РАЗДЕЛ 3 КОРПОРАТИВНОЕ УПРАВЛЕНИЕ В КИТАЕ

SECTION 3 NATIONAL PRACTICES OF CORPORATE GOVERNANCE: CHINA

THE MARKET-ORIENTED GOVERNANCE MODEL OF SOES*: CHINA PERSPECTIVE

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Abstract

In the transition from centralized planned economy to market economy, reallocation of rights between the government and the market leads to the fundamental changes of economic structure, thus causing Paradigm shift from the government-oriented governance pattern in China. Based on survey of 104 public listed companies in China, a descriptive analysis of the market-oriented governance pattern of SOEs is provided. The internal and external governance mechanisms in market-oriented governance model are designed to enhance the reform of modern enterprise institutions in China.

Keywords: government-oriented corporate governance，market-oriented corporate governance，Chinese SOEs

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Introduction

In the transition from centralized planned economy to market economy, reallocation of rights between the government and the market leads to the fundamental changes of economic structure, thus causing transformation in corporate governance patterns in China. The allocation of control power and the establishment of efficient governance have been drawing much attention in the transitional economies like China. In developed economy there have existed various corporate governance patterns. Each pattern is related to a certain stage of development in a country, economic structure and social environment. So the experience from the developed economy cannot be mechanically applied to a transitional economy. When establishing the corporate governance mechanism appropriate to the transitional economy, factors such as the particular external environments and the most efficient way of establishment should be taken into consideration. The evolution of the governance of the state enterprises in China sees a gradual shift from government-oriented to market-oriented corporate governance.

I. Paradigm shift from the government-oriented governance pattern

At the stage of bureaucratic centralized planned economy, the corporate governance of the state enterprises in China is typically government-oriented. The feature of the governance is government behavior combined with the mixing of government authoritative function and the corporate managerial function.

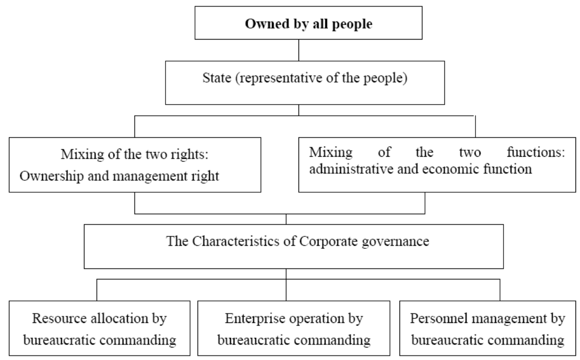

Figure 1. Government-oriented corporate governance of centralized planned economy in China

Source: Li Weian, "Corporate Governance System in Central Planning Economy," *Mita Study of Commerce,* No. 2, Vol. 39, June. 1996. (Japanese)

As is shown in Figure 1, government as representative of the state property enjoys both the ownership and the management rights of the SOEs. The mixing of the two kinds of rights sleds the government to play the role of both the administrators of the state and the owner and manager of the state property. Corporate governance tends to be bureaucratic commanding in nature as a result of combining the administrative function of the government with the economic function of an enterprise.

Resource allocation, enterprise operation and personnel management are all bureaucratic commanding – a phenomenon of "the externalization of internal governance and the internalization of external governance".[1] The consequences are the inefficiency in operation, vacancy of entities shouldering responsibility, the loss of invigoration and high governance costs. As a result the transformation of State Owned Enterprises (SOEs) is in essence the process of abolishing the government-oriented pattern of corporate governance and establishing market-oriented pattern of corporate government.

i) Deregulation and profit sharing – transformation characterized by giving enterprises more autonomy

In the centralized planned economy, as the government's affiliation, enterprises lacked autonomy and enthusiasm. Transforming the highly centralized bureaucratic pattern of corporate governance and changing the enterprises into independent entities in competitive market, therefore, triggered reforms.

Since the end of the nineteen seventies, reforms with emphasis on deregulation and installing incentive mechanisms of profit sharing had been piloted in some enterprises, while the structure of the centralized planned economy remained unchanged. In May 1979, eight enterprises were selected from 30 cities including Beijing, Shanghai and Tianjin by six government ministries (the Ministry of Finance, State Committee of Economy, etc.) as the first to carry out the reform of enlarging enterprise autonomy. In 1984, Interim Regulations on Further Broadening the SOE Autonomy was issued by the state to give the SOE more autonomy in ten aspects. Regulations on Changing Management Mechanism of Industrial Enterprises Owned by All People released in July 1992 confirmed 14 autonomy rights to all enterprises.

