their existing fixed assets (including production buildings, equipment, lands, etc.) into shares in the joint venture, while the foreign partners invest capital, technology or new equipment; and (ii) Chinese SOEs first restructure themselves into share-holding companies, and then transfer part of their shares to foreign investors. Some economists hold that this is a feasible alternative for reforming corporate governance of SOEs in China (see Wu, 1994: 263-4; Qian, 1995: 239).

In China's current statistics, the GJVs still fall broadly under the category of Chinese-foreign joint ventures (CFJVs). This means that there are no nation-wide statistics of how many GJVs are operating in China, or how many Chinese SOEs have been restructured by forming GJVs. Nevertheless, some separate investigations have shown that many GJVs have been established in coastal areas, and the number is expected to increase in the near future. Because they deal with the problem of *de facto* privatization, a politically sensitive issue, many of these investigation reports have been allowed to appear only in certain internally distributed (*neibu faxing*) publications.

An investigation conducted by the state planning commission into the development of CFJVs in Qingdao, Yantai and Dalian cities shows that, in 1993, 359 (22%) of the 1,629 joint-venture projects approved in Qingdao were GJVs. By April 1994, the Yantai government had approved 1,349 projects for restructuring SOEs or county-level collective enterprises by introducing FDI, accounting for 44% of all FDIs in this city. By the end of 1993, more than US\$1.3 billion of foreign capital was involved in the restructuring of 906 SOEs in Dalian (see The State Planning Commission's Investigation Team 1994: 11-2).

Since the economic reform began in 1978, Fujian Province has been one of the pioneer provinces in adopting an open-door policy and the rapid introduction of foreign capital. By 1993, the provincial government had authorized 4,559 SOEs to restructure with the involvement of foreign capital, representing 31.7 per cent of all kinds of CFJVs established in the province. By the end of March 1994, Fuzhou city, the capital of the province, had authorized 203 GJVs, allowing the introduction of US\$350 million in foreign capital. Some 50 per cent of the industrial enterprises subordinated to the Fuzhou government had been restructured through various ways for utilizing foreign capital. In 1993, approvals for establishing GJVs reached its highest number (see Bi Jiyao, 1994b: 33).

Cities in some provinces in northeastern China have made considerable headway in introducing foreign capital in order to restructure SOEs as well. In Tianjin, for example, 476 SOEs (21.09 per cent of SOEs in this city) had been involved in establishing joint ventures with foreign partners by the end of 1993. In Liaoning Province, 375 SOEs formed GJVs with foreign investors (see Centre for Economic Studies at the State Planning Commission, 1994: 27).

The number of so-called 'grafted joint ventures' soared in 1994, and the wave of 'grafting' since 1993 has stirred up a heated debate over 'economic nationalism,' namely a controversy

over the desirability and justifiability of selling state assets to foreign investors. The debate was directly caused by a high-profile take-over deal which occurred in 1994, by which the Hong Kong-based China Strategy Co. Ltd was involved in restructuring all SOEs in Quanzhou (Fujian Province) into one share-holding company, and acquired a 51 per cent stake of the company's shares. Due to this debate, the wave of 'grafting' decreased in 1995, but it has recovered since 1996 (see Gu, 1998, 1999).

### 3.2.2 *Management-employee buyouts*

Management-employee buyouts, by which SOEs have been restructured into employee-owned firms. It has proved that restructuring enterprises from state ownership to employee ownership was a popular government policy for privatization in many transitional countries (Filatotchev *et al.*, 1996; Earle and Estrin, 1996). SMEs restructured through management-employee buyouts in China, however, are normally called 'joint-stock co-operatives' or 'share-holding co-operatives' (*gufen hezuozhi*). Such a practice is strongly encouraged by the party-state, partly because co-operatives fall into the category of public ownership ideologically and partly because many local governments, when making policy decisions, take into consideration predominantly the maintenance of employment over the short to medium term. Chucheng, a small city located in the Shandong province, was a pioneer of management-employee buyouts. From September 1992 to August 1994, under the leadership of the city government, 272 state-owned and collectively owned SMEs (94.4 per cent of the total enterprise number) were transformed into share-holding co-operatives through a variety of management-employee buyout schemes (Sun, 1997: 20-1).

A normal procedure for management-employee buyouts is as follows: First, the total assets of the enterprise under restructuring, after deducting its debts and non-productive assets (such as dormitories and clinics for employees), are divided into shares; second, the shares of the enterprise are issued to employees; and third, the remaining amount of shares is held by a government body (Expert Group, 1997: 12).

### 3.2.3 *Sales*

Sales, by which the state-owned assets of SOEs are sold to legal persons or individuals. There are numerous ways for SOE sales. Normally, a package deal for selling off all assets and liabilities of a SOE to one or two buyers is welcome by local governments. If there are many potential buyers, an auction approach is frequently adopted. (Expert Group, 1997: 10-1).

### 3.2.4 *Leasing*

Leasing is a transitional arrangement that does not involve any property rights restructuring. The ownership of those enterprises in which state assets are leased to non-state businesspersons for a definite period remains unchanged. Leasing arrangements are normally used for those enterprises that bear heavy liabilities, which nobody would like to buy or take over.

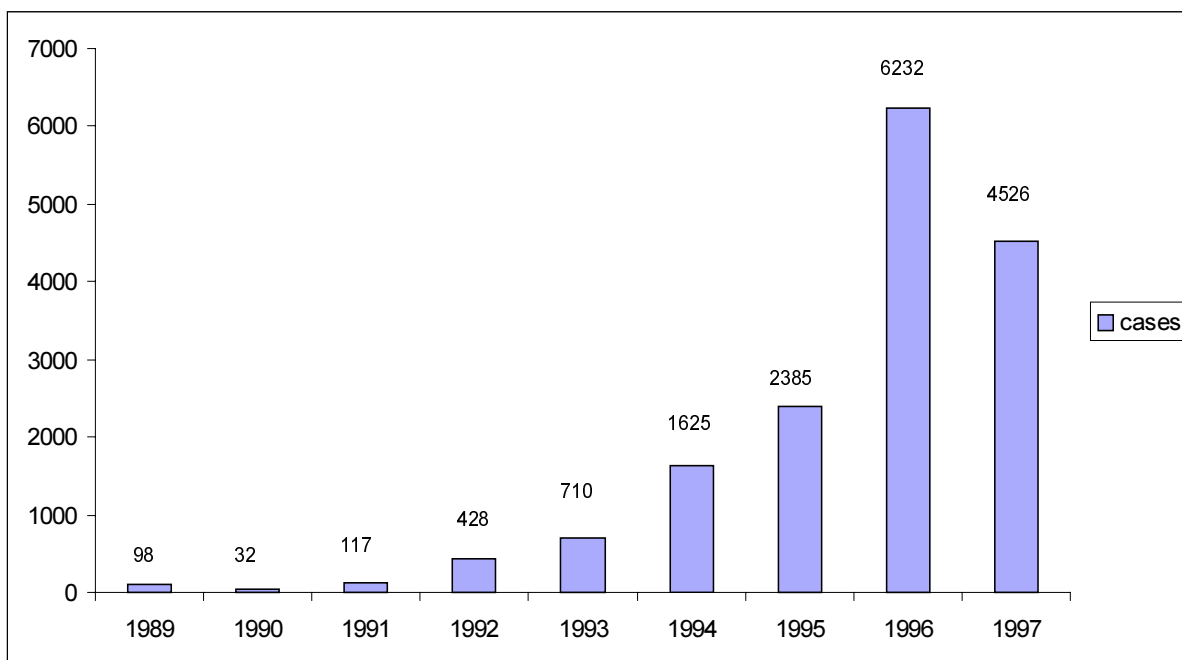
### 3.2.5 *Bankruptcy*

For those enterprises that have too many debts where none of the four above methods is suitable to their restructuring, bankruptcy becomes the last resort. From 1992 onward, the



number of enterprises going bankrupt rapidly increased and peaked in 1996 (see Figure 3.1). The vast majority of bankrupted enterprises fell into the category of small and medium-sized SOEs.

FIGURE 3.1 NUMBER OF ENTERPRISES GOING INTO BANKRUPTCY IN CHINA, 1989-97



Source: *Economic Information Daily*, 28 January 1998.

### 3.3 Why small corporatization? The incentive structure of local government

Small corporatization is a process of institutional change, in which new institutional arrangements are created and adopted to replace old ones. For an institutional change to occur there must be some profitable opportunities that arise from institutional disequilibrium; in other words, there must be some reasons that the existing institutional arrangement is no longer the most efficient one in the choice set (Lin, 1989: 13-4). Indeed, the rise of small corporatization resulted from the inefficiency of the existing institutional arrangements for SOEs. In the early 1990s, ideological changes initiated by high-ranking party-state leaders re-demarcated the boundary of the politically legitimate institutional structure and therefore enlarged the institutional choice set for local actors. Hence these local actors could adopt those institutional arrangements which could bring them more economic advantages. In order to understand this process, we must take a brief look at certain institutional aspects of China's enterprise reform.

#### 3.3.1 The historical context

In the 1980s, among major models for enterprise reform were profit retention systems and contract responsibility systems (CRSs). Before economic reform started in 1979, Chinese SOEs submitted all of their realized profits to their owner, the state. During the initial stages of reform, a variety of profit retention systems was carried out, at the core of which was an institutional arrangement by which a certain amount of profit could be retained by SOEs. Retained profits could be used for the production development fund, the enterprise

welfare fund, and the workers' bonus fund (Lee, 1991: 33-5). During the second half of the 1980s, the Chinese authorities began to impose various CRSs upon the management of SOEs. CRSs were designed to give enterprises sufficient autonomy and sufficiently powerful incentives to allow them to respond to market forces (for more details, see Chen, 1995). The nation-wide implementation of CRSs was achieved in 1992, when SOEs were granted fourteen rights of autonomous management, including setting their own output prices, using and firing labour, and allocating investment finances and fixed capital (Naughton, 1995: 204-5, 294-5).

TABLE 3.2 DEVELOPMENT OF THE NON-STATE SECTORS IN CHINESE NON-AGRICULTURAL ECONOMY, 1980-97 (ALL IN PERCENTAGE)

Year	Share in total IOV*	Share in total employment	Share in state financial revenue**	Share in total retail sales
1980	24.0	40.7	9.3	48.6
1985	35.2	54.6	15.5	59.6
1986	37.7	56.0	27.4	60.6
1987	40.3	57.3	11.5	61.4
1988	43.2	58.1	6.0	60.5
1989	43.9	57.5	16.2	60.9
1990	45.4	60.0	41.4	60.4
1991	43.8	59.9	32.1	59.8
1992	48.5	60.9	27.9	58.7
1993	53.5	63.5	16.2	62.5
1994	62.7	63.1	26.3	68.1
1995	66.0 (67.4)	64.8	33.0	71.2
1996	71.5	66.2	48.6	72.8
1997	74.5	67.0	33.02	76.7

Source: *China Statistical Yearbook 1998*: 130, 433, 595; *China Finance Yearbook 1997*: 461, 480; 1998: 355, 478.

Note: \* IOV = Industrial Output Value; Figures in the bracket in 1995 is calculated in accordance with the new stipulation, which records added IOV rather than gross IOV; \*\* Revenues from bond issues are not included in the calculation.

Some studies have shown that the economic performance (measured by total factor productivity) of SOEs had achieved a considerable degree of improvement during the earlier stages of economic reforms until 1992 (see Li, 1997; Groves *et al.*, 1994; Bai, Li and Wang, 1997; Naughton, 1994). However, productivity growth had been significantly lower for enterprises in the state sector than those in the non-state sector (Perkins, 1996). Since economic reform started in 1978, the non-state sector has been carrying increasing weight in the Chinese economy, and from 1993 onwards the share of non-state enterprises in the industrial gross output value has risen over 50 per cent (see Table 3.2). In brief, it is the non-state sector that has contributed significantly to China's growth 'miracle' during the era of reform (see Tian, 1997).

In the SOE sector, in contrast, the growth of productivity did not necessarily lead to the growth of profits, and as a result governments (central and local) as owners failed to benefit from reform measures up to 1992. The enterprise reform of the 1980s resulted in severe agency problems, which manifested themselves mainly as insider control and

spontaneous privatization (see Qian, 1995). Of course, these problems are common to all transitional economies. 'Insider control (either by the manager and the worker),' as Masahiko Aoki (1995: 7-8) points out, 'appears to be a generic potential in the transition process,' evolving out of inheritances from the planned economy. Common to the reforms of the planned economy was that central planning bureaucrats tried to cope with the problem of economic stagnation by relinquishing most of the planning instruments to the management of SOEs. The managers of SOEs, therefore, gradually built up an irreversible jurisdictional authority within their own SOEs.

In Russia, insider control manifests itself as strong manager control (Aoki, 1995: 9; Litwack, 1995). In China, however, the agency problem of managers was often accompanied by the phenomenon of a coalition between managers and workers in SOEs, as opposed to conflicting interests between the two in a typical capitalist firm, where the managers represent the owners' interest. Workers in SOEs benefited from expanding enterprise autonomy in many ways, including a higher level of wages and bonuses, continued subsidization of residential housing and a variety of welfare provisions, and so forth (Qian, 1995: 224). The collusion between managers and workers was sustained largely because managers needed the umbrella of protection of the masses while they were attempting to gain a greater shares of benefits by insider control. In fact, daring managers could find many ways to gradually transfer state assets under their control into the hands of certain non-state companies which were actually created by their relatives or even themselves (Qian, 1995: 223). From the government point of view, one of the consequences brought about by waves of spontaneous privatization was so-called 'state assets stripping'—which became a popular topic in the Chinese media in 1993 and 1994. A startling account of the magnitude of the practice estimated that some 100 million yuan worth of state assets flowed out of the state coffers each day, or around 30 billion yuan every year.<sup>13</sup>

### 3.3.2 *Local fiscal revenue shortage*

The above analyses of the initial reforms of SOEs reveal the limited effectiveness of reform strategies that do not touch the issue of the property-rights relations in an enterprise. From the point of view of property-rights economics, the source of the problems is that ambiguous property-rights relations between the state and the enterprise turn into ambiguous distributional arrangements and control rights. As it became in some cases a *de facto* privatization, small corporatization is indeed more radical than previous models of enterprise reform. Harvey B. Feigenbaum and Jeffery R. Henig distinguish three types of privatization. The first two are *systematic* and *tactical* privatizations: ones based on some grand political-ideological projects purporting to transform societies, and ones developed to achieve short-term political goals. The small corporatization in China corresponds to the third category to a great extent, i.e., what they call *pragmatic* privatization, which is normally undertaken for budgetary reasons (Feigenbaum and Henig, 1997: 341-2).

As a matter of fact, the operational situation of Chinese SOEs rapidly deteriorated in the early 1990s. The SOE sector as a whole experienced a rapid increase in losses (see Table

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<sup>13</sup> See *Gunagming Daily*, 5 October 1993: 1.

3.3). While SOEs showed higher liability-asset ratios and lower profit-capital ratios in comparison with all industrial enterprises with the independent accounting system, the situation of small and medium-sized SOEs had been the worst (see Tables 3.4 and 3.5).

TABLE 3.3 LOSSES OF STATE-OWNED INDUSTRIAL ENTERPRISES

Year	Amount of losses (billion yuan)	SOEs at Loss / SOE Total Number (%)	Total Losses / Total Pre-tax Profits (%)	Total Losses / Total Net Profits (%)
1978	4.21	19.30	5.32	8.27
1979	3.64	17.64	4.21	6.46
1980	3.43	19.17	3.78	5.86
1981	4.60	22.90	4.93	7.93
1982	4.76	20.78	4.89	7.96
1983	3.21	12.75	3.11	5.01
1984	2.67	10.20	2.31	3.77
1985	3.24	9.66	2.43	2.43
1986	5.45	13.07	4.06	7.90
1987	6.10	13.00	4.03	7.76
1988	8.19	10.91	4.62	9.18
1989	18.02	16.03	10.16	24.25
1990	34.88	27.55	23.20	89.86
1991	36.70	25.84	22.09	91.25
1992	36.93	23.36	18.99	69.01
1993	45.26	28.78	18.44	55.39
1994	48.26	30.89	16.78	58.21
1995	63.96	33.53	22.25	96.09
1996	79.07	37.70	28.89	191.61
1997	83.10	43.90	28.58	194.22

Sources: *China Statistical Yearbook 1998*: 461; *China Finance Yearbook 1997*: 482; 1998: 482.

TABLE 3.4 LIABILITY-ASSET RATIO OF CHINESE INDUSTRIAL ENTERPRISES WITH THE INDEPENDENT ACCOUNTING SYSTEM (PERCENTAGE)

Year	All	Large	Medium	Small	State-owned	Large	Medium	Small
1993	74.38	69.34	83.53	75.56	75.68	74.68	83.49	81.89
1994	66.66	62.39	72.65	69.38	--	--	--	--
1995	64.86	61.28	69.38	67.60	65.62	62.25	71.65	71.51
1996	64.73	60.46	70.35	68.32	65.06	61.13	72.30	72.34
1997	63.94	60.03	69.61	67.35	64.82	61.09	72.23	72.77

Sources: *Chinese Statistical Yearbook*, various years.

Note: Liability-asset ratio = liquid liabilities + long-term liabilities / total assets × 100%.

In 1993, 30.8 per cent of small and medium-sized SOEs ran at a loss. According to a 1994 investigation of 47,000 small and medium-sized SOEs conducted by the Ministry of Finance, the average liability-asset ratio of this group reached 84.1 per cent, much higher than the average level in the SOE sector at that time. In that year, the average capital-output ratio in the SOE sector was 6.7 per cent; and the ratios in large, medium-sized and

small SOEs (respectively owned and administered by the central government, provincial governments, and city/county governments) were 9.1 per cent, 4.7 per cent, and 4.5 per cent. In general, government subsidies to loss-making small and medium SOEs had become a heavy burden for local government in many places in the early 1990s (Lu, 1996: 30; Table 3.6).

TABLE 3.5 PROFIT-CAPITAL RATIO OF CHINESE INDUSTRIAL ENTERPRISES WITH THE INDEPENDENT ACCOUNTING SYSTEM (PERCENTAGE)\*

Year	All	Large	Medium	Small	State-owned	Large	Medium	Small
1993	10.33	11.88	9.42	8.97	9.68	11.26	8.62	6.45
1994	10.21	12.60	7.90	8.28	9.77	12.27	7.01	4.76
1995	8.29	10.57	6.19	6.22	8.01	10.05	5.39	3.48
1996	7.11	8.98	4.78	5.64	6.54	8.37	3.99	2.36
1997	6.92	8.51	4.63	5.71	6.27	8.07	3.48	2.01

Source: *Chinese Statistical Yearbook*, various years.

Note: Profit-capital ratio = pre-tax profit / average net fixed assets + average balance of working capital × 100%.

TABLE 3.6 GOVERNMENT SUBSIDIES TO LOSS-MAKING SOES IN THE 1990S (BILLION YUAN)\*

Year	From central government	Proportion A (%)	From local government	Proportion B (%)
1991	20.00	13.18	31.02	13.51
1992	16.82	6.97	30.94	8.84
1993	10.19	4.07	27.67	7.86
1994	5.77	1.24	30.85	6.56
1995	6.47	1.20	26.89	4.87
1996	7.18	1.15	26.56	4.11
1997	9.93	1.36	26.36	3.62

Source: *China Finance Yearbook*, various years.

Note: \* all figures in the table are calculated from final accounting of revenue and expenditure. Proportion A = Subsidies from the Central Government / Fiscal Expenditure of the Central Government; and Proportion B = Subsidies from Local Governments / Fiscal Expenditure of Local Governments.

Chucheng city provides a good example. In 1992, the city government investigated all SOEs and urban collective enterprises under its jurisdiction, and surprisingly found that 68.7 per cent of them were running at a loss if following the standard accounting system. The total value of the explicit and implicit losses reached 147 million yuan. The investigation also found that most local SOEs and collective firms had ignored the necessary compensation for the state assets for a long period and the devaluation of state assets was significant. Meanwhile, tax payments received from them steadily declined, amounting to only 110 million yuan in that year. Combined with the fixed fiscal subsidies from the provincial government, the city's total fiscal funds were still not sufficient to balance payments for salaries, and for running government organs and the public sector. As a consequence, salaries for teachers and other local civil servants appeared to be in

arrears in some months in the early 1990s. How to solve this fiscal crisis became the most pressing challenge to the city's government.

Under the circumstances of a soft budget constraint in the past, the budgetary crises did not constitute a serious headache to local officials. However, the process of fiscal decentralization since the reform began in the late 1970s, in particular the implementation of a tax assignment system since 1994, has resulted in the existence of a *de facto* fiscal or even political federalism, in which the budget constraint upon local governments had become hardened (see Wong, 1991; Cao, Qian, and Weingast, 1998). When their budgets are under this type of pressure, it is rational for local governments to consider selling off a certain amount of state assets under their control to ease their financial difficulty. In an interview conducted in 1996, Chen Guang, mayor of Chucheng city, gave an explanation of why he promoted the sales of SOEs and urban collective firms in 1992: 'In my city, the total salaries (for employees in the public sector) were about 5.5 million yuan per month. If salaries had been in arrears even by some days, I would have been sworn at by many people. But where could I obtain the money? One after another enterprise was running at a loss. I really had no choice. I was forced to make the choice (of selling SOEs)'.<sup>14</sup>

### 3.3.3 *Insider control is being out of control*

Another driving force behind small corporatization was the disequilibrium of the existing institutional structure. As owners of small and medium-sized SOEs, many local governments found that the profitable opportunities arising from the existing institutional structure were ever decreasing.

For example, industrialization in Shude city (which had been an agricultural town) developed rapidly in the 1980s. Many SOEs and TVEs administered by the city government grew up depending upon bank loans borrowed with government guarantees. Contract responsibility systems were imposed upon almost all enterprises by the government. At the beginning of the 1990s, however, the city government found that a great number of SOEs had become *de facto* managers-owned, and state assets had become the private assets of managers as well as their relatives. In many enterprises, the managers were in collusion with the employees, sharing almost all profits and even assets. It became harder and harder for the government as the owner to retrieve any profit revenues from enterprises. But as the guarantor of credit, the government had to bear the responsibility for the huge amount of debt that enterprises under its jurisdiction owed (Zhang and Zhu, 1995: 38). In other words, local officials became aware of the existence of the problems of agency, insider control, and spontaneous privatization, although they could not use these terms directly at that time.

### 3.3.4 *Ideological change and the extension of ownership choice set*

Facing problems of fiscal crisis and institutional disequilibrium, local government has a great incentive to impose certain institutional changes. But the question is why small corporatization has become the common model for institutional changes. To answer this question, we must take into account the ideological and policy context within which small

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<sup>14</sup> See *Chinese Youth*, No. 2, 1996: 14.

corporatization took place. In as early as the mid-1980s, a number of Chinese economists<sup>15</sup> presented a bold policy proposal for 'share-holding system reform' (*gufenzhi gaige*), namely, systematically restructuring SOEs into share holding companies (Fewsmith, 1994: 185-7). The experiments with the share-holding system reform were initiated in the same years. By the end of the 1980s, more than 3000 'experimental share-holding companies' had been established (Naughton, 1996: 221-2; Ma, 1995: 161-4). Nevertheless, the 'share-holding system reform' was limited to the experimental stage until 1992 because of ideological disputes, in particular one taking place after 1989 over whether a share-holding system is in essence socialist or capitalist.

The role of ideology in institutional changes has been touched on in Douglass C. North's works (45-58; 1990: 22-3, 86). Ideology is a set of beliefs about the world, by which people make moral judgements about many things (including institutional arrangements) in the world. The space for institutional choice is often limited because some specific ideologies deny the legitimacy of some specific institutional arrangements. For a long time, the legitimacy of share-holding system reform had been doubted under the shadow of the dispute over 'socialism versus capitalism'.

Deng Xiaoping's widely publicized tour of south China in January and February 1992 was a turning point. During this inspection tour, Deng, then China's paramount leader, delivered a number of talks to local government officials, in order to launch a reformist ideological offensive against conservative hardliners and to create a favourable climate for the party-state's new reform initiatives. At the core of Deng's talks was his pragmatic perception of socialism. To judge whether something is socialist or not, Deng argued, depends upon 'whether it promotes the growth of the productive forces in a socialist country, increases the overall strength of the socialist state and raises living standards' (see Zhang, 1996: 159, 183-92). From then on, a deideologized political atmosphere of developed, and as a result the ideologically legitimate space for institutional choice greatly widened (Expert Group, 1997: 28).

According to North (1990), institutional change is path dependent. As far as the Chinese case is concerned, the small corporatization that has taken place since 1992 is to a great extent rooted in certain reform experiments launched in the mid-1980s. Although they were quite different from the approach to corporatization that eventually developed, these experiments on 'share-holding system reforms' directly fostered the development of China's capital markets. After a variety of securities (mainly stocks and bonds) emerged, the institutional demand for their exchange was naturally engendered. During the late-1980s, various securities exchange activities sprang up spontaneously in many areas. The authorities attempted to ban such activities many times, but eventually allowed them to be legalized (for more details, see Chen, 1996). In November 1990 and July 1991, two stock exchanges were formally established in Shanghai and Shenzhen respectively (see Mookerjee and Yu, 1995). The establishment and development of capital markets in China laid the institutional foundation for the implementation of the corporatization and privatization of SOEs.

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<sup>15</sup> E.g., Professor Li Yining at Beijing University.

Within the ideological context of Deng's 'talks during the tour of south China', the party's Fourteenth National Congress in October 1992, formally put forward a theory on 'socialist market economy', upgrading the status of the market within the official ideology to an unprecedented degree. On the policy agenda, the congress's political report suggested that the experiments on 'share-holding system reforms' be extended, and that small SOEs could be leased or even sold to any organizations and individuals (Saich, 1992: 1137-44). As a result, small corporatization started in some areas with the active promotion of local government, but in many other areas prudent local governments hesitated and looked around.

The reformist initiatives for small corporatization by some local governments obtained support from the central government. In November 1993, the third plenum of CCP's fourteenth congress ensured that 'small SOEs can be operated with the contract responsibility systems, or be leased; some of them can be restructured as share-holding co-operatives, and some can be sold off to collectives or individuals'. Later on, the central government formulated a further policy principle of 'controlling the large and liberalizing the small'. That is to say, the central government should keep about 1,000 large SOEs under control and leave local governments as much policy flexibility as possible to liberalize and eventually vitalize small and medium-sized SOEs. In September 1997, the CCP's fifteenth congress endorsed a comprehensive plan for implementing the share-holding system reform all over the country—small corporatization was reconfirmed in this programme.

### **3.4 Recontracting for property rights: the role of the state**

One of the most important tasks in small corporatization was the clarification of property rights in SOEs. The situation where the property rights of existing SOEs are unclear is an institutional legacy of the planned economy. Within the institutional structure of the planned economy, the majority of Chinese enterprises (including SOEs and some collectively owned enterprises) were set up with state investments. Concrete investors might be government organs, SOEs, and state-owned non-profit organizations. For many SOEs, there were multiple original investors. Different SOEs were administered and controlled by different government organs. During the process of decentralization since the early 1970s, the administrative power over some SOEs that were founded on the basis of central government investments was transferred to local governments. By the end of the 1980s, local government had taken the ownership of the vast majority of Chinese SOEs, most of them small and medium-sized (Sun, 1997: 13-6; Granick, 1990).

The clarification of property rights arrangements was a process of recontracting for property rights, in which the state and its government bodies played an indispensable, irreplaceable role because of their authority to claim the '*monopoly of the legitimate use of physical force within a given territory*' (see Gerth and Mills, 1981: 78, emphasis in original). During the process of corporatization, local governments—as both the monopolizers of coercive forces at the local level and the owners of local SOEs—imposed on other relevant actors the recontracting for property rights of SOEs. By constantly amending the boundary of the institutional choice set for local actors through policy change, the central government indirectly influenced the process of property rights recontracting.



The process of property rights clarification did not occur in an institutional vacuum. It was shaped by some existing institutional arrangements and policy legacies. During small corporatization, there were three tough problems involving the recontracting of property rights.

The first problem facing different actors is how to assign the property rights to the assets that were formed by retained profits under the profit retention systems. During the 1985-92 experimental share-holding system reform, these assets were regarded as the SOEs' own property, and categorized as so-called 'enterprise collective shares' (*qiye jiti gu*) (Ma, 1995: 163-4). Such a practice, however, has been abandoned during small corporatization since 1992. In Shunde, the city government no longer recognized that all the profits retained by SOEs under the profit retention systems belonged to the enterprises. Instead, only the assets accumulated based on the enterprise welfare fund and the workers' bonus fund, which originated from part of retained profits, were allowed to be recontracted as 'enterprise employee shares' (*qiye zhigong gu*) (Deng, 1996: 139). In Chucheng, where the strength of the local government was stronger than that in areas of Guangdong province, the city government defined all assets in SOEs as state assets (Editorial Board, 1996: 146).

A second problem was how to deal with the assets that were generated by government loans. Before the reforms, SOEs received most circulating capital and all capital investment funds as budgetary grants, and they then remitted all profits and a large share of depreciation allowances to the government. To raise the efficiency of state investment, government policy loans delivered through state-owned banks have increasingly replaced budgetary grants since 1979 (Tidrick and Chen, 1987: 4-5). Over the past two decades, many SOEs which were set up or expanded by policy loans have paid back all the capital (loans) received plus interest. From their point of view, the enterprise assets that were formed on the basis of these policy loans should belong to, and their property rights should be assigned to, all employees. From the government point of view, however, policy loans under the scheme of so-called 'replacing appropriations with loans' (*bo gai dai*) were not genuine bank loans, but in the nature of state investments that were delivered in the form of bank loans. Therefore, the part of the assets of enterprises related to policy loans should be considered as state assets. Up to the present, the Chinese investment system has undergone little change, and the central government has failed to formulate a unified policy to deal with this problem (Sun, 1999).

The third—and perhaps most controversial—problem was how to clarify the property rights of collectively owned enterprises in the urban areas. According to the normal perception of the existing institutional arrangement, enterprises of this sort should be owned by their present and former employees. Therefore, the property rights of urban collective enterprises should be freely assigned to their employees (including those retired employees). From the government point of view, however, part of the assets of many urban collective enterprises should be state assets because they obtained investment funds from the state, and/or they were granted policy loans (with preferential interest rates). In many cases, the majority of assets in these enterprises have come from investments by many different investors, including individuals, collectives, and state organs. Under the original institutional conditions, registration of the 'ownership rights' to these investments was absent, and a shift in investors (in particular institutional investors) often happened. Within

such a context, the clarification and assignment of the property rights in urban collective enterprises is a very difficult job.

To promote the progress of small corporatization and to avoid resistance from enterprises, many local governments simply abandoned their claims to state assets in some or all of the urban collective enterprises under their jurisdiction. The state assets bureaux, in particular the National Bureau of State Assets Management (NBSAM), are normally opposed to such a practice. In some areas, for instance, in Chucheng, the government laid aside the assignment of property rights of urban collective enterprises during the initial phases of small corporatization. The revenues from the sales of assets in these firms were saved in a special account of the Municipal Bureau of State Assets Management, and the government waited for new policy guidelines from the central government (Editorial Board, 1996: 146-7). On 25 November 1994, the NBSAM promulgated 'Temporary Regulations upon the Property Rights Clarification of the State Assets in Collectively Owned Enterprises,' emphasizing the principle of 'who ever invested possesses the property rights.' This policy document strengthened the power of local governments to take charge of affairs such as state assets management, finance and taxation in the process of property rights clarification (*China State Assets Yearbook 1997*: 256-8). Nevertheless, it is very difficult on many occasions to discern who the original investors in COEs were. Therefore, there is a lot of leeway for local government to exercise discretionary power in dealing with the recontracting of COE property rights.

### **3.5. Consequences of local SOE ownership reform: changes in government-enterprise relations**

Small corporatization can be categorized as an institutional change imposed by local governments. The question remains: is the government (typically local governments) gradually withdrawing from business during small corporatization? As is well known, one of the disadvantages of China's existing SOE system was the existence of frequent, intrusive government intervention in the operation of enterprises. Therefore, one of the principles for SOE reforms has been separating business from government (*zhengqi fenkai*), namely decreasing the administrative power of the government over business and leaving more space for the functioning of market forces. But meanwhile, as many authors (e.g., Amsden, Kochanowicz and Taylor, 1994) have argued, during the process of transition from the planned to the market economy, both the central and local governments must play a substantially positive role in pushing the process forward.

As far as the case of China's small corporatization is concerned, rational local governments definitely would not like to do anything that may be harmful to their own interests. Plausibly, small corporatization as a process led by local government has strengthened the control of local government over restructured enterprises. At the core of small corporatization are, of course, the changes in the enterprise system. Because of the inter-relatedness of institutional changes, changes in particular institutional arrangements may result in corresponding changes in demand for changes of other institutional arrangements as well (Lin, 1989: 17). One of the motivations for local government to launch small corporatization was to prevent the escalation of the problem of insider control. Accordingly, certain positive changes in the government itself have also been brought about by small corporatization.

### 3.5.1 *Reforming state assets management system: local government as shareholder and/or venture capitalist*

During small corporatization, local government has played an important role in the process of recontracting for property rights of state assets. Accompanying this process was the reform of the state assets management system. Central to the reform was a clear statement of which government organ would represent the state to hold and manage state-owned shares.

From 1988 onward, China's state assets management system has undergone dramatic organizational changes. The key structural manifestation of these changes is the formation of a new multi-tier state assets management system, which comprises a network of organizations at the central and sub-central levels (see World Bank, 1997: 33-47). State Assets Management Bureaux, which take charge of the policy-making about and regulation of state assets management, have been established at four government levels, national, provincial, municipal, and county. By 1996, the bureaux had been established in all provinces and cities, and in 94.4 per cent of counties (*China State Assets Yearbook 1997*: 87). During the period from 1990 to 1994, the National Bureau of State Assets Management (NBSAM) organized a large-scale campaign to verify the value of state assets. Revaluation and re-registration of all state assets owned and occupied by SOEs and non-profit state organizations were compulsory. Since 1994, local government at various levels have set up a variety of state assets management companies, mostly in the form of share-holding companies.

During the process of small corporatization, the state assets management bureaux of local governments played an important role in policy-making, assets valuation, property rights clarification and assignment, and so forth. In some areas, the restructuring of small and medium-sized SOEs gave direct impetus to the *corporatization of state assets management* organs, namely the setting-up of the above mentioned share-holding companies. This practice became very popular in coastal areas. In Shunde, for instance, four state assets management share-holding companies had been formed by 1997 (Lu, 1996: 77-8).

In other areas where small corporatization proceeded well, however, the corporatization of state assets management organs showed little progress. In Chucheng, for example, the Municipal State Assets Management Bureau took charge of both administrative regulation and commercial operation of state assets. During the restructuring of local SOEs and collective firms, the Bureau administered the transfer of state assets from state to private hands (Wu and Zhang, 1995: 27). This practice was definitely burdened with contradictions and conflicts of interest. It seems that the corporatization of state assets management organs is an indispensable step for consolidating the institutional achievements of SOE restructuring.

### 3.5.2 *The strengthening of corporate governance*

Like other transition economies, China is facing the challenge of strengthening the corporate governance of its SOEs through the introduction of market-oriented incentives. One of the institutional consequences of small corporatization is that the corporate governance structure of small and medium-sized SOEs has been greatly transformed. In the light of China's 1993 company law, all restructured enterprises should be formed as

either limited liability companies or share holding companies, and they should set up regular meetings of shareholders and boards of directors. This law requires small limited liability companies to appoint an executive director rather than set up a board of directors. That executive director may also be appointed as the manager of the company. For a large limited liability company or a share holding company, the law requires it to set up a board of supervisors in order to supervise directors and senior managers and to ensure that they fulfil their responsibilities. All of these developments in institution building, as Mallin and Xie (1998: 37) argue, clearly indicate that 'attention is being paid to the development of these aspects of corporate governance in China, and that, what could be termed the 'rule of man', is becoming more oriented towards, and embodied in, the 'rule of law'.'

In China, however, like in other mature market economies, the question remains open as to who is really controlling the companies after small corporatization and how the corporate governance of these companies can be strengthened to improve their performance. Two problems were common to many companies after restructuring: First, the concept of the meetings of shareholders and the board of directors is so unfamiliar that managers feel at a loss what to do; second, the problem of management control continues to be out of control, so that neither the board of directors nor the board of supervisors can check and balance managers (see Editorial Board, 1996: 127). The latter problem is a continuation of the problem of 'insider control' in SOEs.

There have so far been no systematic empirical studies of corporate governance of those companies which have been transformed from small and medium-sized SOEs, because small corporatization has yet to be completed in many areas. In this research, we are concerned with the question of whether the extent of government intervention in corporate operation has decreased after the formal structure of corporate governance has been set up. Theoretically, the establishment of corporate governance should constitute an institutional impediment to government administrative intervention into the productive and commercial operation of enterprises. In reality, however, it is not necessarily the case. On some occasions, after SOEs have been restructured, the majority shares of newly formed companies are held by shareholding companies run by local government. In these circumstances, it is likely that, in pursuit of certain specific interests, local government may continue to utilize or even abuse the political power they possess to intervene in the business of companies.

Government intervention may be carried out directly by administrative means or indirectly by commercial means through the government shareholding companies. Through intervention, local government may impose upon managers and other shareholders of the companies some deals they would not be willing to accept under normal circumstances. Frequently, some local governments (or state-owned shareholding companies) sell their stakes of a company's shares to a third party at a discount without consulting with the managers and other shareholders of the company. Even if the managers and other shareholders are opposed to the deal, those local governments are inclined to use their status as major shareholders to force other minor shareholders to accept the deal. There are only two possible reasons for local government to make such money-losing deals. First, they are facing a severe fiscal crisis, so that they are eager to cash in the stakes in their hands; second, they have received bribes from the buyers.

Another key point in corporate governance is the right to appoint and to dismiss top managers of the enterprise. Within the existing Chinese institutional structure, however, all managers of SOEs are categorized as 'cadres' and their appointment and dismissal is firmly controlled by the party-state's personnel departments. The Party Organizational Department is the most important and powerful agency which has the ultimate control over personnel above a certain administrative rank; this is the principle known as the 'party controlling personnel' (Qian, 1995: 126-7). In many places, small corporatization has failed to have any impact upon the principle of 'party controlling personnel'. For example, during small corporatization, the city government of Chucheng stipulated in many policy documents that the board of directors were entitled to appoint and dismiss the chief manager, the deputy chief manager, and the chief accountant of the enterprise. But at the same time, these documents also stress that when a SOE is set up or under restructuring, the party-state departments in charge of personnel management must be conscientious in their work of examining, nominating, and approving the managers of the enterprises (Editorial Board, 1996: 94, 111). While the principle of party controlling personnel may reduce the costs of insider control at the present stage of reform, how to gradually reduce the accompanying costs of political and bureaucratic interference remains to be a challenge to China's forthcoming reform (cf. Section 2.2).

### *3.5.3 The promotion of local administrative reforms*

In many areas where small corporatization has been launched, the administrative reform of local government has been promoted to some extent. One of the most evident changes was that many local governments abolished their industrial bureaux, which existed as one heritage of a planned economy. Before small corporatization, various industrial bureaux of Chucheng city government as the superiors of SOEs often asked enterprises to sponsor many of their activities, which was not helpful to those enterprises. After small corporatization, such burdens upon enterprises have been greatly reduced because these government organs have been abolished (Zang, 1995: 47).

Naturally, the abolition of some government organs would encounter strong resistance from bureaucracy. In Quanzhou, more than 10 industrial bureaux were abolished after the China Strategy Co. took over all the SOEs administered by the city government. The officials of these organs, therefore, were very unhappy with the decision of the city government. They managed to deliver their complaints to their superiors, namely industrial departments in the central government, attacking the Quanzhou city government as a 'traitor' by appealing to economic nationalism (see Gu, 1998: 63-4). To weaken the resistance to small corporatization from certain bureaucratic organizations, some local governments managed to transform these government organs into state-owned shareholding companies (Zhao, 1997: 48).

## **3.6 Remaining institutional bottlenecks and impediments to small corporatization**

As described above, one of the driving forces for small corporatization is that many small SOEs and urban collective enterprises have accumulated dangerous levels of debt. Therefore, small corporatization must be accompanied by debt restructuring. A considerable number of enterprises must go bankrupt. However, there are many institutional impediments that constitute obstacles to debt restructuring and bankruptcy.

### *3.6.1 Problems with debt restructuring*

The problem of high indebtedness has its roots in the existing SOE institutional structure. First, without an institutional arrangement for capitalization, many SOEs were set up almost totally by bank loans. Second, without recapitalization, the daily operation of these enterprises also heavily depended upon bank loans. And third, many incorrect investment decisions of SOEs were actually made by those government organs that controlled these enterprises.

As a matter of fact, the problem of high indebtedness is also common among large SOEs, and constitutes a major obstacle to their restructuring in the direction of corporatization. Small corporatization is relatively easy to push forward partly because the amount of bad debt in the small and medium-sized SOE sector is relatively small, although the debt/asset ratio in this sector is relatively higher (Table 3.4).

During small corporatization, there emerged many ways of dealing with debt restructuring. In general, what new investors bought were the net assets of SOEs. That is to say, they gained the assets while they must bear the debts. For the sales of those enterprises whose net assets were negative, local governments managed to attract potential buyers by offering a variety of preferential schemes, such as reduction of land use fees and tax rebates. In some cases of restructuring SOEs into share-holding co-operatives, various types of debt-equity-swap schemes were adopted (Expert Group, 1997: 18-9).

The problem of debt restructuring can be resolved relatively easily if the first three methods for small corporatization mentioned in Section 3.2 are adopted by local actors. However, if the debt burden of a SOE is too heavy to attract anyone to buy it and bankruptcy is also not a good measure, leasing offers a last way out. No lessee would like to undertake all or part of debts in enterprises. Under such consequences, a common step was that the owners of local SOEs, i.e. local governments, froze the existing bank accounts of the leased enterprises and opened new bank accounts for them. The part of the debts that the leasees did not undertake under the leasing agreements was not counted into the new accounts. The problem of debt restructuring would be dealt with after the operations of those enterprises began to improve (Expert Group, 1997: 19) But, because of the information asymmetry, leasees had many possibilities to still obtain many substantial benefits without improving the operations of the enterprises. In other words, the problems of insider control and spontaneous privatization under the structure of the existing management responsibility systems would become worse under leasing. Therefore, leasing as a transitional institutional arrangement should not be adopted unless outsider control can easily be carried out, and if adopted must be used for only a reasonably short period.

### *3.6.2 Institutional limits for corporate (enterprise) bankruptcy*

Many small and medium-sized SOEs are running at a heavy loss and their debt/asset ratio is too high. If they operated in a mature market economy, the only way out for them would be bankruptcy. In China, however, a unified legal framework for corporate (enterprise) bankruptcy is still absent. Corporate bankruptcy is basically controlled by local government. A bankruptcy law for state-owned enterprises (hereafter referred to as the Bankruptcy Law) was passed by the Chinese People's Congress as early as December 1986 (see Chang, 1987). However, cases of corporate bankruptcy were very rare until 1994. In

October 1994, the central government issued a policy, pushing an experiment with corporate bankruptcy in 18 cities. Later, the reform experiment was extended in 110 cities. Top priority was given to making proper arrangements for the placement or re-employment of the workers of bankrupt enterprises. According to the new policy, the so-called 'allowance for workers' placement' (*zhigong anzhi fei*) was allowed to be retrieved from the enterprise assets after liquidation. After the implementation of this 'preferential' policy, the cases of corporate bankruptcies rapidly increased, and reached the peak number of 6,232 in 1996 (see Figure 3.1). It is worth noting that only 1.9 per cent of bankruptcy cases was filed by creditor banks. The vast majority of corporate bankruptcies were pushed forward by local government (see Cao, 1997).

Among the cases of corporate bankruptcy, many fell into the category of 'bankruptcy frauds.' With the support from local governments, some bankrupt enterprises managed to decrease the repayment to creditors to the greatest extent by increasing the allowances for workers' replacement and undervaluing the assets (Tan, 1997). State Banks and the central government were heavily hit by bankruptcy frauds, because the major creditors of bankrupt enterprises were state banks and the four biggest Chinese banks are owned by the central government. Local governments and enterprises were the beneficiaries of bankruptcy frauds. Many 'bankrupt enterprises' reopened without any organizational restructuring after casting off their debt burdens (see Zhang, 1997; Tan, 1997). Because of the flourishing of bankruptcy frauds, the central government issued a new regulation, aiming at making bankruptcy 'be formalized'. This new policy strengthened the veto power of banks, while the power of local governments was not decreased. Without an institutional framework in which the conflict of interests among different parties can be eased, the number of bankruptcy cases decreased in 1997 (see Figure 3.1).

As many institutional obstacles exist, bankruptcy is normally used as the last resort for enterprise restructuring during small corporatization. Many SOEs that sustain chronic losses have to continue their operations, which has dragged down the overall economic effect of small corporatization. However, the improvement of the Chinese bankruptcy institutions must wait for the changes in many other institutional realms. A critical issue is the reform of the banking system, so that there would be an incentive structure for banks to play an active and positive rather than passive role in corporate bankruptcies. Another important issue is to amend the rules of the game, gradually decreasing the intervention of local governments in the process of corporate bankruptcy and eventually forcing them to withdraw completely from the legal process.