But the deregulation and incentive mechanism did not invigorate the enterprises, because the enterprises were only given more freedom on the level of management, but with the government-oriented governance pattern untouched. The reform was still within the ideology of centralized planned economy. Efforts were only made on the basis of the original governance in hopes to keep its advantages while removing its disadvantages. Policies of strengthening accounting regulations and incentive mechanism by profit sharing failed to bring enthusiasm to the enterprises as expected. On the contrary, the unbalance and incompatibility of the system led the reform to the dilemma of inadequate autonomy for the enterprises to optimize resources allocation, while too much freedom to practice insider control.

ii) The reform of contracting out system characterized by giving the enterprise the residual claim right

The measure of deregulation and profit sharing did not bring forth the expected results. Hopes were given to a more revitalizing enterprise system. Contracting out system therefore came into being. The end of 1987 had adopted this system in about 80% of state large

[1] To enterprises, their internal governance is replaced by the governmental behavior, while to the government; its administrative function replaces the enterprises' economic functions. For details see Li Weian, "Corporate Governance System in Central Planning Economy," *Mita Study of Commerce,* No. 2, Vol. 39, June. 1996. (Japanese)

and medium-sized enterprises. In 1989 almost all SOEs adopted this system. But again the contracting out system did not achieve the expected results although efforts had been taken from the beginning to make the system practical, such as the practices of mortgaged contract, bidding contract, etc. The contracting out system has inherent flaw although it is regarded as a step forward in invigorating the enterprises and shaping them into independent entities in the market. With the original government-oriented governance pattern basically untouched, new problems came into being. From the view of principal and agent relationships,[2] enterprise behavior in the period of contracting out system was still government-oriented executive as usual. The only difference lied in the degree of government control. In the past the government reviewed many indicators to examine the enterprise operation, while the contracting out system only used the returns on input and output to evaluate the performance of the enterprises. The government kept as usual the operational profits and crafted the long-term development strategies, such as fixed assets investment and production orientation, etc. The government was the decision-maker while managers as executors of these decisions managed the daily production activities. The proprietors of the enterprise (the government) stayed outside of the enterprise. The absence of the proprietors and the deprivation of decision-making power in the enterprises left the managers no enthusiasm and responsibilities to maximize the returns on properties. Failure in crafting right strategies and making timing decisions was the logic consequence. In terms of profit sharing, the state as the party contracting out the enterprise established a relationship of profit sharing with the contractors. The purpose of the practice was to encourage the contractor to fulfill the state target by dividing the residual claim right between the state and the contractor. As a result, the interest of the contractor could be aligned with that of the proprietor (the state). The contracting out system, however, made the definition of property rights ambiguous, because the sharing of the residual claim right had created two owners on the same property. One is the inside owner – the management of the enterprise with the rights of possessing, utilizing and handling the enterprise property; the other is the outside owner – the state with the proclaimed right of ultimate ownership. But the contractors were put in a privileged position. When the privileges could be used to pursue benefits better than the residual profit, the incentives of profit sharing would hardly function. Meanwhile due to the asymmetry of information, adverse selection and moral hazards, the phenomenon of insider control was worsened. It can be concluded that the contracting out system had pushed the problem of insider control into extreme during the transitional period of the economic reform in China. Neither the reform of deregulation and profit sharing nor that of the contracting out system brought the SOEs to the track of sound development. The problem lied in the absence of effective corporate governance mechanism. But the governance of the period was different from the original one in that the contract agreement between the principal and the agent separated the right of ownership with that of management although it was bureaucratic in nature. Therefore, the corporate governance was still within the limit of government bureaucracy. At the stage the government-oriented governance was based on the state dominated property system and shaped by the bureaucratic contract agreement. The government controlled the enterprises' personnel appointment, assessed their business performance, and evaluated the management achievements. The state as the owner of the enterprises exerted the external governance and kept residual claims right. The structure of the governance was the supervision of the enterprises at all levels of government authorities by performance appraisal and management appointment. The internal governance was a balance among three parties: a. the factory directors or managers in charge of the daily production activities; b. the Party Secretary responsible for the personnel management and the supervision of the enterprise operation; c. the Workers' Congress functioning as the channel for the employees to participate in the democratic management of the enterprises. Three prerequisites are required to make the governance efficient: the government exercises effective supervision over the enterprises; the factory director or manager is a person of high principles and the Party Secretary and the Workers' Congress function effectively. But in reality the prerequisites were not satisfied. First, deregulation and enlarging the enterprises' autonomy had put the government out of the corporate management and the power of control fell in the hands of the managers. The asymmetry of information limited the government's ability to judge whether the performance of the enterprise was achieved by the external factors or by the managers' leadership. The mechanism of incentive and the supervision could not function. This problem could be solved by the complete control of the enterprise by the government. But it would go against the initiative of the reform. Second, the company directors and the managers are economic persons. They would pursue the rationale of maximizing their personal interests. Inadequate supervision would cause adverse selection and moral hazards. Third, the Party Secretary and the factory directors or managers were all insiders of the enterprise with common interests and they would easily act in collusion. Especially when the manager is also the Party Secretary, the function of supervision from the Party was no more than an empty slogan. There were cases in which the Party Secretary exercised effective supervision to the directors and the managers, but often the supervision brought about high bureaucratic cost because of the communication problems and personal conflicts in the enterprises.