### *3.6.3 Reform of the social security system*

The main reason that the authorities are unwilling to allow technically bankrupt enterprises to really go bankrupt is because of the inadequacy of China's social security system. During the process of the enterprise reform, including small corporatization, one of the toughest problems facing both central and local governments is how to, and who should, pay compensations to retired and laid-off workers. As a matter of fact, a lifetime employment system has been operated in the state sector for more than four decades, and to carry out the government policy of full employment a great number of redundant workers have been employed by SOEs. According to a survey of 142 SOEs conducted by the World Bank in 1994, about 85 per cent of the managers interviewed acknowledged that

there were considerable numbers of redundant workers in the enterprises under their management (see Table 3.7).

TABLE 3.7 REDUNDANT WORKERS IN 142 SOES, FIRST QUARTER OF 1994

Percentage of redundant workers in total employment	Share in surveyed enterprises
More than 30	17.0
20 to 30	16.2
10 to 20	26.8
5 to 10	24.6

Source: World Bank (1996: 14).

Some fragmentary surveys conducted by Chinese economists suggest that the problem of overmanning was even more severe. It is estimated that in the mid-1990s there were at least 15 million redundant workers in SOEs, amounting to one-third of the total number of employees (see Lin *et al.*, 1997: 102; Yang *et al.*, 1998: 123). Generally speaking, the quality of workers in the sector of small and medium-sized SOEs (measured by their educational level and skill) is lower than that of those employed by large SOEs (see Li and Wei, 1996: 26, 28). As a result, the proportion re-employed of those laid off by small and medium-sized SOEs is likely to be low.

Changes in different institutional realms are interlocked. The smooth progress of small corporatization is dependent upon how fast a social safety net can be built up. Within the pre-reform institutional structure, there was no genuine social security system, but only a work-unit-based one. Pensions were paid by the work-units from which the pensioner retired. Medical expenses of all current and retired employees were also paid by their work-units. Such a work-unit-based social security system constitutes an institutional impediment to any radical organizational restructuring of enterprises.

China's reform of the pension provision system started in 1984. An unemployment insurance scheme covering SOE workers was established in 1986. A comprehensive reform of the public medical care system began in 1992. What these reforms in different realms of the social security system have in common is that new programmes are set up in the form of a social pooling system. Enterprises (employers) and individual workers (employees) participating in pooling programmes put a portion of their total wages into different insurance funds which are managed by local government. Contribution rates to different insurance funds in different areas are also decided by the local government (see White and Shang, 1996). In the late 1980s and the early 1990s, these reforms were carried out experimentally, and the coverage of the new insurance programmes was limited to SOE employees. These social pooling programmes, which were basically administered by city or county governments, were too decentralized and localized to be operated efficiently. In the mid-1990s and late 1990s, the social security reforms have accelerated, moving in the direction of extending coverage to employees in the non-state sector and moving the administration of social pooling programmes to the provincial level.

In some areas, small corporatization and social security reforms are mutually reinforcing. Many functions of delivering social security provisions have been gradually shifted into



the hands of social insurance organizations run by local government. During small corporatization, the Shunde municipal government raised some funds from state-asset sales to set up an insurance company, which took over all the pensions of restructured enterprises. Since 1992, the city government has imposed compulsory old age and medical insurance systems upon all employees (Expert Group, 1997: 19-20).

Because the central government has so far not imposed a unified policy, the speed and scope of social security reforms vary from place to place. The measures adopted by local governments to deal with social security problems during small corporatization are various, and many may not be helpful for building-up a new social security system. Although local experiments have their advantages in stimulating innovations in ownership restructuring and other micro-level reforms, the establishment of a meaningful and well functioning social security system for the Chinese public is certainly beyond the capacity of local experiments. The central and provincial governments have to play a leading role in the process.

## CHAPTER 4

### FROM VAGUELY DEFINED TO JOINT-STOCK CO-OPERATIVES: OWNERSHIP REFORM IN THE TVE SECTOR

*Laixiang Sun*

#### 4.1 TVE profile and TVE miracle

'Township and village enterprise' (TVE) is a specific Chinese term to identify those firms that are either collectively established by or initially based on and closely associated with rural communities such as townships and villages. This term has increasingly become an administrative and historical icon rather than economic one. But it is a very important concept for our understanding of China's reform and development since the late 1970s.

In official statistics TVEs cover a wide range of ownership categories, including collective ownership by township and village communities, private ownership by households and groups of households, joint ownership by domestic and foreign investors, and joint ownership by domestic shareholders (Table 4.1). The sector does not include SOEs and enterprises owned by urban collectives, although it does include enterprises owned jointly by urban and rural enterprises.

In Table 4.1, enterprises under the ownership category of township and village are typically those with dominant community ownership or joint-stock co-operatives originated from ownership transformation of collective TVEs and from co-operation of private firms. In the discussion that follows, we use 'core TVEs' to denote those TVEs with dominant community ownership or which are joint-stock co-operatives. The term TVE is then understood in the broader sense of all rural enterprises listed in Table 4.1, where rural private firms are included in the category of those run by individual households or joint households.

In 1985, the core TVEs contributed about 60 per cent to the total revenue and total employment of the whole TVE sector, and about 63 per cent to the total pre-tax profits (profits and taxes). By 1996, the corresponding proportions in total revenue decreased relatively slightly to about 54 per cent; but those in total employment and in total pre-tax profits decreased significantly to 44 and 51 per cent, respectively. One of the main reasons for the decrease in core TVE proportions is the entry of large numbers of small private firms as indicated by the row on number of firms. The fact that the relatively stable shares of core TVEs in TVE total revenue has been accompanied by the significant decreases of their employment and pre-tax profits shares indicates that, although the impressive performance of all TVEs is also true for the core TVEs, the core TVEs appear to have

become more capital-intensive and relatively less profitable. While their total number of firms remained stable, the average employment sizes of township- and village-run enterprises increased significantly, from 50 and 18 persons in 1985 to 72 and 26 persons in 1996, respectively. By contrast, the average employment sizes of private firms increased insignificantly, from 2.7 persons in 1985 to 3.5 persons in 1996. In fact, more than half of household-run firms are engaged in retail sales and catering services, and most of household-run industrial firms do piecework for or sub-contract with core TVEs, SOEs, and other corporate firms (Section 1.1; Table 4.2; Sun, 1997).

The range of activities undertaken by TVEs is much broader than their name implies. TVEs are most heavily engaged in industrial production, then in construction, commerce, transportation and communications, services, and agriculture, successively (Table 4.2). Their industrial activities include all 40 industrial categories appearing in Chinese statistics. According to the 'old' twelve sub-sector classification of industry presented in Table 4.3, the first five sub-sectors for 1994 TVE industrial production were, in order, machinery, textile and clothing, building materials, food and beverages, and metallurgy. Some TVEs have reached beyond China to set up joint ventures in Eastern Europe, Russia, Southeast Asia, and the US. By end of 1996, there were 3,626 overseas TVE sub-companies (*TVE Yearbook 1997*: 4; Wong *et al.*, 1995). The shares of one TVE are traded on the Hong Kong Stock Exchange.<sup>16</sup>

TVEs also vary in size. For example, by the end of 1997 there were about 7,000 large and medium TVEs with on average about 1,000 employees each. The 329 large TVE groups officially registered in mid-1996 by the ministry of agriculture average 183 million yuan (US\$22 million) each in total assets, 300 million yuan (US\$36 million) each in annual sales and 32.5 million yuan (US\$3.9 million) in profits before taxes.<sup>17</sup>

TVEs have been engines of China's rapid economic growth since the early 1980s. In 1980, there were 1.4 million TVEs with 30 million employees. By 1997, there were 20.1 million TVEs with 130.5 million workers (*Yearbook 1998*: 419-20). Their real total output increased by an average rate of 21 per cent per annum from 1978 to 1995 (*Yearbook 1996*: 389 and 403), and the growth rate of their real value added remained over 18 per cent in 1996 and 1997.<sup>18</sup> As noted above in Section 1.1, by 1995 the TVE sector produced nearly 30 per cent of China's gross domestic product (GDP). In the same year, industrial TVEs produced about half of the total industrial value added, profit, and output.<sup>19</sup>

Since the late 1980s, TVE achievement in exports has been most impressive in comparison with TVE performance in other areas. Table 4.4 presents TVE export growth in terms of both total scale and relative share. It can be seen that during the ten-year period of 1988-97, the TVEs' shares in the total national export increased from 16.9 to 46.3 per cent. The TVEs' total export value increased from US\$8.02 to 84.6 billion. This is equivalent to an annual growth rate of 26.5 per cent in terms of US dollars, despite the devaluation of yuan

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<sup>16</sup> *People's Daily* (overseas edition), 16 July 1996.

<sup>17</sup> *People's Daily*, 6 February 1998: 2; *Hsingtao* 25 June 1996: A8.

<sup>18</sup> *People's Daily*, 28 February 1998.

<sup>19</sup> Data source: 'Selection from the 1995 National Industrial Census', published in *People's Daily*, 19 February 1997; and Ministry of Agriculture, 1997.

from 3.7 to 8.3 yuan per US dollar. It is also worth mentioning that the TVEs' export growth has been largely contributed by those TVEs with dominant community ownership. All of 150,000 TVEs that have export licences are those with dominant community ownership.

There is an obvious contradiction between the outstanding performance of TVEs and the outcome predicted by traditional property rights theory. As pointed out by Weitzman and Xu (1994), a community-run TVE is best described as a 'vaguely defined co-operative'. It is 'an essentially communal organization quite far removed from having a well defined ownership structure'. First, a typical TVE has no owner in the sense of traditional property rights theory. Nominally, TVEs are collectively owned by all the members of a community. Moreover, these collective owners usually do not have clearly defined shares. Second, there are no residual control rights in the traditional sense. 'Owners' must wait passively to enjoy the ownership benefits, which mainly take the form of expenditures of the TVE which fund communal social investments. The 'owners' of a TVE do not have full rights to use the after-tax income, since government regulations require that a majority of these funds be used for reinvestment or for social purposes. Third, an individual 'owner' has no way to sell, inherit or otherwise transfer any part or proportion of TVE assets. According to traditional property rights theory, the community-run TVEs should therefore be relatively inefficient, and for that reason they should be privatized.

In reality, not only has the growth rate of TVE output been impressive in both absolute and relative terms, but the improvement in TVE productivity has also been extraordinary. Various estimates place the annual growth rate of the total factor productivity of core TVEs at between 5 per cent and 12 per cent over more than a decade. This is an outstanding achievement by world standards. Although capital-labour ratios among TVEs are only about 25 per cent of those in the SOE sector, output-labour ratios among TVEs are about 80 per cent of those in the state sector. (cf. World Bank, 1996: 51, Weitzman and Xu, 1994, Jefferson and Rawski, 1994: 56, Woo *et al.*, 1994). Likewise, community-run TVEs have exhibited competitive advantages over private firms in China. Despite their other *quasi-governmental social obligations* evidences show the core TVEs were at least as productive as private enterprises during the 1980s and early 1990s (Bowles and Dong, 1999; Che and Qian, 1998; Jin and Qian, 1998; Nee, 1992; Pitt and Putterman, 1998; Svejnar, 1990).

#### **4.2 Why have TVEs been so successful?<sup>20</sup>**

The TVE phenomenon is unique in the sense that the emergence of rural entrepreneurs and enterprises has not been experienced in any other country on such a large scale and at such a rapid rate. Its roots can be traced back to the late 1950s, but its development was not truly noticeable until the late 1970s when China began to carry out reforms and to open up to the outside world. The TVE development so far is not an outcome of any carefully designed policy or plan. The government policy changed from tolerance to encouragement during the 1980s, only after recognizing that the TVE was a vehicle to increase rural income, and more importantly, to absorb a large amount of surplus rural labour force without much

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<sup>20</sup> This section is mainly based on Perotti, Sun and Zou (1999).

need for state investment—a serious problem which had been confronting the Chinese governments at all levels.

Generally speaking, there has been an overall favourable environment for TVE growth during the reform period, providing both incentives and disciplines for township and village governments and TVE managers in the process of TVE development. These favourable conditions can be summed up into six major points: 'revenue hunger' and hard budget constraints confronted by township and village communities; initiatives and supports of community governments; unique domestic market opportunities; catching comparative advantages in international market; flexibility due to smallness and accounting system; and support from SOEs. In addition to these favourable conditions, TVEs also have advantages over their major competitors the SOEs in such areas as ownership and governance structures, personnel/employment systems, and labour-management relations. We present a brief analysis over each of these points below.

#### *4.2.1 Revenue hunger of and hard budget constraints to township and village governments*

In China the central, provincial, municipal, prefectural, and county governments all have sufficient authority to regulate markets through administrative methods. They can also be involved in credit decisions because the local branches of state banks have been subject to both the vertical and regional accountability (dual co-ordination). *Ex ante*, governments at the level of the county or above are directly involved in the formulation of credit plans and can direct specialized banks to make loans. *Ex post*, governments have the authority to decide whether or not SOEs should pay back the loans (Sun, 1999: chapter 3).

Township and village governments have no such authority. A township or village government cannot protect its TVEs by erecting trade barriers to keep out competition simply because the market within the community is both too small and limited. Township and village governments have no access to the state banking system, because historically all townships and villages are institutionalized as part of the traditional rural sector whereas the banking system is a part of the modern urban sector. Likewise, all staff members of state banks are registered in the urban residency registration system and have no links with the rural sector except through business dealings.

As a consequence, state banks have typically followed commercial principles in making loans to TVEs. Often they ask township or village governments to act as guarantors of investment loans. If a township or village has a poor credit repayment record, state banks can refuse the loan application. In addition, they can withhold interest payments and some of the principal from the bank accounts of the community or its TVEs. Each township or village government well understands that its community may be able to delay debt repayments over the short term, but that they cannot be delayed indefinitely. Meanwhile, a poor credit record implies that the community must depend on self-financing for future development and debt servicing. This is not possible even for agricultural communities, which need bank credits seasonally for the purchase of such inputs as seeds, chemical fertilisers and pesticides, etc.

While confronted with hard budget constraint, townships and villages have to create revenue for themselves. The potential of revenue generation in the agricultural sector is typically very limited if not negative. For example, in 1990 the average family farm held only 0.42 hectare farmland but it had 1.73 labourers engaging in agriculture (Ministry of Agriculture, 1991). According to a recent econometric estimation based on county level data on agricultural and natural conditions (Sun *et al.*, 1998), even in the northwest region where the ratio of land over labourer is several times greater than those in the coastal regions, the output elasticity of labour still indicates that the marginal output of labour (323 kg. of grain) is lower than the subsistence wage level.<sup>21</sup> This fact indicates an overall labour surplus in the agricultural sector. Moreover, agricultural products had been under-priced until very recently. For purchasing even basic agricultural inputs and financing basic expenditures such as school, relief payment for sickness, and maintaining basic infrastructure, the community has to often look for revenue generation sources beyond agriculture (Wiemer, 1994). While engaging in non-agricultural activities, the competition is always very tough.

The above facts force township and village communities to confront the pressure of revenue hunger, employment generation, market competition, and hard budget constraint. Though cross-subsidises of TVEs within a community is possible, the extent of such subsidies is quite limited. Thus, in reaction to the economic austerity in 1989 and 1990, several million TVEs were closed down or taken over by other TVEs (Zou and Sun, 1998, table 1). In contrast, at the same time the losses among SOEs soared, but only a handful actually went bankrupt. A 120 billion yuan credit relief operation was initiated in the fourth quarter of 1989 to write off non-performing interenterprise credits, mainly inter-SOE credits (Portyakov, 1991).

#### *4.2.2 Initiatives and support of community government*

Core TVEs are typically initiated or directly established by township and village governments. Motivated by revenue generation, employment creation, and the strong desire of the community to improve living standards and increase wealth, township and village governments have been strongly enthusiastic in developing TVEs. This enthusiasm has been further strengthened by an increasing responsibility for improvement of local education, infrastructure, and social welfare, which have been gradually shifted from upper levels of government to the township and village level.

Three critical contributions of township and village governments to TVEs have been outlined by Chang and Wang (1994: 443-4). First, township and village governments are part of a large governmental system with broad powers. In addition, there has been a long tradition of authoritarian government in China. Consequently, the full support of township and village government can provide community members and other TVE stakeholders with a sense of security, which is needed to achieve long-term development.

Second, township and village governments can offer managerial inputs to TVEs in several ways. Because the market intermediaries are in their infancy and ordinary citizens who

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<sup>21</sup> Taking the average national dependency ratio of 1.9, and using roughly 250 kg. of grain as the subsistence consumption level per person, this implies a subsistence requirement of 475 kg. of grain per agricultural labourer.

have suitable market-oriented talents are a scarce resource, township and village governments are essential in the organization of major economic and political activities within their jurisdiction. Without well functioning market intermediaries and other mechanisms for settling disputes, township and village governments are often the only available local institutions with the necessary creditability to mediate transactions and the authority to settle disputes that may arise in the process of creating TVEs.

Third, because they are often the only available local institutions with the needed creditability to mediate transactions, township and village governments have played an essential role in gaining access to outside resources, particularly bank loans.

In addition to these three contributions, township and village governments are not only the guarantors of TVE loans, but are also the executors of the collective financing and debt repayment system. This collective financing and debt repayment system represents another support for TVE growth. All the funds required for the start-up of a new TVE can be borrowed from existing TVEs with the help of the township or village government (Wong *et al.*, 1995). This system also offers township and village governments the power to initiate and co-ordinate internal reorganizations or take-overs so that communities can avoid the social and economic costs of either bankruptcy and/or take-over by outsiders (Sun, 1997).

#### *4.2.3 Unique domestic market opportunities*

To a large extent, TVE success also depends on the unique opportunities created by China's market liberalization, especially relaxation of the state monopoly over industry. The protected industrial sector was effectively opened to new entrants beginning in 1979. A large number of TVEs started up and rushed to take advantage of sharing the monopoly profits in the industrial sector. For these early entrants in the late 1970s and early 1980s, the average rate of net profit on capital was 32 per cent and the total rate of profit and tax per unit of capital was 40 per cent (*Yearbook 1993*: 396-7). Continued TVE entry gradually created and intensified competition, inducing monopoly profits to decrease and finally to vanish. However, the windfall profits enjoyed by early entrants greatly contributed to the TVE takeoff.

In the early years of TVE development, there were many empty niches in the consumer goods market (processed foods, clothes, etc.) and primary processed products market, mainly owing to long-standing shortages induced by the inefficient command economy. Not surprisingly, TVEs jumped to meet the demands of these markets. Moreover, the rapid economic development in both urban and rural areas has created a whole series of new markets—a good example is building construction and building materials production in both urban and rural areas, TVEs have become dominating in these industries since the mid-1980s (Naughton, 1996: 150-1).

Meanwhile, the two-track system of market and planning has also eased constraints on TVEs, providing them with access to raw materials and market shares outside the state plan. They can afford higher input prices by setting up higher prices for outputs, or by simply using low quality input to produce cheap and poor quality goods to meet the corresponding effective demands.

#### 4.2.4 *Catching comparative advantages in the international market*

Geographically, TVEs are most developed in the coastal provinces of Guangdong, Fujian, Zhejiang, and Jiangsu. These provinces, both historically and today, have close links with the overseas Chinese in Hong Kong, Taiwan and Southeast Asia. TVE development in these provinces has fitted well in with the requirements of the international division of labour and the considerable cost advantages of rural China.

For overseas Chinese investors, the attractions of TVEs in the coastal areas manifest themselves in: (a) a large number of cheap and well-disciplined Chinese rural labourers released by the successful agricultural reform and development in the early 1980s; (b) various preferential arrangements in tax exemption, currency conversion and repatriation of profits granted by the open-door policy; (c) flexible and relatively convenient approval procedures for their investment projects in the rural society; (d) proximity to their bases; and (e) the cultural convenience in general and traditional family or kinship network in particular cases. It is also conceivable that (a), (b) and (c) are attractive to other foreign investors.

Foreign investments have played an important role in TVE development. For example, in 1995, there were 38,743 TVE-foreign joint ventures with accumulated foreign capital investment of US\$31.8 billion (*TVE Yearbook 1996*: 6). In addition, a great number of TVEs have engaged in materials processing for foreign firms under sub-contracting arrangements. Foreign investors and foreign firms contracting with TVEs have brought in scarce foreign capital and relatively advanced technology and management skills, while their marketing networks abroad provide easy access to international markets. Compared with domestic buyers, there are fewer problems with interenterprise debts, because exports also guarantee payment, which is mostly due upon delivery. Thanks to the compatible incentives and comparative advantages, TVE achievement in exports has been most impressive, as presented above in Section 4.1 and Table 4.4.

#### 4.2.5 *Flexibility due to smallness of scale and a loose accounting system*

Most TVEs are small in size and engage in labour intensive industries with low asset specificity. By 1996, the average size of township-run enterprises was 73 employees per firm and that of village-run enterprises was 26 employees per firm (Table 4.1). In the earlier years, average TVE size certainly was smaller. For example, in 1980, the average size of township-run enterprises was 41 employees per firm and that of village-run enterprises was 15 employees per firm (*Yearbook 1997*: 399-400). This makes them very flexible in reacting to market changes, switching products, and catching new market opportunities.

The accounting system for TVEs has been much less standardized and strict than the one used in SOEs. Only the TVE owners are accountable for bookkeeping, and not all of the income and expenditure need go through banks. Thus, they can use such flexible financial and bookkeeping systems to develop their business. TVEs typically pay the highest salaries to their marketing staff, which can be more than ten times an average worker's income. TVEs have enjoyed the flexibility to pay higher commission, send gifts, or even offer bribes to government or SOE officials so as to get low price inputs or materials in shortage and to expand market shares of their products.



In contrast, these conveniences have rarely been possible for SOEs, the major competitors of TVEs in China. The accounting systems of SOEs have been much more standardized, and is controlled by a uniform national accounting inspection system with careful supervision of such items as wages and travel expenses.

#### 4.2.6 *Support from SOEs*

The growth of TVEs in city suburbs has been facilitated by direct co-operation between urban SOEs and rural TVEs, mainly in the form of subcontracting. In the suburban areas of Beijing, Tianjin and Shanghai in the early 1980s, an estimated 60-80 per cent of TVE output was produced by firms subcontracting with large urban SOEs (*Industrial Almanac*, 1986: 50). In Jiangsu and Zhejiang provinces, where TVEs have dominated the local economies since the mid-1980s, the proportions were only slightly lower in the mid-1980s. Linkages with Shanghai SOEs in these two provinces have played a decisive role in their TVE development (Tao, 1988: 100).

Why are urban SOEs motivated to co-operate closely with TVEs? Naughton (1996: 155-6) gives three plausible reasons, namely to diversify their sources of supply, the cheap costs of labour and land use, and the flexibility to escape some rigid controls of the state sector.

#### 4.2.7 *Relative advantages of TVE ownership and governance structure*

TVEs are under the direct jurisdiction of their township or village government. The government-enterprise relationship is much simpler and more direct than that of SOEs. In terms of the owner-management relationship, community members as owners of their core TVEs do have incentives to monitor the community government officials and TVE management, though the real effectiveness varies across different communities. Because community members, as owners, possess the right to derive both short-run and long-run residual benefits from TVE operations, when necessary they are willing to give up short-run benefits, such as dividends and part of wages, in exchange for the benefits of greater long-run profitability. Here, the term 'benefits' can be broadly defined as including job opportunities and security, pension funds, and communal welfare programmes in housing, health care, irrigation, road construction, and other infrastructure (Bowles and Dong, 1999; Chang and Wang, 1994; Sun, 1997).

Although the residual control rights exercised by community governments may imply a certain risk of bureaucratization, the control by the government over implementation and co-ordination of internal reorganization, or over the take-over process, does side-step the social and economic costs that would occur as a result of either bankruptcy through court action or take-over by outsiders. This control is quite similar in character to that exercised by the main bank in a Japanese corporate group (*Keiretsu*).

Because the residual control rights of core TVEs within a community is held by the township or village government, the community becomes a *de facto* corporation or 'mini conglomerate', facing a hard budget constraint. Under the pressure of intense market and interjurisdictional competition, this arrangement can facilitate a consensus or communal norm among community members, community government officials, and TVE managers and workers to maximize profits even by sacrificing all or part of wage income. Moreover,

because a community is diversified in an economic sense, it can diversify the business risk. A township or village can easily create several small-scale TVEs in manufacturing, agriculture, commerce, construction, and transportation and then expand the size of these TVEs (Section 2.3; Chen, 1998; Zou and Sun, 1998).

A community can be seen as a small society, in which the citizens/owners can vote by a show of hands in semi-competitive elections for community officials. In wealthier villages and villages that enjoy a large TVE economy, this is particularly true (O'Brien, 1994: 47 and 51; *The Economist*, 2 November 1996: 81-3; Howell, 1998). The villagers may also directly participate in discussions with community leaders. These avenues contribute to the resolution of the agency problems and help reduce costs of organization.

A community can also be seen as a corporation, governed by, for instance, a system of responsibility contracts and subcontracts. Such a system can be arranged between the community representative assemblies and the community government, between the government and the TVEs, and within the TVEs. These contracts and subcontracts have facilitated the solution of monitoring problems within the community and within the TVEs (Chen, 1998; Lin, 1995; Wong *et al.*, 1995).

#### 4.2.8 *Comparative advantages of TVE personnel and employment systems*

For TVE employees there is no guarantee of lifetime employment—the so-called 'iron rice bowl'—which has been enjoyed by SOE employees until very recently. There have been an increasing number of rural surplus labourers who are released by agricultural development and pushed by regional development unbalance. Therefore, the rural labour market for TVEs has been highly competitive. TVEs can employ workers from both local communities and other places outside their communities. Thanks to the competition, there are no generous welfare benefits (housing in particular) for TVE employees. The equivalent of the unemployment and retirement insurance for them typically lies on their rights to use their contracted land in their home villages. As a consequence, TVEs have enjoyed low labour cost and a clear management objective. In the meantime, a competitive labour market plus a land contracting system induces high labour mobility, the opportunity cost of unemployment for TVE workers being much lower than for SOE workers. If unemployed, the worst thing for them is to return to farming. This mobility combined with the bottom-line insurance may help reduce the problem of labour-management conflicts.

The role of TVE manager is relatively well defined. The tasks and objectives of a TVE manager or management team are typically specified in a contract between them and their township or village government. They only need to report to the community government. This simple principal-agent contract also makes their work considerably easier and more efficient.

The major compensation for TVE managers includes direct pecuniary benefits in various forms such as higher wages, year-end bonuses and contract fulfilment bonuses. These bonuses are closely linked with the TVE performance and thus can be considered as a kind of sharing scheme of residual benefits. Typically, the bonuses of TVE managers are not only related to their own TVE performance but also decided through comparison with the performance levels of other TVEs in the same township or village. This horizontal

comparison has generated competition pressure among managers of different TVEs (Wu *et al.*, 1990: 332).

TVE managers also face competition and threat from the managerial labour market. They are not guaranteed lifetime status, and their terms are fixed for a limited period. As a result, entrepreneurship has developed over time in the TVE sector. TVE managers are becoming more experienced and professionally competent, and more capable to deal with market competition.

TVE workers are easy to be disciplined and managed. They have sufficient motivation and face strong pressure to work hard. They are motivated by the close link between their wages and performance. Piece-rate and team-responsibility-wage systems are common in the TVE sector. TVE employees are almost without exception contract workers, hired for the year or the season with no job security as there are many others waiting for jobs. They often work longer hours and much harder than SOE workers do, because if their performance is not satisfactory, their job contracts may not be renewed or even terminated in advance (Ho, 1994). Collectively, if business goes badly, everybody in the firm will lose their job. Therefore TVE workers clearly understand that their own future is closely tied with that of the firm, with which they have to share the risk (Bowles and Dong, 1999).

The outstanding performance of TVE workers may be further explained by a kind of group or mutual monitoring at the horizontal level. This mechanism is induced by the threat of collective unemployment caused by the failure of their enterprise, creating what could be described in academic terms as a 'co-operative culture' within a small commons' (Weitzman and Xu, 1994; Jefferson, 1998).

### **4.3 Why TVEs need ownership restructuring**

#### *4.3.1 The most widely reported reason: 'mechanism degeneration'*

The so called 'mechanism degeneration' of TVEs has been widely reported since the early 1990s.<sup>22</sup> TVE mechanism degeneration refers mainly to increasing bureaucratization in communities with successful TVEs, softening budget constraints across TVEs in the same community, and other trends towards SOE-similar mechanisms. Many aspects of mechanism degeneration have been linked to the problems inherent in TVE ownership and governance structures. Among them, two are often pointed out.

First, township and village governments are not purely economic actors. As TVEs mature, the objectives of township and village government officials are coming increasingly into conflict with those of TVE managers, although initially these two sets of objectives were quite similar (Wang, 1990; Shi and You, 1997). Township and village governments have assigned priority to raising employment, local prosperity and financial revenue. This could conflict with the efficiency requirement of individual TVEs, impose SOE-similar mechanisms to TVEs and thus hinder the stable, long-term development of TVEs. The powerful control rights of township and village governments could thus lead to unfavourable interference into TVE management. Township and village governments also

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<sup>22</sup> See, e.g. Ren *et al.*, 1990; *China Information Daily* 2 August 1993: 2; Ministry of Agriculture, 1997.

seem to be shifting the responsibility for the overall development of rural communities onto individual TVEs that they control. As a result, many TVEs are now also experiencing redundant employment and increasingly heavy social burdens. They are becoming quite similar to SOEs in many ways and thus create a strong desire for reform (Byrd and Lin, 1990: 125, 304 and 351; Shi and You, 1997; Xu and Zhang, 1997).

Second, bureaucratization and corruption among community government officials and TVE managers are growing. In those townships and villages where the development of grassroots democratization has lagged behind, the problem of who monitors the monitors becomes increasingly serious. This is because there is a lack of effective checking and restraint devices to curb corrupt behaviour of those increasingly powerful community government officials. For example, many TVEs are becoming 'purses' of their community governments, required to pay all sort of expenses for the community government officials. And many TVE managers are stripping TVE assets for their own uses (Shi and You, 1997).

Although there has been supervisions from county governments as highlighted in Che and Qian (1998), this kind of monitoring may be limited due to the problem of information asymmetry. The restraints from county governments are mainly based on the discipline of the Communist Party. This may not make sense for most officials at grassroots level, because the probability that they will be promoted to the status of a formal bureaucrat is small. Indeed, compared with the economic and social rents they enjoy from the TVEs, the career of being a low-rank bureaucrat is not that attractive. In addition, this monitoring is bound to be weak because of the communication difficulties in rural areas and the fact that there are usually a large number of community-run TVEs, townships and villages in a county.<sup>23</sup>

The phenomenon of 'mechanism degeneration' is reported to have become increasingly widespread and to be sufficiently serious to justify the demand for ownership restructuring. However, the explanation based on mechanism degeneration cannot justify the supply-side reason for ownership restructuring. Since the TVE managers and community government officials clearly benefit from the mechanism degeneration, what incentive do they have to give up their benefits and to initiate ownership restructuring? In order to understand the incentive-compatible reason for ownership restructuring of the core TVEs, we need to examine the intertemporal asset structure of the core TVEs in comparison with other ownership forms.

#### *4.3.2 An incentive compatible reason: capitalization urge*

In Table 4.5 we compare the debt-asset ratios between TVEs and industrial SOEs and among TVEs with different ownership forms for 1995, when comparable data are available. It can be seen that township-run TVEs had the highest debt-assets ratio (68 per cent), then industrial SOEs in second (66 per cent), village-run TVEs in third (55 per cent). Debt-asset ratios in private TVEs were very low, 35 per cent for joint-household-run firms and 25 per cent for individual household-run firms. Although industrial SOEs are typically

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<sup>23</sup> In 1996 each county had on average 21.2 townships, 345.5 villages, and 723.2 community run TVEs (*Yearbook 1996*: 3, 17, and 399).

more capital intensive and have enjoyed more equity investment from the state, making the direct comparison unfair for TVEs, the comparison indicates that both industrial SOEs and township-run SOEs were highly leveraged on average in 1995. Village-run TVEs started to have excessive debts as well.

Data which would allow extension of Table 4.5 through time are not available. However, we do have such intertemporal data for an illustrative prefecture-level city, Suzhou in Jiangsu Province. TVEs in Suzhou have been regarded as representative of an approach known as the Southern Jiangsu Model in which all TVEs are collectively established by township and village communities and have kept pure community ownership until very recently. Table 4.6 shows the rising trend of debt-asset ratio of all community-run TVEs in Suzhou. Tables 4.5 and 4.6 show that community-run TVEs in Suzhou had the debt-asset ratio of 61.9 per cent in 1994, very similar to the corresponding national average of 62.8 in 1995. This similarity may be instructive for our understanding of the worsening debt burden issue of TVEs at the national level. Second, Table 4.6 shows a rapid rising of debt-asset ratios from 1980 onwards. In the first half of the 1980s, TVEs in Suzhou had a quite healthy debt-equity structure. However, along with their success and take-off over the next decade, their debt-asset ratio increased rapidly and have reached over 60 per cent since 1992.

In consideration of the fact that the average debt-asset ratio may cover the heterogeneous real debt-equity structures across firms, we present a comparison of debt-asset ratios and performance for 111 surveyed township-run TVEs in Table 4.7, which is based on data from a survey conducted in Southern Jiangsu in 1995. These township-run enterprises had an average debt-asset ratio of 70.4 per cent, which was slightly higher than the national average of 68 per cent (Table 4.5).

Three observations can be directly spelled out from Table 4.7:

- (a) Among the surveyed TVEs, only 10 (9 per cent) had healthy debt-asset ratios of less or equal to 50 per cent, 46 (41 per cent) were extremely highly leveraged with debt-asset ratios of over 80 per cent, and 21 (19 per cent) were *de facto* insolvent with debt-asset ratios of over 100 per cent.
- (b) Thanks to the labour intensive feature and low labour costs, over 80 per cent of those TVEs with debt-asset ratios between 60 and 70 per cent were still profitable.
- (c) However, there is an obvious positive correlation between the proportions of loss-making firms in each group and group debt-asset ratios. In the first group with healthy debt-asset ratios, no firms made a loss. In the groups with debt-asset ratios of 80-90, 90-100, and over 100 per cent, loss-making firms accounted for about 28, 43, and 52 per cent of the total number of TVEs in each group, respectively. This positive correlation indicates that the firm with higher debt-asset ratio faces not only higher cost of debt services but also higher risks of business failure.

Why was the debt/asset ratio of community-run TVEs rising so rapidly in the 1980s and has it remained at so high level in the 1990s? There are two most intuitive and instructive reasons. First, the continuous entry of a large number of TVEs and other type of firms intensified competition, eroding the exceptional profits available early on (Section 4.2). As a result, the ratio of profits after taxes over assets for community-run TVEs steadily decreased from

more than 30 per cent in the early 1980s to about 7.5 per cent in 1995 and 1996 (*Yearbook, 1993*: 396-7; *TVE Yearbook 1996*: 100, *1997*: 122). The steadily declining profitability has significantly reduced the capital accumulation capability of the core TVEs and pushed them to increasingly depend on credit financing.

Second, along with the rapid expansion of community conglomerates, the financial capability for the community government to cross-subsidize its TVEs and to guarantee more loans for them has increased rapidly as well. This makes it feasible for the core TVEs to increasingly rely on debt financing. At the same time, information asymmetry problem becomes increasingly severe due to the speedily expanded scale of the community conglomerate and the accompanying bureaucratization. As a consequence, individual core TVEs take the advantage of softening budget constraint to borrow more, choose higher risk, but reduce their effort (Zou and Sun, 1996: proposition 1).

Because the budget constraint for the community as a whole has been and will continue to be hard, the implication of opportunistic activities by individual TVEs for the community government is clear and straightforward: The community government ultimately bears the unlimited liability for its community TVEs. This increasingly softening budget constraint to individual TVEs may finally induce the bankruptcy of the whole community. In order to get rid of the unlimited liability it holds for its community TVEs and avoid the threat of community bankruptcy, the community government with many highly leveraged TVEs has strong incentive to initiate ownership restructuring programme within the community. For the interest of the community government, the first purpose of the restructuring is capitalization of the community-run TVEs. In comparison with county and city governments, township and village governments face fewer political constraints: avoidance of layoffs is not a constraint for TVEs (Section 4.2) and the community governments have constantly initiated reorganization and liquidation of community TVEs since the very beginning (Zou and Sun, 1998: section 5).

Profitable TVEs have to follow the orders from the community government to lend money to fellow TVEs with poorer performance. The opportunity costs of such lending are very high, because not only is the likelihood of repayment low, but also the lenders can use the money more efficiently. In this sense they are losers *ex post* under the community ownership. *Ex ante*, if the probability is high that a TVE will be profitable, the perception of the value of the cross-subsidy for this TVE will be negative. Therefore the TVE will have strong incentive to seek more autonomy, to improve its asset structure, and to strengthen its competitive ability through ownership restructuring.

Although loss-making TVEs benefit from the cross-subsidies within the community and from the loans guaranteed by the community government, they face the pressure of lowering reputation and the threat of liquidation and closing-down. Once the firm is closed down, both managers and workers will lose their non-agricultural jobs thus the sources of higher income and more respected social status. When the firm continues its business, the compensation for both managers and workers is typically low because the firm has to pay the interest and part of principals of its debt first. Therefore, the loss-making TVEs have strong motivation to avoid closing-down and to increase their equity capital through ownership restructuring.

For TVE workers the increase of equity capital in their TVEs will strengthen their job security and bring them more income in terms of wage, bonuses, social welfare, and others. Paid subscription of shares is often immediately compensated in part by the distribution of the 'matching shares' (*pei gu*). The matching shares are free of charge, in the proportion of one subscription to one or two matching shares, and correspond to the original collective equity. These shares together will bring dividends in the future and the subscribed shares can be transferred within the community and in some case out of the community. In addition, these shares bring the TVE workers certain control rights over their TVEs. Therefore, TVE workers who have rights to subscribe shares often strongly support the ownership restructuring through formation of joint-stock co-operatives, However the half of those workers who have no such rights (temporary workers from other communities) feel dissatisfied with such restructuring (Wang *et al.*, 1997: 233-44).

#### **4.4 The emergence of joint-stock co-operatives in the TVE sector**

Although the ownership restructuring of core TVEs has taken diverse forms, the dominant one is the joint-stock co-operative. Table 4.8 reports the distribution of the forms of ownership restructuring in the core TVE sector by the end of 1997. Nation-wide 33.5 per cent of core TVEs with dominant community ownership had restructured their ownership form by that time. Of these restructuring core TVEs, 63.37 per cent adopted the form of joint-stock co-operative, 12.15 per cent (mainly small ones) were sold to private investors, 4.66 per cent were transformed into limited liability companies with management- or outside investor-ownership, 3.82 per cent were merged or organized into corporate groups, 1.58 per cent were restructured into joint-stock companies (part of them became openly held companies), 0.66 per cent went into bankruptcy, and finally, 13.91 per cent were leased mainly to managers or manager-teams or re-registered back to private ownership.

Among the restructuring forms listed in Table 4.8, the form of joint-stock co-operative is both new and dominant, and is thus the one that holds the greatest research interest. Many local varieties of the joint-stock co-operative form have evolved path-dependently and adapted to local political and institutional conditions. In order to sketch out the major features of the ownership and governance structures emerging in different local models, we classify them into three stylized groups: community-based, enterprise-based, and those in the broad agricultural sector.<sup>24</sup>

##### *4.4.1 Community-based joint-stock co-operatives*

Community-based joint-stock co-operatives emerged in the late 1980s in those rich villages with significant collective capital accumulation and located on the outskirts of rapidly expanding cities like Guangzhou and Shenzhen. The direct driving forces for establishment of community based joint-stock co-operatives include: (a) releasing the lasting tension and increasingly sharp conflicts between village government officials and villagers; (b) a large number of villagers having to leave the community following the state requisition of their lands; and (c) meeting the high equity capital demand of the village economy.

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<sup>24</sup> The broad agricultural sector includes farming, forestry, animal husbandry, and fishery.

The tension and conflicts resulted from the increasing bureaucratization of community governments and corrupt behaviour of community officials. Community officials enjoyed complete control over collective assets but did not need to bear the downside risks. Their corrupt business dealings, repeated loss making decisions and asset stripping behaviours finally induced open conflicts and forced the higher level governments to look for solutions. In those villages that suffered from open conflicts, the joint-stock co-operative form was firstly regarded as a way to establish economic democracy by the corresponding higher level governments (Huang, 1993: 165).

Letting every adult villager become a shareholder and setting up the governance structure similar to one in a share-holding company have in fact brought both economic and political democracy into these communities. Each household selects its share holder representative. Within the assemblies of shareholder representatives, the 'one-person-one-vote' principle is adopted. By this arrangement, the significant benefits from membership shares and subscribed shares generate an incentive for households to participate the equity democracy. The framework of share-holder representative assemblies monitoring board of directors and board of directors monitoring TVE managers provides a mechanism for villagers to exercise democracy more regularly and effectively. Although community collective shares continue to exist, the control rights over them are equally shared across community households, rather than simply being exercised by community leaders. This makes community collective shares quite different from state shares in restructured SOEs (Sections 3.5 and 3.6).

In the coastal areas, many cities have been expanding rapidly. For many villages on the outskirts of rapidly expanding cities, city governments may requisition a large proportion or even most of their collective lands for city expansion. Although farmers who lose their contracted lands can change their social status into urban one and get a formal job in the urban sector assigned by the city government, they have full rights to claim their shares of community capital accumulation left to the village. In order to resolve these types of claims and smooth the process of land requisition, the form of joint-stock co-operative became desirable for all governments from village to city levels. It was likened as 'returning the shares to their original creators' (*huan gu yu min*) (Huang and Zheng, 1993). In these villages, those original villagers who have jobs outside the village have only the rights to get dividends from their share-holdings and have no voting rights. Voting rights are held by the representatives from each household and the voting principle in these assemblies of shareholder representatives is also one-person-one-vote.

In these rich villages, most households had large amount of savings deposited in state banks, while at the same time the village on its own account had to borrow from state banks, SOEs, and other institutions. Both villagers and village leaders have had an incentive to look for a mechanism to directly link their own household savings with the investment demand of their own village TVEs. Although this motivation may not have directly initiated community-based joint-stock co-operatives, it has significantly contributed to their development and improvement (Huang, 1993). Subscribed shares based on cash payment have been the most active shares and become increasingly important both as a proportion of total equity and in their influence on the improvement of governance structure.



These community based joint-stock co-operatives typically hold shares in: joint-venture companies with foreign or domestic companies; their own subordinate companies; and other communities. In these kinds of share-holdings, the community based joint-stock co-operatives act just like a typical institutional shareholder or venture capitalist. Their internal ownership and governance structures seems to have brought competitive advantages in their practice of establishing joint ventures and functioning as parent companies, as indicated by some comparative evidence (Huang and Zheng, 1993: 117-9; *TVE Yearbook 1997*: 305).

#### 4.4.2 Enterprise-based joint-stock co-operatives

The overwhelming majority of joint-stock co-operatives are enterprise based. The shareholders of an enterprise based joint-stock co-operative typically include its own employees, individual citizens of the community, the community government in the name of all community citizens, and other institutional shareholders outside the community. The presence of community collective shares has been hotly debated in China. The major points made by the opponents include: (a) collective shares continuously provide grounds for political intervention by the community government; and (b) the mechanism to monitor community government is far from the well-established and this mechanism is bound to be different from the one that monitors enterprises (see, e.g. Wang *et al.*, 1997; Tan, 1998; Han and Zhang, 1993, among others).

The proponents indicate that at the village level at least, the existence of village collective shares is crucial for the balanced development of the village economy and is particularly important for supporting agricultural and infrastructure development. They insist on that village should be basically an enterprise organization and that the committee of villagers or villager's representatives is an autonomous organization of the villagers rather than a government body, according to the Organic Law of Villager's Committee of the People's Republic of China. They suggest that emphasis on the separation of government and enterprises at village level would artificially bureaucratize the village organization and induce organizational conflicts within the village (Policy Research Office of Yichang County, 1997).

It seems that both the opponents and proponents of community collective shares bring insights into the discussion and the practical issues. At village level, the proponents' opinion may be more relevant. In fact village based joint-stock co-operatives have appeared to be socially and economically effective (*TVE Yearbook 1997*: 3.5; Han and Zhang, 1993: 141). The existence of village collective shares would not be a problem in a village-based joint-stock co-operative as we discussed in the previous sub-section. In other villages, the presence of village collective shares may be a problem in practice but may also facilitate the emergence of village-based joint-stock co-operative.

At the township level and above, the problems highlighted by the opponents may be more relevant. Here too, the solutions to these problems may take a variety of forms. For example, in Zhucheng City in Shandong Province, the city government sold all shares to enterprise employees and managers and leased the land to the restructured joint-stock co-operatives (Sun, 1997: 20-2). In Henggang Town of Shenzhen City, the township collective shares are held by the Henggang Joint-Stock Investment Company, which is in

turn directly monitored by the Assembly of Share-Holder Representatives from the subordinate villages rather than the town government (Henggang Town, 1993).

#### 4.4.3 *Joint-stock co-operatives in the broad agricultural sector*

According to China's official definition, the broad agricultural sector includes crop farming, livestock, forestry, and fishery (*Statistical Yearbook of China 1997*: 404). Joint-stock co-operatives in the broad agricultural sector emerge mainly in the forms of forest farm, orchard, aquatic farm, irrigation system, and marketing co-operative (*Almanac of China's Economy 1994*: 672-3; Han and Zhang, 1993: 212-8, 253-320). The economic rationality behind these organizational forms is to certain extent similar to that behind farmer-owned co-operatives in the west, which specialize in processing and marketing agricultural products (Hansmann, 1996: chapter 7). In these joint-stock co-operatives, producer-owners have highly homogeneous interests, their products are relatively homogeneous as well, and the requirement of economy of scale goes beyond the capability of individual households. Moreover, due to the great scarcity of capital and job opportunity in rural China and serious market imperfections in all markets, farmers need to accumulate capital, to create more jobs using their own capital, and to increase their production scale and marketing power collectively, in the form of joint-stock co-operative. As a consequence, these joint-stock co-operatives typically match capital shares with job opportunities (*yizi dailao*). There is division of labour within the co-operatives and the co-operatives are not only in charge of processing and marketing, but also producing. This feature makes China's joint-stock co-operatives in the agricultural sector different in major ways from their counterpart in the west.

One China-specific form of farmer-owned co-operative is so-called 'land-share co-operatives' (*tudi gufen hezushe*). This form has emerged in some of the most developed coastal areas. The basic feature of this form is to convert the land contract right of each member household in the village into shares, which is named 'capitalization of land contract right'. Thus the villagers who are not working as farmers can enjoy their land contract rights in terms of shares, becoming shareholders in a larger farm managed by a specialized farming family. The specialized farm household managing the land pays a share of its revenues as dividends to the families holding shares of the farm, in addition to paying agricultural taxes to the state and land-use fees to the village government. The share value is usually determined in discussions and negotiations in the village assembly, where the voting and other features of joint-stock co-operative obtains (*Almanac of China's Economy 1994*: 672; Chen and Han, 1994).

One might expect that China's joint-stock co-operatives in the agricultural sector converge, sooner or later, to the western form of farmer-owned co-operatives and specialize in processing and marketing of agricultural products and in provision of certain services to producers. However, such a convergence would be seriously constrained by the factor endowment of China's agriculture. This structure is characterized by the highest land scarcity, high capital scarcity, and serious labour abundance and may persist in the future for generations. It is this structure that vests more responsibilities in China's farmer-owned co-operatives than in their counterpart in the west.

#### **4.5 Remaining challenges to TVE development and reform**

Although TVE ownership restructuring in general and the emergence of joint-stock co-operatives in particular has been effective in curing TVE mechanism degeneration and in improving TVE capitalization, the restructuring is still in a middle way. The development is uneven, and in particular there are great difficulties at present stage to make consistent, unified, and rigorous legal provisions for standardizing the establishment and operation of joint-stock co-operatives. Many other problems that are closely linked with the features of development in a developing economy like rural China have surfaced and constrained the further development of TVEs. The four major development challenges can be summarized as follows.

First, enterprise management is in general still far from professional and proficient. The major managers are typically from the local community and have a relatively quite poor educational background. They have strong incentives to develop their business but lack of management skills to deal with market competition and to improve internal efficiency. The development of tools for market-based economic decision-making has lagged behind the general growth of the TVE sector. For example, the enterprise accountant usually functions as a bookkeeper rather than an integral part of management mainly due to the severe shortage of professional accountants. As a consequence, many TVE managers have no access to the information flows generated by modern accounting practices, which in turn hinders them from making rational and timely business decisions (*China Daily*, 26 October 1995: 2). The shortage of competent engineers and technicians has also undermined the improvement of TVE technological management.

Second, there is an obvious conflict between risk diversification, which implies small scale, and existing technical economies of scale in production. TVEs are typically locally initiated and locally based. In order to diversify business risks, it is rational for a township or village to set up several small-scale TVEs that diversify into different sectors. However, on the other hand, in many industries, small-scale production has no profitable potential at all in the medium- or long-term. This conflict casts a shadow over the long-term prospects of many small-scale TVEs.

Third, the entry of TVEs in many cases is local-resource-driven rather than market-demand-driven. In the past they had no marketing problems due to the widespread supply shortages. From the mid-1990s onwards, the demand-constraint appears to have become dominant in Chinese economy. Confronted with the increasing demand-constraint, they have to adjust their product structure and update their products so as to meet market demand and maintain their market shares. How to conduct such adjustment and updating has become an urgent challenge to many local-resource-based TVEs.

Fourth, almost all TVEs have been initiated by township governments, village governments, households, and joint-households (so-called 'four-wheel driven'), and are based on local resources and conditions. The comparative benefits include very low TVE entry costs into non-agricultural sectors and sufficient exploitation of local resources and comparative advantages. However, the costs are significant as well. Rural industrialization has not yet induced meaningful urbanization. As a consequence, TVEs in general will continue to miss the great benefits created by urbanization for a long period. In other

words, the further development of TVEs will be increasingly restricted by the lack of infrastructure, market information and strategic services (cf. Section 1.3) and by poor transportation and communication networks. Furthermore, human capital development of TVEs will be increasingly constrained by localized and kinship-based vested interests and by dual role of their employees as both workers and peasants.

At the macroeconomic level, the widespread pattern of TVE distribution suggests three negative consequences:

- (a) the uses of scarce land and existing infrastructure are inefficient;
- (b) the development of the service industry is restricted by the absence of demand for its products, meaning that the strong job-creating capability of the service industry, which is urgently needed in China, would not be sufficiently exploited; and
- (c) there is the risk that environmental pollution may go unchecked in certain localities. In order to tackle these problems the Chinese government has started to pay greater attention to the establishment of industrialized small cities and towns since early 1990s. Some experiments have been conducted and some supporting policies have been issued. The role of both central and local governments in this area is certainly critical.

The challenges linked with the general development problems cannot be solved by ownership reform alone, though ownership reform will create a sound institutional environment for tackling these development problems. Ownership restructuring is only one of the major subjects in the process of TVE development. Management modernization, creation of forms of urbanization which are compatible with TVE growth, human capital development, and catching up modernized corporations are all critical challenges faced by TVEs and China's government. The challenges from both reform and development dimensions will continue to place pressure on all of the players in this competition field, providing them with strong incentives and stimulating them to look for innovative and adaptive solutions one after another.

TABLE 4.1 BUSINESS REVENUE, PROFIT PLUS TAXES, EMPLOYMENT AND NUMBER OF RURAL ENTERPRISES, BY TYPE OF OWNERSHIP  
1985-96

	Township			Village			Household + joint households			Total		
	1985	1991	1996	1985	1991	1996	1985	1991	1996	1985	1991	1996
Revenue												
billions yuan	85.6	305.3	1,828.5	53.7	246.2	1,833.2	93.9	351.2	3172.6	233.2	902.7	6834.3
share (%)	36.7	33.8	26.8	23.0	27.3	26.8	40.3	38.9	46.4	100.0	100.0	100.0
Profit & taxes												
billions yuan	13.2	28.5	144.1	10.3	29.7	173.0	14.0	48.9	308.2	37.5	107.1	625.3
share (%)	35.2	26.6	23.0	27.5	27.7	27.7	37.3	45.7	49.3	100.0	100.0	100.0
Employment												
million persons	21.1	24.3	29.6	20.4	23.4	29.9	28.3	48.5	75.6	69.8	96.1	135.1
share (%)	30.2	25.3	21.9	29.2	24.3	22.1	40.5	50.5	56.0	100.0	100.0	100.0
Number												
thousand firms	420	380	410	1,150	1,060	1,140	10,650	17,650	21,810	12,220	19,090	23,360
share (%)	3.4	2.0	1.8	9.4	5.6	4.9	87.2	92.5	93.4	100.0	100.0	100.0

Sources: *Yearbook of China's Township and Village Enterprises 1996*: 99-109; *1997*: 121-2.

TABLE 4.2 THE SECTORAL DISTRIBUTION OF RURAL ENTERPRISES, 1995 AND 1996

	Township		Village		Household + joint households		All rural firms	
	1995	1996	1995	1996	1995	1996	1995	1996
Revenue Share (%)								
Industry	80.19	79.16	80.44	78.20				
Construction	10.73	10.28	5.24	5.25				
Transport	1.11	1.23	1.52	1.55				
Commerce	5.02	5.80	6.80	7.22				
Service	0.58	0.59	1.46	1.64				
Agriculture	1.47	2.19	3.60	5.29				
Others	0.90	0.75	0.93	0.84				
Value Added Share (%)								
Industry	80.22	79.56	82.22	80.21	61.17	59.88	74.03	71.50
Construction	12.53	12.23	5.58	5.58	8.27	7.08	8.78	8.13
Transport	1.38	1.42	1.95	2.24	12.38	12.94	5.51	6.49
Commerce	3.23	3.76	4.17	4.83	11.71	13.34	6.57	8.09
Service	0.70	0.74	1.59	1.83	5.40	5.93	2.68	3.23
Agriculture	1.60	1.93	4.02	4.76	0.34	0.03	1.92	1.95
Others	0.32	0.33	0.47	0.58	0.73	0.81	0.51	0.60

Sources: Yearbook of China's Township and Village Enterprises 1996: 99-100; 1997: 121-2.

TABLE 4.3 SUBSECTORAL SHARES OF OUTPUT AND EMPLOYMENT IN RURAL INDUSTRY, 1985-94

	Shares of output value				Shares of employment			
	1985	1989	1992	1994	1985	1989	1992	1994
Metallurgy	2.63	5.14	6.34	8.23	2.18	2.91	3.03	6.87
Power	0.30	0.31	0.27	2.33	0.45	0.44	0.41	3.15
Coal and Coke	3.90	3.05	2.24	1.66	5.45	5.10	4.89	4.14
Petroleum	n.a.	0.23	0.27	1.08	n.a.	0.09	0.11	1.85
Chemical	7.44	10.25	11.11	9.52	5.68	7.06	7.96	6.28
Machinery	20.00	23.93	27.64	24.02	14.62	18.56	19.67	19.42
Building materials	18.64	17.43	14.49	13.82	30.64	28.86	24.41	19.57
Forest	2.67	2.46	2.30	3.42	3.08	2.84	2.73	5.44
Food, beverages and tobacco	7.80	8.45	7.75	8.93	7.81	6.97	6.77	6.99
Textile, clothing & leather	17.02	18.50	19.99	18.86	13.81	14.60	17.07	17.36
Papermaking & cultural articles	4.12	6.20	6.36	3.87	5.21	8.56	8.65	4.80
<b>Others</b>	14.76	4.05	1.24	n.a.	10.72	4.00	4.29	n.a.
<b>Total</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>

Source: *Statistical Yearbook of China 1987* (English version): 226–7; 1991: 419–20; 1993: 441–2; and 1995: 399.

Note: For translation between 'new' and 'old' industrial classifications, see *Statistics on Labour and Wages of China, 1949–1985* (1987: 275–82).

TABLE 4.4 THE GROWTH OF TVE EXPORT, 1988-97

	1988	1991	1993	1995	1997
TVE export (billion US dollars)	8.02	14.8	38.1	64.5	84.6
TVE share in total export (%)	16.9	20.6	41.5	43.3	46.3
Average exchange rate (yuan/\$1)	3.718	5.327	5.761	8.369	8.270

Sources: *Yearbook of China's Township and Village Enterprises 1990*: 20, 1996: 102-3; *Statistical Yearbook of China 1993*: 633, 1997: 587; and *People's Daily*, 5 February and 22 March 1998.

TABLE 4.5 THE COMPARISON OF DEBT-ASSET RATIOS BY OWNERSHIP, END OF 1995

	Industrial SOEs	Township-run TVEs	Village-run TVEs	Community-run TVEs	Joint households	Individual households
Total assets (billion yuan)	4747.21	1182.00	806.70	1988.70	156.50	568.00
Total debts (billion yuan)	3123.66	803.60	446.00	1249.60	54.80	144.10
Debt/asset (%)	65.80	67.99	55.29	62.84	35.02	25.37

Sources: Data for industrial SOEs are taken from 'Selection from the 1995 National Industrial Census' published in *People's Daily*, 25 July 1998. Data for TVEs with different ownership forms are from *TVE Yearbook 1996*: 100-1.

TABLE 4.6 THE RISING DEBT/ASSET RATIO OF CORE TVES IN SUZHOU CITY, JIANGSU PROVINCE, 1980-94

Year	Total assets <sup>a</sup> (billion yuan)	Total debt (billion yuan)	Total equity <sup>b</sup> (billion yuan)	Debt/Asset (per cent)
1980	1.71	0.64	1.08	37.17
1982	2.47	1.02	1.46	41.15
1983	3.10	1.27	1.83	41.04
1984	4.62	2.34	2.28	50.62
1985	6.90	3.67	3.23	53.23
1986	8.34	4.84	3.50	58.00
1987	10.92	6.55	4.37	59.98
1988	15.36	9.53	5.83	62.07
1989	18.06	10.50	7.56	58.13
1990	20.86	12.01	8.86	57.54
1991	26.90	15.77	11.22	58.64
1992	40.00	24.01	15.98	60.03
1993	57.80	35.32	22.48	61.11
1994	72.96	45.18	27.78	61.92

Source: Xu and Zhang (1997).

Notes: (a) total assets are defined as the sum of year-end book value of fixed assets, working capital, incorporeal capital, and long term investment.;(b) total equity is held by the communities (townships or villages) and the enterprises, respectively, according to the sources of investment.



TABLE 4.7 COMPARISON OF DEBT/ASSET RATIO + PERFORMANCE OF TOWNSHIP-RUN TVEs, SURVEY DATA IN SOUTHERN JIANGSU 1995

Grouped by debt/asset ratio (per cent)	Within each group							
	Frequency		Profitable		Loss-making		Break even	
	Number	per cent	Number	% in the group	Number	% in the group	number	% in the group
• 50	10	9.01	6	60.0	0	0.0	4	40.0
50 - 60	15	13.51	10	66.7	3	20.0	2	13.8
60 - 70	21	18.92	17	81.0	4	19.1	0	0.0
70 - 80	19	17.12	13	68.4	4	21.1	2	10.5
80 - 90	19	16.21	13	72.2	5	27.8	0	0.0
90 - 100	7	6.31	4	57.1	3	42.9	0	0.0
100<	21	18.92	7	33.3	11	52.4	3	14.3
Total	111	100.00	70	63.1	30	27.0	11	9.9

Source: Shi and You (1997).

Notes: All 111 surveyed firms are township enterprises. They are distributed in four counties (Wuxian, Wujiang, Taicang, and Kunshan) and four industries (light textile, construction materials, machinery, and chemicals). Of them, 11 had assets of 50 million yuan, 35 had assets between 10 and 50 million yuan, 25 between 5 and 10 million yuan, and 41 had assets less than 5 million yuan. Their average debt/asset ratio was 70.4 per cent.

TABLE 4.8 THE DISTRIBUTION OF OWNERSHIP RESTRUCTURING FORMS, BY THE END OF 1997 (PER CENT)

	Joint-stock co-operative	Sold to private investors	Limited Liability	Merged & Re-grouped	Joint-stock company	Bankruptcy	Others
Restructured core-TVEs	63.37	12.15	4.66	3.82	1.58	0.66	13.91
Total core-TVEs	21.23	4.07	1.56	1.28	0.53	0.22	4.66

Source: *People's Daily*, 25 July 1998.

Notes: The data are from Ministry of Agriculture. In total, 33.50 per cent of community-owned TVEs restructured their ownership form by the end of 1997. 'Others' consist of mainly leasing and the re-registration of 'fake' collective TVEs back to private ownership.

## CHAPTER 5

### THE DYNAMICS OF THE PRIVATE SECTOR

*Laixiang Sun*

#### 5.1 Development of the private sector: an overview

The private sector of the Chinese economy consists of domestically owned private and household enterprises.<sup>25</sup> According to the official definition, 'a private enterprise refers to an economic organization that aims at making profit and in which assets are privately owned and there are eight or more employees', a privately owned firm with less than 8 employees is then classified as household or joint-household enterprise (State Council, 1988).

TABLE 5.1 PRIVATE AND HOUSEHOLD ENTERPRISES IN INDUSTRIAL PRODUCTION,  
1985 AND 1995

	Capital share (%)		Employment share (%)		Output value share (%)	
	1985	1995	1985	1995	1985	1995
Private firm	n.a.	1.0	n.a.	3.3	n.a.	2.6
Household firm	0.5	1.9	8.9	17.5	1.8	10.5

Source: 'Selection from the 1995 National Industrial Census', *People's Daily*, 19 February 1997.

Since household firms rose from zero in the later 1970s, and private firms rose from zero in the mid-1980s (Wang and Changfu, 1997: 2-8),<sup>26</sup> their growth rates by all standards of measurement have been the highest in comparison with those of other ownership categories. For a better understanding of their relative positions in the national economy, we compile Tables 5.1 and 5.2 to show the shares of capital, employment, and output values of private and household industrial enterprises in the national industry in 1985 and 1995, and the shares of employment and retail sales of private and household trading enterprises in the national retail trades in the period of 1990-7. Industry and commerce are sectors number one and two for private firms and number two and one sectors for household firms, respectively (Tables 5.5 and 5.6).

<sup>25</sup> This definition is consistent with that in Chinese official statistics, where enterprises owned by foreigners and those owned by overseas Chinese from Hong Kong and Taiwan are classified as an independent category. For the purposes of this study, which focuses on analysing the evolutionary changes in ownership and governance structures of China's domestic firms, we will not discuss the features of these foreigner-owned and overseas-Chinese-owned firms.

<sup>26</sup> Official statistical data for private enterprises started to appear in various yearbooks from 1993 onwards.

Tables 5.1 and 5.2 show that until the mid-1990s the relative position of private enterprises in the national economy was still insignificant although there was a strong growth trend. However, in 1995 the private sector as a whole produced 13.1 per cent of national industrial output and provided 20.8 per cent of industrial employment based on only 2.9 per cent of total industrial capital. This indicates that the private sector has most effectively exploited the comparative advantage of factor endowment in China's economy. In the commerce sector, the private sector has provided more than 73 per cent of employment since 1996 and accounted for more than 46 per cent of total retail sales since 1997. It is expected that the latter share will soon exceed 50 per cent.

TABLE 5.2 PRIVATE AND HOUSEHOLD ENTERPRISES IN RETAIL TRADE, 1990-7

	Employment share (%)			Share in total retail sales (%)		
	1990	1994	1996	1990	1995	1997
Private firm	n.a.	1.83	3.15	n.a.	1.64	3.79
Household firm	50.14	66.32	70.59	21.65 <sup>a</sup>	30.33 <sup>a</sup>	42.28

Source: *Statistical Yearbook of China* 1991: 570; 1996: 556; 1998: 590, 594, 595 and 599.

Notes: <sup>a</sup> shares in total retail sales of consumer goods.

TABLE 5.3 BASIC INDICATORS FOR PRIVATE ENTERPRISES IN CHINA, 1993-7

	Number of enterprises	Number of investors	Number of employees	Registered asset (million yuan)	Asset per firm (1,000 yuan)	Employees per firm (person)
1992	73,646	167,100	1,340,618	{22,101}	{159.00}	18.2
Rural	65,987	136,000	977,780			14.8
Urban						
1993	105,781	232,200	1,864,800	19,045	180.04	17.6
Rural	132,138	281,600	1,861,400	48,972	370.61	14.1
Urban						
1994	190,852	388,000	3,159,714	44,630	233.85	16.6
Rural	241,388	501,000	3,323,988	100,154	414.91	13.8
Urban						
1995	283,052	556,000	4,149,800	79,526	280.96	14.7
Rural	371,479	783,600	4,070,300	182,645	491.67	11.0
Urban						
1996	332,900	649,500	4,861,700	104,560	314.09	14.6
Rural	486,400	1,055,100	5,145,100	270,678	556.49	10.6
Urban						
1997	365,075	710,000	5,997,000			16.4
Rural	595,650	1,332,000	7,496,000	{514,000}	{535.01}	12.6
Urban						

Source: *Almanac of China's Economy* 1993: 841; 1994: 664; 1995: 607 and 769; 1996: 714 and 920; 1997: 872; *Statistical Yearbook of China* 1993: 113; 1994: 102; 1995: 102; 1998: 152; *People's Daily*, 8 March 1999; and Wang and Changfu (1997: 13).

Table 5.3 reports basic indicators for private enterprises in China during 1993-7, which include total numbers of firms, investor-owners, and employees, the total registered

capital, capital per firm and employees per firm in rural and urban areas. Table 5.3 shows that by 1997 there were about 960,000 private enterprises owned by about 2 million private investors and these firms provided employment for about 13.5 million people. All these three figures reflect a 7-fold multiplication in the five years since 1992.

It can be seen from Table 5.3 that private enterprises in urban areas expanded more rapidly than its counterpart in rural areas although the rural part expanded very quickly as well. In 1992, numbers of firms and employees in the urban part accounted for 47 and 42 per cent of the total, and by 1997 these two shares increased to 62 and 65 per cent, respectively. The much more rapid expansion of the urban private enterprise sub-sector can be attributed to two factors: an increasing large number of layoffs from state-owned and urban collective firms since 1993 (Gu, 1999) and much greater opportunities for private firms in urban areas. Both factors are largely induced by the renewed reform efforts since 1992. Another distinctive feature between the urban and rural private firms is revealed by the figures of capital per firm and employees per firm. On average, the rural private firms show a relatively large size in terms of employee per firm but a much smaller size in terms of capital per firm, indicating that the urban firms are relatively capital intensive and the rural ones are relatively labour intensive. A large part of the difference may be due to the fact that land and buildings in urban areas are much more expensive than in rural areas.

TABLE 5.4 BASIC INDICATORS OF HOUSEHOLD FIRMS IN CHINA, 1981-97

Year	Number of firms			Employment			Total revenue (billion yuan)
	Number (million)	Rural (%)	Urban (%)	Person (million)	Rural (%)	Urban (%)	
1981	1.83	52.54	47.46	2.27	53.56	46.44	1.09
1985	11.71	76.13	23.87	17.66	78.27	21.73	75.06
1990	13.28	70.32	29.68	20.93	71.22	28.78	149.22
1991	14.17	70.43	29.57	22.58	71.58	28.42	179.82
1992	15.34	68.93	31.07	24.68	70.00	30.00	186.13
1993	17.67	67.42	32.58	29.39	68.38	31.62	330.92
1994	21.87	67.07	32.93	37.56	67.56	32.44	421.14
1995	25.29	66.07	33.9	46.14	66.20	33.80	897.25
1996	27.04	65.41	34.59	50.17	65.94	34.06	1155.42
1997	28.51	64.09	35.91	54.42	64.73	35.27	n.a.

Sources: *Almanac of China's Economy 1997*: 872 and *Statistical Yearbook of China 1998*: 153.

Although the typical size of private firms has been small, some large private firms have emerged. In January 1999, the first batch of 20 large private firms were granted autonomy in import and export business. At average, each of them had registered capital of 68 million yuan and annual business revenue of 650 million yuan. Their average size in terms of capital was about 127 times the average for all private firms in 1998 (*People's Daily*, 29 March 1999).

By 1997, there were 28.5 million household firms which provided jobs for 54.4 million people. The former figure is 2.1 times and the latter is 2.6 times those of 1990 (Table 5.4). With respect to the rural and urban distribution, the shares of urban household firms in the total numbers of firms and employees increased from less than 30 per cent in 1990 to more

than 35 per cent in 1997, indicating a more rapid expansion of the sub-sector of urban household enterprise. For both rural and urban household firms, their average number of employees per firm is almost same in any given year. The average size in terms of employees per firms increased slightly year by year, rising from 1.6 persons per firm in 1990 to 1.9 persons per firm in 1997. The reasons for the more rapid expansion of the urban household enterprise sub-sector are the same as those for the expansion of the urban private enterprise sub-sector.

Tables 5.5 and 5.6 present the percentage distributions of numbers of private and household enterprises by industry. Table 5.5 shows that although some private enterprises shifted to the service sector, more than half of them continued to engage in industrial production in the first half of the 1990s. The second largest sector for the private enterprises is the commerce sector, which made up 36.7 per cent of China's private firms in 1995. A remarkable new phenomenon is the emergence and rapid expansion of the private-owned professional consulting and service firms in the 1990s.

TABLE 5.5 PERCENTAGE DISTRIBUTION OF NUMBER OF PRIVATE ENTERPRISES BY INDUSTRY, 1991-5

	1991	1993	1994	1995
Industry	67.31	52.80	51.10	50.50
Construction	2.69	2.83	2.40	2.50
Transportation	1.25	1.10	0.93	0.90
Commerce	20.75	31.10	33.50	36.70
Catering services	1.86	2.02	2.20	2.10
Social services	2.00	4.84	4.63	6.40
Repairing	1.80	1.27	1.22	0.56
Professional consulting	0.87	2.40	2.10	n.a.
Others	1.21	1.80	1.40	2.25 <sup>a</sup>

Source: *Almanac of China's Economy 1995*: 608, *1996*: 714; Wang and Changfu *1997*: 108).

Note: <sup>a</sup> this figure may include that of 'professional consulting'. Columns may not tally due to rounding; the larger error beyond rounding in the 1995 column appears in the original source table (*Almanac of China's Economy 1996*: 714).

TABLE 5.6 PERCENTAGE DISTRIBUTION OF NUMBER OF HOUSEHOLD FIRMS BY INDUSTRY, 1990-5

	1990	1991	1992	1993	1994	1995
Industry	12.30	12.40	12.04	11.80	11.90	11.90
Construction	0.20	0.19	0.19	0.19	0.21	0.26
Transportation	9.50	9.70	9.45	10.10	11.30	10.80
Commerce	54.20	54.40	55.14	54.74	52.80	52.00
Catering services	10.20	10.20	10.28	10.42	10.00	9.40
Social services	5.90	6.00	6.10	6.15	6.20	12.30
Repairing	6.70	6.20	5.82	5.43	5.10	4.30
Others	0.93	0.90	0.98	1.29	1.40	1.20

Source: *Almanac of China's Economy 1996*: 717.

Note: Columns may not tally due to rounding.

Household firms have concentrated in the broad service sector in general, and in commerce (mainly retail trade) in particular. More than half of the household firms has engaged in retail trade and another ten per cent in catering services. The industrial and transportation sectors have attracted another (little more than) 20 per cent of household firms. Of those industrial household firms, a vast majority do sub-contracting or piecework for SOEs, TVEs, and other 'corporate' organizations.

Although private enterprises have been exposed to the greatest economic uncertainty and risk in comparison with other ownership forms in the communist-party-ruled economy of China, the attractiveness of them has increased significantly. Table 5.7 reports the comparative structure of age, previous occupations, and educational levels of the heads of private enterprises at the starting time of their private businesses in the years 1988 and 1992. This table is based on two detailed surveys conducted by the Sociology Institute of the Chinese Academy of Social Sciences, National Association of Industry and Commerce and other collaborating institutions in 1988 and 1992.

The most impressive phenomenon revealed in Table 5.7 is that a significantly increasing number of government officials quit their government positions and set up their own private firms. A phenomenon has been named '*xiahai*' (a literal translation is 'leaping into the sea') in Chinese.<sup>27</sup> From 1988 to 1992, the total number of private enterprises almost doubled (Wang and Changfu, 1997: 11-3). Along with this rapid expansion, the proportion of *xiahai* officials among the private entrepreneurs increased by 5.7 percentage points, from 19.8 per cent in 1988 to 25.5 per cent in 1992. Additional government officials quit their positions to join other non-state business entities. *Xiahai* is an interesting phenomenon and seems to be unique to China, which has started to attract increasing research interest (Li, 1998). For example, in Russia, politicians are typically not accepted by the private sector with the exception of Moscow, and they are continuously tying up with former SOEs and acting as rent-seekers (Shleifer, 1997).

The private business has exhibited increasing attractiveness to SOE technicians and workers as well. The share of SOE technicians among total private entrepreneurs increased from 1.9 per cent in 1988 to 4.9 per cent in 1992. Although the share of SOE workers decreased from 13.2 per cent in 1988 to 10.8 per cent in 1992, the absolute number of *xiahai* workers increased significantly. Please note that before 1993 the vast majority of these *xiahai* workers and technicians had not been laid-off by SOEs. In most cases the opposite was true—they were typically some of the most competent staff members of the SOEs.

Largely due to the massive joining of the *xiahai* wave by bureaucrats, skilled workers, and technicians, the average educational level of the private entrepreneurs improved significantly. The share of those with the educational level of high school and above increased from 48.3 per cent in 1988 to 61.1 per cent in 1992. In particular, the share of those with university and above level education increased from 9.5 per cent in 1988 to 16.3

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<sup>27</sup> 'Sea' and 'ocean' are used to represent private and other non-state businesses in the Chinese word *xiahai*, because the initial joint ventures and private enterprises were connected with overseas Chinese in the early 1980s and domestic private enterprises first emerged in the coastal areas and Hainan island. For economic analysis of the *xiahai* phenomenon, see Section 5.3.

per cent in 1992. *Xiaohai* phenomenon indicates a successful transfer of human capital from an inefficient to a highly efficient sector in the transition.

TABLE 5.7 AGE, PREVIOUS OCCUPATION, AND EDUCATIONAL LEVEL OF THE HEAD OF PRIVATE ENTERPRISES WHO STARTED THEIR OWN BUSINESS IN 1988 AND 1992

	1988	1992
Average age (years)	31.5	36.7
Original occupation (%)		
Self-employed	35.8	36.9
Peasants	20.8	15.8
Officials	19.8	25.5
Workers	13.2	10.8
Technicians	1.9	4.9
Jobless	8.5	6.1
Educational level (%)		
University & above	9.5	16.3
High school	38.8	44.8
Middle school	37.1	32.6
Primary school & below	14.7	6.4

Source: Surveys conducted by the Sociology Institute of the Chinese Academy of Social Sciences, National Association of Industry and Commerce, and other collaborating institutions; *People's Daily*, 8 March 1999.

## 5.2 The Wenzhou model: an example of private sector development in China

Wenzhou is a prefecture-level municipality and located in the southeast corner of coastal Zhejiang province.<sup>28</sup> Wenzhou covers 11,800 square kilometres, including two municipal districts, one inland city, and eight rural counties. Wenzhou has a population of over six million, and is the most populous among Zhejiang's prefectures. Due to its mountainous terrain, high population density, and natural resource shortage, life based on only agriculture was extremely difficult as proven in the pre-reform period. For example, in 1978, the average annual per capita income of rural residents in Wenzhou was only 113.5 *yuan*, lower than the national average of 133.6 *yuan*, far lower than the provincial average of 165 *yuan* (Yuan, 1987: 10).<sup>29</sup>

The high scarcity of land had in fact stimulated 'underground' household workshops to conduct traditional handicrafts such as umbrella making, shoe making, cotton spinning, weaving, and fluffing, and even production of vital materials and energy before the mid-1970s. Since 1978, the development of the private sector in Wenzhou has gone through three stages: first scattered household businesses; then business affiliation (*guahu*) of household enterprises to SOEs, TVEs and other corporations; and then formation of joint-stock co-operatives and corporations.

The economic achievement of Wenzhou is most impressive among prefectures in China. From 1978 to 1997, the municipal GDP increased from 1.33 billion *yuan* to 60.5 billion

<sup>28</sup> For English publications on the Wenzhou Model, see Liu (1992) and Parris (1993), among others.

<sup>29</sup> *People's Daily*, 30 March 1999; *Comprehensive Statistics on China's Rural Economy, 1949-1986*: 558.

yuan, government revenue increased from 135 million yuan to 870 million yuan, and annual per capita income of rural residents increased from 113.5 yuan to 3,700 yuan. All these growth rate records are more than double the national average and have been dominantly created by the private sector.<sup>30</sup>

### 5.2.1 *Scattering household industries and trade*

The first time the Wenzhou model became known nation-wide was in 1973, when the Central Committee of the Communist Party of China ordered circulation of an evidence-document describing 'capitalist restoration' in Wenzhou. The document characterized Wenzhou as a bad model of capitalist restoration and required all local governments to draw the negative lessons from it. The document indicated that by 1973 there were tens of thousands rural households engaged in household production of non-agricultural products and trade. These business activities are identified as illegal 'underground factories' and black market operations during the Cultural Revolution period.

Ironically, it is due to the chaos of the Cultural Revolution, that state control over society weakened considerably in those remote and mountainous regions like Wenzhou. In these regions, basic consumer goods were in severe shortage, urban unemployment and rural labour abundance were increasing, and the public economy was barely functioning. The simple survival urge pushed individuals and households to undertake alternative strategies beyond their state assignments. They set up household workshops and sold products on the black market in towns and cities. They also started to employ the strategy of business affiliation, but on a small scale.

As a component of the reform initiative in the late 1970s, national policy on household industry and commerce was relaxed. The 'private petty commodity economy' of household workshops and trade was recognized as a way of filling in the gaps left by the SOEs and collectives. As a result, household industries and private trade in traditional and new small commodities started to grow very rapidly in Wenzhou, although a longer-term legal or ideological basis for them was still absent.

### 5.2.2 *Business affiliation (guahu)*

For individual households, the development of scattered household industries and trade is severely constrained by their disadvantages in areas such as product marketing, input material search, licence application and approval, and establishment of commercial trust and a good reputation. For local governments, monitoring numerous household businesses in terms of licence qualification and the follow-up qualification control alone would be too onerous to be easily manageable.

To solve these difficulties at the least cost, in addition to the popular practice of sub-contracting, the innovative arrangement 'business affiliation' (*guahu*) was initiated and developed. Under this arrangement, household industrial and commercial firms attached themselves to an established collectively-owned or state-owned enterprise, paying a fee for the use of its name (and thus its license and commercial reputation), stationery, letters of introduction, and most importantly, bank account numbers and receipt books. Taxes were

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<sup>30</sup> *People's Daily*, 30 March 1999.



collected from the established public enterprises rather than these attached households. In comparison with sub-contracting, business affiliation gives more autonomy and flexibility to household firms. The cost is that some attached household firms have more room to undertake opportunistic behaviour and damage the reputation of the established public enterprise. In both forms of sub-contracting and business affiliation, local governments delegate *de facto* monitoring rights to the established public firm. As a result, local governments obtained much greater administrative control over what were essentially underground firms before.

The business affiliation form became pervasive in Wenzhou in the late 1970s and 1980s. Although the relevant statistical data are not available, one source indicates that by the mid-1980s, about 62 per cent of household industrial and commercial firms were *guahu* firms. In some areas the figure was as high as 90 per cent (Huang, 1986).

### 5.2.3 *Wearing a red hat (dai hongmaozi)*

Parallel to the business affiliation practice of household firms, private firms which have grown beyond family-based entities usually registered as collectively owned entities and accepted their neighbourhood committee or village government as the responsible administrative body. In exchange, the administrative body collected a management fee and shared other benefits and control rights to a varying degree. This practice was known as 'wearing a red hat' (*dai hongmaozi*). The red hat allows these *de facto* private enterprises to avoid political risk and the stigma long associated with private business in China. It also brought them greater access to bank credits, raw materials, land, power and fuel quotas, contracts, etc. On the other hand, local governments and officials benefited by being able to register, police and collect taxes and fees from this otherwise underground economy (Parris, 1993). Both the business affiliation and the 'red hat' arrangements provided a sound basis for smoother and cost-saving transactions and for the rapid economic development in Wenzhou in the early years of reform.

### 5.2.4 *Joint-stock co-operatives and corporations*

The practice of business affiliation and wearing a red hat is a transactional relationship which can be distinguished as a 'quasi-market contract' between private firms and the administrative bodies or public firms for purchasing or renting the desired institutional and social capital (Sections 1.3 and 2.1). In the case of 'business as usual', the costs of such quasi-market contracting (including costs associated with implementing, enforcing and re-negotiating agreements, and protecting against third-party infringement of property rights) in terms of time, money and risk may not increase too much. However, in an economy with impressive growth and dynamics like Wenzhou, these transactional costs increase very rapidly. The established public enterprises become increasingly interested in predatory rent maximization rather than effective provision of services. Disputes are raised typically before the fixed re-negotiation date by the public firm and the attached firms have to follow its predatory requirement due to the lock-in effect. On the other hand, many attached household firms behave opportunistically to maximize their own profit at the cost of the business reputation of the whole group. By the mid-1980, products with poor quality and/or fake brand names produced by the business affiliation firms brought a bad reputation to all Wenzhou firms. As a consequence, even local governments became

intolerant of, and started to reorganize, the business affiliation firms (Han and Zhang, 1993: 181).

In comparison with the arrangements of business affiliation and red hat wearing the arrangement of joint-stock co-operatives has obvious cost-benefit advantages. The disputes over the issue of sharing residual benefits and residual control rights between the individual attached firm and its 'nominal supervisor', namely the established public firm or institution, disappear for a joint-stock co-operative firm. In other words, the previous quasi-market contracting arrangement over residual benefits and residual control rights is now replaced by direct ownership arrangement, resulting in a significant reduction of transaction costs. The joint-stock form creates economies of scales in terms of capital, production and marketing for the firm. The legal position of the co-operative and the significantly enlarged scale of business bring in the much needed institutional and social trust to the firm, for which the firms in the affiliated relationship were having to pay a high and increasing price. Disputes may occur among shareholders of the firm over some important issues. However, the distribution of residual benefits is well defined by shares now, and the exercise of residual control rights becomes better matched with the corresponding residual benefits rights.

Driven by these significant cost-benefit advantages, as well as the reputational collapse and ensuing government promoted reorganization of the business affiliation firms, the ownership arrangement of joint-stock co-operative emerged much earlier in Wenzhou than in other regions. By 1990, there already were about 13,000 joint-stock co-operatives in Wenzhou. Of them, 2,325 were certified by the city government as having achieved the norm in terms of standardized institutional arrangements, accounting system, and decision-making procedures (Han and Zhang, 1993: 185-7). In 1997, the number of joint-stock co-operatives in Wenzhou reached about 43,000. Of them, about 31,000 were industrial firms, which produced about 86 billion yuan of output, accounting for over 70 per cent of the city's total industrial output (Li, 1997).<sup>31</sup>

The most distinctive feature of joint-stock co-operatives in Wenzhou is that about 90 per cent of them originate from the voluntary co-operation of private and household enterprises, rather than from the ownership restructuring of the original collective firms (Han and Zhang, 1993: 182-3). As a result, joint-stock co-operatives in Wenzhou have been dominated by management joint-stock ownership and employee joint-stock ownership, in which there is no community share or collective share.

The management-owned joint-stock form makes it easy for co-operatives to transform themselves into a limited liability company and joint-stock company, because managers typically have the majority of shares. From 1994 to 1997, 6,738 joint-stock co-operatives with management ownership restructured themselves into the forms of limited liability company and joint-stock company. By 1997 there were 10,868 limited liability companies and 15 joint-stock companies in Wenzhou (Wang and Wang, 1998). At the same time, in many employee-joint-stock co-operatives, the tendency of increasing share-concentration to the core shareholders (mainly, core managers) has continued.

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<sup>31</sup> *People's Daily*, 30 March 1999.

The Wenzhou model has shown a successful process of the private sector development and evolution in China. In the evolutionary process, the available material, human, institutional and social capital seem to have been efficiently utilized. The evolution has fitted well into the development levels of this capital, particularly the progressive level of 'knowing-how'. The process in Wenzhou is a typical one of 'reform from below'. Although reform policy from above provides a favourable atmosphere for local initiatives, the radical extent of these initiatives and their subsequent evolution are determined by individuals, households, groups and government officials at the local level pursuing their pragmatic interests and responding to the failure of the state sector to meet local demands. They have managed to work the state socialist system to their own advantage, and to transform the existing institutions into market-oriented ones.

Local governments have played a pivotal role in the evolutionary process. They not only collude with local entrepreneurs to pursue local interests, but also function as an active market regulator to promote fair competition, technology improvement, and the establishment of the quality reputation of Wenzhou production in national and international markets (Li, 1997). At the same time they have actively intermediated the 'chronic negotiation' between local groups and the agents of central and provincial governments to resolve conflicts, accommodate the changing environments, and recommend the new institutions and policy options (Parris, 1993).

### **5.3 The dependence of private enterprises on local governments for social and institutional capital**

Although for a long period many *de facto* private enterprises ran their business by the methods of business affiliation and red hat wearing, not all of them did so. For example, during the period of 1981-7, when the government policy towards private enterprises was 'tolerating but discouraging', the numbers of registered private enterprises in Anhui Province were 370 in 1983, 644 in 1984, 1,336 in 1985, 1,642 in 1986 and 1,640 in 1987, respectively (Wang and Changfu, 1997: 6). During 1988-94, when government policy shifted to encourage the development of private enterprises but leaving many discrimination policies intact, tens of thousands of private enterprises emerged and developed, and they registered themselves as private ownership directly (Table 5.3).

In an environment characterized by policy discrimination, ideological hostility, and unstable central government policy towards private enterprises, the impressive development of private enterprises raises several interesting and important questions, all of which are of policy significance: How might one favour stable expectations for long-term investment and the development of private enterprises rather than the uncertainty which can arise from the haphazard enforcement of laws and regulations by agents of the state? Can channels for inter-regional information exchange be identified? How can social trust and morality be established and used to facilitate resource allocation, stable expectations and information flows? In addition to these questions, the unique phenomenon of *xiaohai* that refers to government officials voluntarily quitting their government positions to join the community of private business (Section 5.1) should deserve special research attention.

### 5.3.1 *The contributions of community linkage and patron-client ties*

In a transition and developing economy like China, accesses to key raw materials, land, equipment, funds, and contacts have been historically associated with government agencies at different level. Particularly in the context of China, the bureaucracy has been the dominant integrative structure in the social order until very recently. In order to obtain the accesses to key material factors as well as social and institutional capital that are necessary for long-term development of private enterprises, private enterprises in China always require local government support and co-operation with local governments in many ways. This support is typically supplied partly in exchange for a share in both residual benefits rights and residual control rights. As a result, there have been obvious differences between these private enterprises in China and the typical private enterprise in a capitalist economy. These differences were well understood by the Central Committee of the Communist Party of China in the early years of the reform.

'Of enterprises which are currently exceeding regulation employment numbers, some have implemented systems different from private enterprises (*siren qiye*), for example, taking a certain proportion of after-tax profits to be invested in collective assets; regulating the limits of dividends and owners' income; issuing a certain amount of profit to workers, etc. These thus have elements of [a] co-operative economy to varying degrees. We should help them continue to improve, and they may be treated differently from capitalist employers'. (State Bureau of Industrial and Commercial Administration and Theoretical Department, *Beijing Daily* 1984).

The rural private enterprises appear more like the wider community enterprises in which township and village governments have established informal but effective proprietary interests (Young, 1994). On the other hand, the ties between the urban entrepreneurs who operate private enterprises and the officials staffing state administrative, distributive and production entities appear more like patron-client relationships (Wank, 1996).

Along with the increasing marketization, which has led to many material factors becoming directly available in the markets, private enterprises have nonetheless continuously needed local government support to establish and guarantee social trust in their business activities. Partly induced by the long history of authoritarian governments, the bureaucracy in China has been the dominant integrative structure in the social order. The social trust embodied in a community or a patron-client relationship is not readily transferable by one actor to another community entity or relationship. This fact increases the likelihood of ongoing future co-operation and an orientation towards mutual benefit. As a consequence, it is possible to see that social trust in this form, like other production factors or capital, is productive. It enables actors to calculate risks and likely returns, encourages business activity by creating the reasonable expectation that others involved in the relationship will behave in a fairly predictable way, and tends to foster much more business activity than alternative forms, including the absence of this type of social trust.

This social trust links entrepreneurs with the overarching bureaucratic structure. The connection cannot be viewed simply as a localized exchange of commercial wealth for bureaucratic power. Its contribution to productivity and marketization may be much more

significant. From the perspective of private entrepreneurs, the connection provides local stability in an environment characterized by unstable central government policy and ideological hostility. At the same time, it offers private entrepreneurs institutionalized access to crucial resources such as bank credits, land and key raw materials, many of which remain directly or indirectly controlled by government. From the perspective of local governments and officials, the connection institutionalizes new sources of revenue to cope with the increasing expenditure and development pressure (Li, 1996; Wank, 1996; Wong, 1995).

The major contribution of community linkage and/or patron-client ties is stylized as the stimulation of competition, support for innovation, the reduction of uncertainty, and the facilitation of market linkages (Leff, 1964; Wank, 1996). This stylized contribution may be more suited for the ties between rural private enterprises and community governments.

Competition takes place among government entities and officials as well as among private entrepreneurs. Private entrepreneurs compete against each other for bureaucratic favours that are in short supply, including business licences and dispensations from restrictions on access to the commodities which private businesses trade. The licences and dispensations are usually renewed on an annual basis, enabling annual cost adjustments. This assures that in the long run only the most productive entities can meet the payment requirements (including bribes).

Competition takes place among bureaucratic actors because bureaucratic resources are generally abundant, inducing better service even at the fringes. For instance, although the state had not authorized private companies to engage in direct foreign trade until January 1999, state-owned foreign trade companies have sometimes provided a cover so that private firms could engage in direct foreign trade. This has represented a practical means for coping with fluctuations in supply and demand and for beating out other state foreign trade companies (Wank, 1996).

Such ties only stimulate and support innovation if they move beyond predation and induce reform from below. According to the 'individual business family' policy implemented in China in the late 1970s, a private firm could not expand its business beyond seven employees and beyond the use of vehicle transport. Many local governments circumvented this policy by allowing private firms to register as collectives, as practised in Wenzhou (Section 5.2). Without such a practice, the significance of private business in job creation, the generation of fiscal revenue and the elimination of gaps in supply and demand might not have been recognized by the state and the public by 1984 (Liu, 1992; Parris, 1993, Wank, 1996; Young, 1994).

The ties between private entrepreneurs and local government entities and officials have reduced the political uncertainties that used to follow national-level political and policy cycles. They have thereby encouraged investment and the diversification away from speculative trade and towards services and industrial production. Because private firms can use these ties to obtain the officially mediated resources, which enhance profits and security, they are motivated to develop these ties as new market channels. As a consequence, reciprocal relationships have developed to the extent that private firms have sometimes helped publicly-owned units market their products, provided production inputs

for them and infused capital through public-private partnerships. They have thus helped public enterprises 'grow out of the plan' (Naughton, 1995; Wank, 1996).

### 5.3.2 *The contributions of 'xiahai'*

The phenomenon of *xiahai* started in as early as the mid-1980. In the remote and mountainous regions, like Wenzhou, it was reported that an official at the position of the head of a township Party Committee in Yongjia county quit his job and started his own commercial orchard business in 1986 (Bai *et al.*, 1987: 40-1). A survey of some 50 entrepreneurs in private enterprises conducted in 1988 shows that 17 per cent were former state officials (*guojia ganbu*) (Wenzhou Tansuo, no. 2, February 1989: 29). Besides those who left government jobs and directly made their way into the private enterprises, many government officials in Wenzhou had taken moonlighting jobs in the private sector to supplement their salaries since the early 1980s (Bai *et al.*, 1987).

In large cities, *xiahai* has a broader meaning. In the mid-1980s, in order to increase local government revenue and local employment, many government agencies began establishing subordinate business entities in the form of 'being run by people' (*minying*) and 'sponsored by government agencies' (*gongzhu*). Many government officials became managers of these business organizations, and they were allowed to maintain their original status in the bureaucratic hierarchy for risk-compensation. Gradually, such businesses are fully taken over by managers, becoming entirely 'run by people' rather than by the sponsoring governments. Partly impressed by the achievements of such independent and semi-private enterprises and partly pushed by the efforts to downsize government bodies, the popularity of *xiahai* has generally increased since the mid-1980s. Moreover, an increasing number of government officials directly join the private sector after quitting their government jobs. According to a survey conducted around 1992, about 30 per cent of the officials surveyed were thinking about 'leaping' into the business community (Chen, 1993). Another survey of local government officials conducted in 1995 indicated that near 20 per cent were planning to 'leap' into the business community, of which 35 per cent were looking for joint-venture enterprises, 21 per cent for private enterprises, and 15 per cent for state enterprises with successful reform (*Almanac of China's Economy 1996*: 976-80). According to Table 5.7, *xiahai* government officials made up about one-fifth of the head of private enterprises in 1988 and over one-fourth in 1992.

Similar to the economics of patron-client tie between private entrepreneurs and local government agencies and officials, *xiahai* is also mutually beneficial. In the private sector there has been a high demand for those officials, not only for their general knowledge and management experience, but more importantly for their skills in dealing with government regulations and for their connection to officials. For these former bureaucrats, joining a private firm or setting up their own private enterprises bring them much higher economic benefits and personal freedom, despite the business risks. For the governments, *xiahai* officials help them to obtain more accurate information from the private sector, particularly the proper feedback over government regulations and monitoring practices. In addition their activities generate revenue and employment at the local level.

For any social institutional arrangement, benefits are always accompanied by costs. The negative impact of *xiahai* and the patron-client tie is that these two arrangements create an

environment in which the government and the business are not separated. As a result, government-business collusion may be popular and corruption may prevail. The critical concern is whether the benefits are significantly greater than the costs and whether the induced corruption is in check.

Li (1996, 1998) present a strong argument in this respect, suggesting that the both arrangements have had a fundamentally positive net impact on China's transition. Particularly *xiahai* has pushed for dynamic changes in the Chinese bureaucracy. First, the prevalence of *xiahai* induces *ex ante* changes in the behaviour of bureaucrats before leaving the government jobs. Since a more prosperous non-state sector creates more opportunities for the incumbent officials when leaving their government jobs, the attractiveness of *xiahai* makes bureaucrats more interested in local economic growth and the expansion of the non-state sector, including the private sector. The *ex ante* behaviour of bureaucrats is also affected through a reputational effect. In order to be able to find a good position in the local business community when it is necessary to take the action of *xiahai*, an incumbent bureaucrat must establish a pro-business and pro-reform reputation. A renowned anti-reformist bureaucrat will find that he is not welcomed by the local business community. In the contrast, a pro-reformist official who helps the local businesses and nurtures personal rapport with local entrepreneurs is always warmly welcomed by the local business community.

Second, *xiahai* leads to changes in *ex post* behaviour of the bureaucrats who leave the government jobs. When joining the non-state sector, the former bureaucrats now find that many of the bureaucratic regulations which they intended to maintain before are obstacles to their business development. They have the incentive and are in the position to help business community to get around and lobby for reforming these regulations. Thanks to their bureaucratic knowledge and skills, they are the more effective lobbyists for reduction of these regulations than are outsiders.

#### **5.4 The remaining constraints to private sector development**

There are three major constraints to the future development of the private sector. They are: the remaining policy and moral discrimination against private enterprises; the lasting tension between workers and managers; and the problems linked to the classic development process, which are in part similar to those already discussed in Section 4.5.

##### *5.4.1 Remaining policy and moral discrimination*

Private enterprises in general and small ones in particular have great difficulties in such areas as obtaining bank credit, renting land, and purchasing key inputs and materials. Although nominal tax rates became same as those in other ownership categories very recently, many administration fees, apportioned charges, and arbitrary fines imposed by local government bodies have persisted in varying forms across times. In the case that private enterprises obtain quotas for key inputs like power, they have to pay much higher prices. For example, in the city of Xishan city in Jiangsu province, the price of power paid by private enterprises were about three time that paid by non-private firms in 1998 (Xue, 1998).

The persistence of these policy discriminations cannot be fully explained by such factors as long-existing socialist ideology and the possibility that local government organs take their bureaucratic advantages to increase their own interests. Information asymmetry between small private enterprises and government monitoring organs has been most severe. As a consequence, many private enterprises have engaged in opportunistic behaviour to make profits with little consideration of the government regulations and monitoring or care for the basic rights and working conditions of employees. These opportunistic behaviours have damaged the reputation of the general private sector and brought a substantial public distrust of the private sector. To a great extent, it is those opportunistic behaviours that have enhanced the public's moral discrimination against private enterprises.

#### *5.4.2 Tension between workers and management*

A high tension has existed between workers and managers in most private enterprises. Although some private firms are reported by media to have ignored or even seriously violated the Labour Law of People's Republic of China, the majority of them are clearly aware of their disadvantage in the field of worker-management relations and have taken certain compensatory measures. The most explicit measure is that private enterprises usually pay a much higher wage to their employees as compared with other ownership forms in the same city or community. However, such measures have failed to remove the loyalty gap between private enterprises and TVEs, as revealed by a recent research (Bowles and Dong, 1999).

In the survey conducted by Bowles and Dong in Shangzhi County of Heilongjiang Province in 1995, the average wage in private enterprises is 48 per cent higher than that in township enterprises and 27 per cent higher than that in village enterprises. With this wage difference, the proportion of workers who would accept a 10 per cent pay cut to help his/her enterprise was 48.8 per cent higher in a community collectively owned enterprise than in a private firm. In the response to the question why TVE managers remain with TVE rather than move to higher paying private enterprises, 'workforce is more supportive' is one of important reason. This finding suggests that there is a much higher cost of the manager-worker agency problem in the private sector than in non-private sectors. While the question of how to solve the owner-manager agency problem remains one of the major challenges to the restructured TVEs and SOEs in the future (Chapters 3 and 4), how to resolve the manager-worker agency problem will be a top challenge to the further development of private enterprises in China.

#### *5.4.3 Classical development problems*

In addition to the general development problems faced by all enterprises in a developing and transition economy like China, the following two may be more relevant to the private sectors in China.

First, as in the case of TVEs, enterprise management is still primary rather than professional and proficient. Even in the most developed areas like South Jiangsu, available survey data indicate that most of owners/managers of private enterprises strongly urge local government to organize training and services for them in the areas of directive industrial policies, investment risk and security, management accounting, regulations and laws, technological consulting, social insurance, safety precautions, quality control, etc.



(Xue, 1998). However, both training and service professionals in these areas are and will continue to be severely in shortage in the near future. In the competition for obtaining access to them, the private sector seems to continuously be at a disadvantage and in the last position in the priority list of local governments.

Second, in comparison with other ownership forms, the private sector has shown a high advantage in the service industry. However, the development of the service sector has been severely constrained by the lagged urbanization in the process of rapid rural industrialization. As a consequence, the majority of private enterprises have to crowd themselves into the general industrial sector, in which they have no advantage.

These two points indicate that both human capital development and proper urbanization will greatly promote development of the private sector in China.

## CHAPTER 6

### IMPLICATIONS TO SME DEVELOPMENT IN RUSSIA AND OTHER TRANSITION ECONOMIES: LESSONS FROM CHINA

*Robert J. McIntyre and Laixiang Sun*

#### 6.1 Introduction

Transition from a centrally planned to a market economy is one of the most significant economic and social events in the twentieth century. Two big surprises happened during the transition. The first was the sharp initial decline in output in most countries of the former Soviet Union (FSU) and Eastern Europe. The second one was China's outstanding achievement on its different path of transition and economic development. By maintaining nearly 10 per cent average growth rate for two decades during which it made the successful transition from a centrally planned to an emerging market economy, China grew dramatically. By 1998 end it produced more than one-half of the total GDP produced by all transition economies in 1998. China's GDP structure has now become similar to that of Poland and the Soviet Union in the 1980s, with the agricultural share of GDP being 18 per cent in 1998 (Qian, 1999).<sup>32</sup> In the years to come, China and the transition countries of former Soviet Union and Eastern Europe will face similar development challenges, in addition to the ones linked with the ongoing transition.

While it is widely acknowledged that Russia and other Eastern European transition economies are unlikely to follow the general process and sequencing of China's transition, these novel ways of providing positive incentives, introducing hard budget constraints and promoting competition have attracted impressively increasing attention (Qian, 1999; Stiglitz, 1998, 1999). In China, positive incentives were provided not only to enterprise management and workers but more importantly to local governments. Competition was created not only among firms with various ownership forms but also among local governments at provincial, prefectural, city, county, township and village level. Positive incentives and hard budget constraints for local governments were provided or induced by the combination of fiscal contracting under regional decentralization, local government ownership, and increasing monetary centralization. Competition was brought in through the entry and expansion of non-state enterprises, mainly township- and village-run enterprises. After the first fifteen years of pragmatic reform with the emphasis on positive incentive, hardening budget constraints and increasing competition, China set a clear goal during the 1993 to 1998 period of establishing a rule-based market economy which incorporates internationally recognized best-practice institutions. Because these questions of how to put in place positive incentives and hard budget constraints for enterprises and

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<sup>32</sup> *People's Daily*, 26 February 1999.

local governments, and how to introduce and promote competition, are still largely open in Russia and other Eastern European transition economies, China's experience in these respects is relevant and broadly instructive.

In the specific areas such as the emergence and evolution of SMEs with diversified ownership forms, China's experience may be even more directly applicable. The emergence and evolution of SMEs in general and private and community-based SMEs in particular have been mainly pushed by the survival urges and initiatives of individuals, households, community and grass-root institutions, and local governments at lower levels. Such survival urges and grass-root initiatives existed and worked spontaneously even in a very hostile environment like one in Wenzhou province in the early 1970s (Section 5.2). In fact, during the transition in Russia and other former Soviet Union countries from 1989 to 1995 the so-called hidden economy showed a highest growth rate as well. In the case of Russia, the hidden economy was estimated to be equal to about 14 per cent of official GDP in 1989. Six years later, the corresponding share was put by different estimation approaches at 39-71 per cent. At the same time, some of the hidden businesses have grown out of hiding (Johnson *et al.*, 1997; Lackó, 1999). If the society and governments can provide an increasingly friendly environment for the hidden businesses (as did the Chinese, Polish, and Czech governments), the hidden economy will certainly grow into a formal one and become an important engine of economic growth.

In this closing chapter, we first suggest five lessons for promoting SMEs in the transition economies:

- (1) The Wenzhou model is highly instructive, suggesting ways in which a large hidden economy can grow out of hiding, and in which the urge for survival, innovative initiatives of individuals, households, communities, and local governments are the key for success.
- (2) There are two key vehicles for informal SMEs to grow out of hiding and for general SME development: protection and support by local government; and voluntary co-operation of individuals and households in the form of joint-stock co-operatives or joint-stock partnerships.
- (3) Proper transformation of the role of governments in general and local governments in particular are critical for SME development. Two key vehicles can be identified for providing local government itself with the incentive to reform: creating inter-jurisdictional competition; and changing the incentive structure of local government through credible revenue-sharing and subsidy-reduction contracts between supervisory and subordinate levels of governments.
- (4) Although the classical period core-TVE with dominant community ownership is being transformed in China, it may well be a plausible 'next step model' for many of the other transition countries where local government ownership has emerged. A build up of activity and experience under TVE-like forms may be desirable in these cases, before considering another round of ownership restructuring.
- (5) The ownership arrangement of the joint-stock co-operatives may have cost-benefit advantages in other transition economies as well. The joint-stock form creates economies of scales in terms of capital, production and marketing for the firm. The co-operative structure will bring more reliable business partners and a set of extended social and economic connections to the small firm, thus increasing business security.

The enlarged business scale and social/economic network can bring much-needed institutional and social trust to the firm as well.

Then, we will discuss the issues connected to the emergence of local government ownership in Russia and other FSU countries and the feasibility of local governments as market preservers in these countries. We will also uncover some of the ideological, psychological, and historical obstacles existing in the FSU which inhibit them from drawing institutional construction lessons from the Chinese experience. In fact, these perceptual obstacles exist as well among the circle of western economist-advisors. An excellent illustration of the later is presented in Qian (1999) who shows that the World Bank *World Development Report 1996: From Plan to Market* was forced to interpret China's experiences mainly in boxes rather than in the text itself because China simply does not fit the general framework of the report.

## **6.2 Five lessons for promoting SMEs in the transition economies**

### *6.2.1 The hidden economy can grow out of hiding*

The basic condition for firms in the hidden economy to get out of or grow out of the hidden economy sector is that there are apparent net economic benefits when they join the formal economy. However, this basic condition has been hardly met in Russia and other FSU countries—often the opposite is true. Those governments act in an unpredictable way and are mainly interested in punitive extraction of taxes and registration and licensing charges. Numerous government departments and controlling agencies act as the 'official mafia' who build up various bureaucratic barriers and then live on their rents. Corrupt government officials often claim bribes in addition to their monopoly rents. It is reported that these 'official mafia' are capable of destroying any prosperous firms (Layard and Parker, 1996; OECD, 1998; Radaev, 1999). These grabbing activities make the formal economy unattractive for the majority of SMEs, particularly small and micro enterprises. Instead, they operate in the hidden economy, resolving business disputes through negotiations of private security agencies. Protection by such security agencies or 'mafia' becomes a relatively cost-saving institutional arrangement, even though this is still very expensive and lacks long-term credibility.

This disappointing trend can be reversed if a proper incentive structure for local governments can be installed and inter-jurisdictional competition can be introduced, as suggested by China's experience in general and the Wenzhou Model in particular. The unpredictable and punitive extractive behaviours of local governments are largely induced by the same behaviours conducted from above by the regional and federal governments. Local governments always argue that governments at higher levels deprive them of any instruments to increase revenues and thus improve their ability to deliver services (Freinkman and Yossifov, 1999).

The same argument was loudly expressed as well in China for many years before the implementation of *fiscal responsibility contract system*. The artificially complicated tax codes and registration and licensing regulations provide many great chances for local officials to build up their rents. These complexities in the codes and regulations can be simplified by the federal or regional governments through the legislative processes. They also can be simplified or just simply avoided in practice if local governments have an

incentive to promote local SME growth. Corruption can be kept within reasonable limits: if tax codes and other regulations are essentially simplified and become transparent in practice; if local governments are driven by revenue generation incentives but are disciplined by inter-jurisdictional competition; and if the practices of democratic local elections and local self-government are strengthened. These important aspects will be further discussed in the following sub-sections 2 and 3.

### 6.2.2 *The key role of local governments and the voluntary co-operation of small firms*

In the case of China, the protection to private and household enterprises provided by local governments has been quite comprehensive and critical. Without these protections, the private sector would still have a spontaneous and informal status, with no chance to capture the benefits of the formal economy while also avoiding political harassment and predation by the state. Three most important components in the protection package are worth highlighting.

First, in terms of institutional arrangement and services, the practice of 'business affiliation' (*guahu*) and 'wearing a red hat' (*dai hongmaozi*) made a great contribution to the private sector development in the late 1970s and 1980s, when ideological and policy hostility towards private ownership had not yet been effectively removed (Section 5.2). These arrangements provided the most-needed institutional and social capital to the private sector, in addition to formalized access to markets.

Second, in terms of taxation, although the state regulations over taxing the private sector were artificially complicated and very tough until 1994, all local governments simplified the regulations in practice through very quick horizontal learning. Complicated progressive taxation requirements were largely ignored, instead quarterly-based or even annually-based lump-sum taxes were collected from small enterprises. This taxation practice is mutually beneficial and socially productive: the tax burden of small business is essentially lightened; lump-sum taxation is quite transparent and easy to operate, leaving much less room for corrupt behaviour of local taxation officials and greatly reducing the cost of tax collection; and the taxation base for local governments was rapidly enlarged due to the resultant expansion of the SME sector.<sup>33</sup>

Third, the most impressive protection to the private sector was provided by the permission to use anonymous household saving deposit accounts. Most directly, this permission provided a simple and effective commitment device to limit the government's predatory behaviour and create private incentives. When bank deposits are anonymous, the government does not know the identity of depositors and thus is unable to trace a particular person and confiscate his/her financial wealth. Through this simple arrangement, the government *de facto* achieves a credible commitment to creating private incentives, which

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<sup>33</sup> In field trips to Gansu Province in 1986 and Hunan Province in 1987, Laixiang Sun interviewed several heads of counties and prefectures, all of whom were proud of their local taxation practice of this type and showed the strong willingness to lobby the central government to simplify the existing taxation regulations. They indicated that if the central government regulations were strictly followed, more than 90 per cent of small businesses in their jurisdiction would be unable to survive. They were also reluctant to increase the local *de facto* tax rate on small businesses simply because they were afraid that this would drive local entrepreneurs out of their jurisdictions.

has been recognized to be difficult to achieve in a society where the rule of law is not developed (Bai *et al.*, 1999).

Another important consequence of this permission is substantial financial deepening, which in turn provided increasing 'quasi-fiscal' revenue to the government in the forms of seigniorage, government bonds, taxation on the financial assets of banks, and banks' policy loans to the state sector. Under these anonymous banking arrangements private and household firms feel safe in making cash transactions and saving their working capital and financial wealth as deposits in state banks. Thanks to this arrangement and alongside the rapid increase in household income, total household bank deposits increased from less than 6 per cent of GDP in 1978 to about 50 per cent in 1993 and to 62 per cent in 1997 (*Statistical Yearbook of China 1998*: 55 and 325). By one estimation, the quasi-fiscal revenue collected by the Chinese government during 1986-94 was on average equal to about 9 per cent of GDP, or more than one half of government budget revenue (Bai *et al.*, 1999).

In both China and FSU countries 'conventional institutional arrangements' such as the rule of law and balanced separation of powers, which function in modern market economies to constrain the government from arbitrary intrusion into private economic activities, are still largely absent. Where the state is not constrained, it can easily behave in a predatory manner towards private business and break its commitment to preserve private incentives. That is the well-known *commitment problem* identified by the 'new institutional economics' (North, 1997; Williamson, 1994). A lack of such commitment typically results in discretionary marginal tax rates that are too high and are detrimental to private incentives. The government itself also suffers from its lack of commitment: when private incentives are undermined the taxation base shrinks and little additional revenue can be collected. Under conditions where there are no conventional institutions to constrain the government from arbitrary intrusion into economic activities, how can private business incentives be unleashed, how can the hidden economy be encouraged to join the formal one, and how can the government solve the commitment problem in a way that allows it to benefit from its credible commitment? China's unconventional practices mentioned above present a successful and instructive lesson for FSU countries on how to deal with similar problems.

Firms operating in the hidden economy face great uncertainty and risks, in addition to high transaction costs. There is a spontaneous tendency among them to join the formal economy in order to obtain formal access to various markets and reduce uncertainty. If prompt action can be taken to constrain the predatory behaviours of the government and thus reduce the power of the 'official mafia', these firms might be able to grow out of hiding in conventional ways. However, such a scenario does not seem to be realistic in the near future in the FSU countries. In order to encourage hidden firms to grow out of hiding and increase the security of all SMEs, the unconventional ownership arrangements practised in China, such as business affiliations, local government and private firm joint ventures, joint-stock co-operatives and joint-stock partnership, all become desirable and feasible options.

### 6.2.3 *Providing incentives for local governments to reform themselves*

Given the survival urge and the spontaneous initiatives of individuals, households, and communities for their development, local governments have played the most critical role in

promoting the development of the private sector in China. The strong incentives of local governments have been created not only by devolving a large part of regulatory authority from the central to local governments, but more importantly by providing fiscal incentives in the form of the 'fiscal responsibility contracting system' (*caizheng chengbao zhi*), which was introduced in 1980 and improved afterwards. The fiscal contracting system is well known by the nickname of 'eating from and managing your own kitchen' (*fenzao chifan*), in opposition to the previous system of 'unified revenue collection and unified spending' (*tongshou tongzhi*), known as 'eating from one big pot' (*chi daguofan*).

Under the fiscal contracting system subordinate- and supervisory-level governments entered into long-term (usually five-year) fiscal contracts, under which the subordinate governments were granted the right to retain a progressively increasing share of marginal budgetary revenue. Many local governments were allowed to retain 100 per cent at the margin, thereby making them 'residual claimants'. In addition, local governments also received 'extra-budgetary funds', which were not subject to sharing, and 'off-budget funds', which were not even incorporated into the budget process and thus remained unknown to the central government. This system also linked local government expenditure with the revenue generated locally to ensure that these governments assumed responsibility for the financial consequences of their decisions.

It is widely recognized that China's fiscal contracting system provided local governments with strong (marginal) fiscal incentives. In addition to this, recent empirical analysis (Jin *et al.*, 1999) reveals that the horizontal distribution across provinces of per capita budgetary spending actually improved rather than deteriorated over time, because the strong marginal revenue collection coexisted with continuing infra-marginal redistribution of budgetary revenues. The same analysis also highlights that stronger fiscal incentives, measured in terms of a higher retention rate on contractual marginal revenue, were associated with faster development of non-state enterprises and more reform in state-owned enterprises. This indicates that better local government protection of and support for the non-state sector make their jurisdictions more attractive for entrepreneurs to come in.

China's experience further indicates that the strong (marginal) revenue incentives induce local governments to promote the export of local products into other regions and countries, to attract inflows of financial and human capital by various means, and to enforce the localization of component production by large state enterprises. These efforts in turn induce and strengthen: inter-jurisdictional competition; the spin-off type of decentralization of large firms; and export promotion.

These positive contributions contrast sharply with the disappointing outcomes of fiscal federalism in Russia. Zhuravskaya (1998) conducted a regression analysis based on the data of 35 cities for 1992-7 and finds that the correlation coefficient between the change in 'shared revenues' (with the supervisory government) and change in 'own revenue' is  $-0.90$ . It means that any increase in a city's budget by 1 rouble is offset by the decrease in shared revenues of 0.90 rouble. The analysis also suggests that the predatory behaviours of local governments towards private businesses and competition are largely induced by these perverse incentives they face. In trying to formulate ways in which Russia could reverse this type of perverse incentive for local governments, China's practice of fiscal responsibility contracting is instructive and promising.

#### 6.2.4 *China's TVEs as one of the 'next step models'*

The Chinese TVEs are a momentous development whose broad implications and policy relevance have become unavoidably clear with the final collapse of 'reform optimism' in Russia and most other FSU countries after 17 August 1998. This does not imply a case for the simple transplantation of the 'Chinese innovations' we have enumerated, but for taking advantage of the fact that many parallel factors underlying the unconventional form of ownership and governance already exist in most of the FSU and some parts of Central and Eastern Europe. A simple list of these parallel factors would include: the progressive development of local elections and self-government; vertical and horizontal disintegration of large firms into separate semi-autonomous business units or terms; spin-offs of large firms which are jointly owned by the parent firm and employees; emergence of local government ownership; emergence of new private firms; expansion of the hidden economy; and spontaneous business initiatives of numerous individuals, households, and grassroots institutions. Recombining and mobilizing these positive factors in an innovative way like that practised by the Chinese TVEs would certainly bring new growth momentum into play.

Without a specific plan or even an overarching general reform logic, new forms of political-economic organizations like TVEs were created in China. The TVEs in general, and the core-TVEs with dominant community ownership in particular, combine a market orientation, which is characterized by a binding budget constraint and a serious profit orientation, export success (see Table 4.4 above) and predominately social ownership, which means that the ownership of the core-TVEs is simultaneously non-private and non-state. If we define the period before the significant ownership restructuring of TVEs (i.e. roughly before 1992) as the classical period for TVE development, the underlying organizational feature of TVEs during this time has been characterized as having the features of 'local governments as industrial firms', 'community up-close capitalism', and 'community socialism' (Chapter 4, above; Gates, 1998; Scholes, 1991; Stiglitz, 1999; Walder, 1995).<sup>34</sup>

Under this organizational arrangement, the most acute 'us versus them' stalemates are largely avoided and each stakeholder is interested in and constrained to 'doing business' instead of 'looting or grabbing'. More importantly, the local, up-close capitalists (community members) have much more at stake than do remote investors, this in turn makes them care more about the long-term development of their community firms and leads to a 'logic of commitment' (Stiglitz, 1999). The emergence of *community conglomerates* revives or reinforces this localized *de facto* social ownership or community up-closed capitalism, although not as the exclusive form of TVE. This development has strong similarities to the extensively studied and widely admired 'Mondragon-type *corporacion cooperativa*' from the Basque Region of Spain (Hansmann, 1996: 98-103).

As noted in detail in Chapters 2 and 4 above, the TVEs themselves have continued to evolve, taking on diverse forms. The rapidly spreading reorganization of TVEs into joint-stock co-operatives is producing quite different things in different places. Further

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<sup>34</sup> For the outsiders, the community looks like 'up-close capitalism', however, for the insiders, they live with 'community socialism'.



evolutionary changes are likely which will again extend the range of different but co-existing forms of property, ownership and management. While the present ownership restructuring movement has added many new varieties to the system, including some forms that are purely private, the system shows no tendency comprehensively to converge to textbook forms of predominant pure private ownership.

This most recent TVE development process is quite unusual in the economic history of transitional economies, since it is an anticipatory reform in the absence of crisis. As a result a great variety of new TVE forms have arisen. Some TVEs are changed only superficially and for these TVEs local government still largely dominate their ownership and control them tightly, although even here some incentive clarification has been achieved. However many TVEs have undergone real change. Although in some cases this change takes the form of purely private, narrowly held personal or limited liability companies, the predominant new form appears to be the joint-stock co-operative with employee ownership as the major part of a complex blend which includes more or less extensive local government share ownership. These joint-stock co-operatives are recognisable in western terminology as 'closed producer co-operatives' or 'up-close capitalism'. In all cases the new firms have more clearly focussed incentive arrangements which stress market-determined standards of managerial achievement and move away from some of the agency problems of the classical TVEs.

Because the TVE form has been both diverse and institutionally dynamic it teaches many, sometimes contradictory, lessons. As a result, the answer to the intriguing question of what to do to trigger Chinese-style dynamic organizational innovations elsewhere will differ depending upon the economic, social and especially institutional conditions of each specific country. But the successful TVE experience opens up a new range of options and possibilities for discussion and comparison. For example, some TVE-like ownership and governance forms may be desirable and work well in those places where full or partial local government ownership and community ownership have emerged. The TVE-like forms may be a plausible 'next step model' before considering another round of ownership restructuring in those countries.

#### 6.2.5 *Joint-stock co-operative as an alternative choice*

In Section 2.3 above we summarized the stylized features of joint-stock co-operatives as follows:

- (a) Managers and employees own a majority of the total share of the firm, and shareholdings among them differ on the basis of their paid in subscriptions.
- (b) The firm is closely held. It means that *ownership shares are typically not freely marketable, although subscribed shares can be transferred within the community.*
- (c) The local government may hold a large part of the shares in the name of citizens of the community (city, county, township, and village).
- (d) In addition to the shares held by the insiders and local government, there usually are some (or even a large number of) shares of outside equity which carry one vote per share.
- (e) A representative form of governance is usually in place and it is based on 'one-person-one-vote', 'one-share-one-vote', or a combination of both voting principles.

(f) The firm is typically small or of medium size.

In the same section we also analysed the economic rationality and functioning mechanism of joint-stock co-operatives in China. A comparative analysis based on different models for dealing with insiders' control was presented there as well (Table 2.1). Here we would like to emphasize that the ownership arrangement of joint-stock co-operatives may have cost-benefit advantages in other transition economies as well. The joint-stock form, even when it is closely held, can create economies of scales in terms of capital, production and marketing for the small firm. The co-operative structure brings in more reliable business partners and provides a set of extended social and economic connections to the firm, thus increasing business security. Small firms in the Russia and other FSU countries are now having to pay a high price in order to operate in conditions which lack these types of linkages. Moreover, the enlarged business scale and extended social/economic network will also bring much needed institutional and social trust to the firm. Last but not least, there are cultural traditions and backgrounds in those other transition countries that are highly suitable for such better-defined co-operatives.

For an individual firm, the flexibility of the ownership arrangement of joint-stock co-operative allows it easily to transform itself into a joint-venture firm, a limited liability company or a publicly listed stock company if this is warranted by the expansion of the firm. However, for the majority of small- and medium-sized firms, which have little chance to become openly held companies or attract venture capitalists, joint-stock co-operatives may not be a transitional ownership arrangement and maybe play a permanent significant role in the development of the SME sector in transition economies.

### **6.3 The emerging role of local governments as market preservers in Russia and other FSU countries**

#### *6.3.1 Local pragmatism in Russia*

Local- and regional-level decision-makers in Russia and other FSU countries have needed to find ways to operate in an environment where the national government often failed to carry out the necessary steps to allow healthy growth of market institutions. It is widely acknowledged that national policy in most of these countries has not only largely failed to establish an institutional format consistent with successful market development, but also has nearly abandoned the normal functions of government in dealing with the health, educational and welfare needs of the population. The redistribution of state property has been carried out in ways which seem to effectively maximize the likelihood of imbedding dysfunctional forms of criminal activity in the system, thwarting hopes of investment-driven growth, raising transaction costs in both old and novel ways, and thus failing to create positive production or efficiency incentives (Amsden *et al.*, 1995; Stiglitz, 1999).

However, on the other side, many Russian local governments have worked to keep markets functioning in the face of irrational economic policy pressure from the centre which literally threaten survival at the local level. Different economic and social policies have been adopted at the local level that attempted to buffer the negative effects of national-level 'shock' policies by creating market-mediating structures. While the concrete actions of local-level authorities in a series of oblasts and autonomous republics have generally been reported as a form of dated opposition to markets *per se*, a more nuanced

consideration of how markets (in conditions of serious disequilibrium and institutional transformation) really work suggests that these measures are better understood as a form of market-wise pragmatism (McIntyre, 1998). Furthermore, a recent large study of differences in Russian regional performance by van Selm (1998) indirectly supports this view, showing that 'reform regions' performed better only in terms of nominal incomes.<sup>35</sup>

When coherently carried out, this local-level package of pragmatic policies allows the eventual emergence of market forces, but only after sufficient time has elapsed to allow infrastructural development sufficient to permit their successful functioning. A combination of certain price and supply control measures seems to have made a contribution to preventing pervasive criminalization of economic life during the early stages of the transition process. Because criminalization did not develop and entrench itself in these 'resistant to market reforms' areas at that early stage, markets are better able to function now. There was a substantial economic logic to policies pursued in many of these areas, which bear no resemblance to the 'price controls by decree' commonly mocked in economics textbooks.

It is important to note the different ways in which regions have managed the specific 'local' features of the national economic crisis. It is also useful to search local experience for clues to approaches or measures that might lead to improved national-level policies in the future. In this regard, the local experimentalism and institutional evolutionism of China's transition have great implications for Russia and other FSU countries. In the late 1990s there has been a little discussed wave of 'de-privatization' in Russia, which directly raises the possibility of (more) local-level ownership and operation of small- and medium-scale productive enterprises. The Chinese-style of federalism and locally controlled TVEs may well be a realistic option in light of the current Russian policy dead-end on both 'fiscal federalism' and 'enterprise reform'.

### *6.3.2 The emergence of local government property rights*

Despite the seemingly obvious connections of the institutional needs of Russian local authorities to the lessons of the Chinese case, there has been a failure to notice or admit the following two important facts. First, much Russian and other FSU privatization is temporary or provisional. And second, local government ownership is already important in Russia and other FSU countries and is likely to be more so in the future. There are both structural and behavioural reasons to expect further development in this direction. The structural point is that there is already much TVE-equivalent ownership and there will be much more as failed and corruptly privatized assets fall out of 'private hands' but land in 'public, but not national government, hands'.

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<sup>35</sup> McIntyre (1999b) makes the argument that Nizhny Novgorod represents a case of nearly complete reform failure in those areas for which it is well known (agriculture and communal services). Favourable results are restricted to two areas: the small enterprise privatization during the 1991-1992 period when Gregory Yavlinsky and the Moscow consulting group EPI Center had an active role there; and in the continued success of GAZ (Gorky Auto Zavod). The pro-reform Russian business press adjusted to the tarnishing of the Nizhny Novgorod 'model' by making more frequent mention of Samara. See also McIntyre (1999a, 1999c) and Hanson (1996: 205-6).

A slow process of informal and even some cases formal de-privatization has been going on in Russia, mostly resulting from assumption by local-level authorities of functional ownership in cases of: (a) the death or imprisonment of first recipients of privatized small-scale productive property (in a situation where inheritance law is not to be taken seriously in dealing with capital goods of often uncertain origins); (b) the looming collapse of locally important producers (an odd large-scale example of this is the take-over of both Moscow auto factories by the city government); (c) the more general Moscow example, in which the city government has a large equity share in virtually all Western DFI in Moscow proper and is the founder of numerous locally initiated enterprises. Formal de-privatization has occurred in cases where legal re-evaluation of privatization arrangements has occurred. Since very many Russian privatizations can be plausibly described as illegal, almost anything might be fair game for local governments in the future. Kaluga oblast is one area where there has been a quiet but systematic reworking of privatization decisions.

Because of the desire of so-called 'market reformers' to prevent discussion of alternatives (since their programme did and does totally contradict social opinions on equity and propriety), secrecy was and is required. This has produced in Russia and elsewhere massive *developmentally dysfunctional corruption*, completely opposite in character and functional implications to what Amsden has described as 'patriotic corruption' (Amsden, 1989). This 'anti-patriotic corruption' has been caused by the methods of Russia's so-called reformers themselves. The lack of assent at the same time would make any reform accomplishments subject to reversal. More attention to the New Economic Policy (NEP) model and less to transplanting Anglo-American-type financial institutional variety and tolerance of institutions would improve Russia's chances for achieving a civilized and prosperous future. Exactly in that spirit we suggest that a TVE-like form of ownership and governance structure is politically attractive in Russia and elsewhere.

The survival pressures bearing down on local administrations are likely to encourage adoption of certain features of the Chinese reform path, specifically the rise of some hybrid form of local social ownership of small- and medium-sized productive enterprise. As the current wave of small-scale de-privatization (due to the death or criminal conviction of original holders of privatized entities) continues, the choice of re-privatization or direct oblast/municipal operation poses itself. It is possible that in a few years Russia (away from Moscow and a few other large cities) will have acquired something analogous to the Chinese mixture of local institutional forms.

Ironically the city of Moscow, often mistakenly seen as the showcase of Russian 'free market reform', was exempted entirely from most national privatization decisions and policies, and has run an active and complex industrial policy. It has not accidentally become the effective owner of both of the Moscow automobile plants, Zil and Moskvitch. It owns large equity shares in virtually all direct foreign investment projects in Moscow proper and has begun to incorporate the surrounding Moscow Oblast into its economic development schemes. This Moscow City development perhaps argues for a broader application of the approach suggested here, which may at first glance appear to be a survival strategy suitable only for 'small towns in depressed areas'. Parallel developments should be expected whenever there is a looming collapse of locally important producers. A number of interesting examples of this emerged during the 'crisis period' after 17 August 1998, including in Ekaterinburg and elsewhere (Ulyanovsk, again).

**6.4 What obstructs FSU in drawing lessons from China?**

*6.4.1 The simple dichotomy of ownership forms in the transition*

For a series of reasons the comparative systems implications of both the broader Chinese transition experience and the TVE development in particular have not been very well appreciated in the discussions what to do in Russia and other FSU countries. In addition to the particularly intense Russian desire to learn nothing from China, other important reasons for this gap include:

1. The wide acceptance of the largely ideological 'rejection of transplants' and 'no third way' propositions;
2. The prevalence in reporting and analysis of Chinese economic development of a false dichotomy of:

nationally controlled SOEs	<i>versus</i>	conventional private ownership
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However, even during the 'classical reform period' Chinese conditions require a more complex four-way division of ownership forms:

nationally controlled SOEs	:	locally controlled SOEs	:	township/village enterprises (TVEs)	:	conventional private ownership
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A further proliferation of ownership forms has occurred during the second stage of reforms after 1992, particularly during the process of small corporatization and other ownership restructuring. Therefore even this expanded four-way typology requires qualifications and further sub-divisions to fully encompass the rich institutional variety described in the above chapters.

3. The assumption that the dynamism of the TVE sector must already have peaked, which is supported by an exaggerated sense of the size, role and technical complexity of the purely private sector;
4. The failure to notice that the much-heralded intensification of efforts to reform the SOE sector after the death of Deng was leading to the further expansion of the TVE sector rather than to real 'bankruptcies' and ultimate privatization.

*6.4.2 Neo-classical hegemony in most transition economies*

In rejecting the Soviet-type economic-political system a broad spectrum of Russian and east-central European intellectuals and new government functionaries have rushed to embrace a starkly ideologized and empirically ungrounded version of free-market capitalism (Stiglitz, 1999). It has been argued (McIntyre, 1999a) that a common ideological sub-text of the neo-classical perspective led to a failure to think clearly about

the short-run selection mechanisms and the divergence of short-run from long-run survival characteristics under the peculiar circumstances of the transformation process. The hegemonic position of this mixture of simple contingent analytical propositions and purely ideological assertions seems to have induced most of the Eastern European and former Soviet Union governments to focus their attention on creating the superficial aspects of market-modernity, but in many cases ignore the institutional requirements for success under the actually existing conditions of the contemporary capitalist world market.

Only very large countries, which are aided by distance and systemic-risk filters can, even in principle, exercise independent economic policy under such conditions. China has done this, Russia despite much more favourable initial conditions has catastrophically failed to do so (Nolan, 1995; Stiglitz, 1999). In China a very different path was followed. Brief reference to the logic of failure elsewhere throws the Chinese path into sharp relief.

#### *6.4.3 Ideological hegemony and 'no third way' maxims*

Rather than being a simplified summary of a scientifically tenable set of conclusions, assembled on the basis of careful weighing of evidence and experience, the No Third Way presuppositions are simply ideological assertions. These seductive arguments directly contradict the developmental lessons to be drawn from diverse eastern European experience before 1989; the historical patterns found in advanced capitalist countries for the last century; the 'newly industrialized' Asian countries after World War II; and rapidly accumulating evidence from the period after 1989 in eastern Europe and the FSU. They lack serious scientific content, yet lie at the base of the standard transition strategies (transition orthodoxy) prescribed for ex-Soviet-type economies.

Apologists for conventional approaches often argue that shock therapy is a dead issue, either having occurred as an earlier but no longer relevant event or never really occurring. This is simply an evasion, since slower or step-by-step application of the same fundamentally wrong policy produces comparable but more drawn out disaster. The first rush of excitement with shock therapy is long past and many pragmatic compromises have emerged despite the absolutist dynamics of the policies it inspires, but the logic of the approach remains at the core of much of the policy-relevant discussion by both governmental and international organizations of what to do next in these countries. Not by accident did the new (retreaded) Chubais-Nemtsov team in Russia in 1997-8 immediately echo the assumptions and rhetoric of the Gaidar policy disasters of 1991-2.

The firmly established conventional wisdom about markets and market reform which provides the intellectual grounding for these policies has been applied across a broad range of countries and conditions. The 'rejection of transplants' analogy lying behind this approach has two distinct sub-points that: (1) only large reforms can work; and (2) mixed institutions cannot survive.

Because of the adoption of this perspective as part of the so-called 'Washington Consensus' most Western analysts have misunderstood or simply not considered: (1) the already mixed nature of Soviet-type systems; (2) the special characteristics of the constituent production/settlement units; and (3) the potential for the coexistence of old elements with the emerging new features (Stiglitz, 1998, 1999; McIntyre, 1996b, 1999a). When systems-

level structural adjustment policies are applied in this manner, without taking account of the special working arrangements of the old system, they result in largely destructive micro- and meso-level effects. The destruction caused by these marketization and privatization policies was capricious, failing to preserve those aspects of the old system which had and have future development potential, encouraging a short-term speculative mentality and use of resources, while building up political tensions unlikely to be consistent with continued democratic process (Amsden *et al.*, 1995).

The point to be emphasized here is that this is a subject about which observers and analysts have very strong presuppositions and these same presuppositions are not by accident built into the theoretical structure which forms the core of most analysis of transition economies. This is not bad or good, but it is important to notice. Despite this widespread tendency to think in terms of pure models, all of the worlds actual economic systems combine market, command and traditional elements.

'There is no evidence that mixed systems are unstable or tend to become 'more pure' through any kind of Darwinian selection process. The fitness and survivability of particular institutional combinations appear to be much more a question of the coherence and compatibility of the incentive and information flow characteristics of the components, the internal political situation and the surrounding world market conditions, which have as well a political dimension.' (McIntyre, 1999c)

'The main lesson from the Chinese experience is that considerable growth is possible with sensible but not perfect institutions, and some 'transitional institutions' can be more effective than 'best practice institutions' for a period of time because of the second-best principle: removing one distortion may be counter-productive in the presence of another distortion.' (Qian, 1999)

#### 6.4.4 *Can the motive forces of the Chinese miracle be mobilized elsewhere?*

The dynamism and sustained success of China's transition in general and the TVE development in particular offer a series of lessons that are hopeful for other countries currently undergoing transition. The Chinese experience suggests the broad adaptability of a variety of forms of local area and worker ownership which are conveniently very much like well-established co-operative and partnership forms in advanced capitalist countries. It suggests that under proper surrounding conditions these entities can successfully interact with a wide variety of different ownership and management forms (including joint ventures with foreign firms), operate in many different product areas (ranging from simple building materials to advanced electronic devices) and function at diverse technological levels. This Chinese experience cannot be simply and directly copied, but if reasonable interpreted, it need not be. That is because it performs the useful function of disproving the core assumptions of much of the Western economic advice to Russia and some other FSU countries that to have success in the transformation process a country must move to Anglo-American style ownership forms quickly and exclusively. Attempts to duplicate Anglo-American type details may not be wise, and are certainly not an inevitable feature of successful efforts to adopt 'market arrangements'. In demonstrating this fact the Chinese

reform experience opens up the range of possibilities for other transition economies. It suggests a number of possible paths out of the current policy dead-end.

This of course leaves open the behavioural question of the extent to which Russian, Ukrainian, etc., local-level governmental bodies can come to exhibit Chinese-type functional features? Can binding budget constraints emerge under contemporary Russian or Ukrainian conditions? There are already few subsidies from the centre, but oblast and city governments may not take the tough managerial approach to their enterprises that have characterized most local-level authorities in China in the 1990s. The prevalence of *non-money means-of-payment* (direct and multi-party barter as well as payment-in-kind of wages) which has special disadvantages for small entities, makes this situation hard to evaluate, even in cases where a local government wants to be stern master.

There is every reason to expect a Chinese-type local ownership structure to emerge in Russia and no reason not to expect the same kind of incentive-logic to work there, if sufficiently open operating conditions can be established. Both understanding in greater detail how this approach worked in China and finding ways in which these forces can be mobilized in contemporary Russian and other FSU conditions are vital tasks for public policy research.



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