[2] Wujinglian, *Modern Corporation and Corporate Transformation*, Tianjin People's Press, 1994.(Chinese)

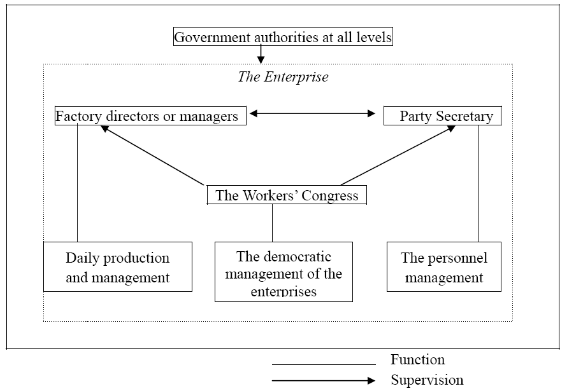

Figure 2. Transitional government-oriented governance pattern

Source: Hirata and Li Weian, "Corporate Governance in Transitional China," *Zeimukeirikyoukai,* Oct. 1997. (Japanese)

Furthermore, it was even more difficult for the Workers' Congress to exercise supervision because the employees depended upon the management for their salaries, welfare and promotions. It can be concluded that the defects in the bureaucratic governance are endogenous and the result of the property ownership system. Efforts should be first of all directed to change the system and then the market-oriented governance for SOEs could be constructed.

II. A descriptive analysis of the market-oriented governance pattern of SOEs

The bureaucratic governance is the consequence of the government-dominated system of property ownership. The defects of the governance pattern are inherent in the ownership system. Therefore the transformation should be first of all carried out in the ownership system to prepare the necessary conditions for the new governance. Establishing share-holding system in some selected enterprises triggered the experiment.

Up till now the establishment of modern corporate system (MCS) has been regarded as the most important step in the transformation of the state-owned large and medium-sized enterprises. One of the procedures is to set up market-oriented corporate governance pattern with the purpose of aligning the interest of all parties. Compared with other forms of companies, the public listed companies (PLCs) in China have set up relatively standardized market-oriented corporate governance. So the paper will only focus on the PLC in China to analyze the corporate governance problems and its improvement.

i) Internal governance mechanism

As the characteristics of corporate transformation in China, MCS is mainly piloted in PLCs. But because of the imperfection of the commercial law and the immaturity of stock market, the supervision of the companies is of distance supervision and control similar to that in the civil law system. The internal governance is in the form of regulations and rules, which are specified in Company Law. The law stipulates the allocation of power among the four parties, i.e., the shareholders' general meeting, the board of directors, the board of supervisors and the management. The shareholders' general meeting holds the supreme power in the governance; the board of directors has the power of decision-making; the board of supervisors supervises the management and managers are in charge of business of operation. The system aims at creating a balance and control mechanism in power allocation. But two problems arise in practice. First, as one of the characteristics of PLCs in China, the state and the enterprises are usually in the majority stockholding position. This has led to the power unification of the shareholders' general meeting, board of directors and the management. Thus the separation of powers cannot be realized. Second, the power system cannot act efficiently and effectively in decision-making because of the figurehead shareholders' general meeting, the overpowered board of directors and the weak board of supervisors. To illustrate the problems, the following is an investigation of PLCs in China.[3]

Basic corporate governance system

The investigation of 104 PLCs shows that the majority (75.42% in Table 1) has adopted the dual system of CEO and chairman, while 14.41% take the system of the Party Committee responsibility or CEO responsibility under the leadership of the Party

[3] Data come from *Report on balance and control mechanism of SOEs in China* (project director: Li Weian) sponsored by the State Committee of Economics and Trade and the International Business School of Nankai Univ. The investigation adopts the method of random sampling. A total of 300 companies were sampled from the 745 PLCs in China in 1997. Questionnaires were sent to be filled out by the executives. The investigation lasted for 5 months and 104 valid questionnaires were collected with the proportion of 34.67% and about 20,000 pieces of primary data were obtained, which was in accordance with requirements of questionnaire investigation.

Committee. It can be assumed that the CEO responsibility under the leadership of the board of directors has been the basic governance pattern of PLCs. The power is oriented more to the CEOs or the board of directors in about 24.58% of the PLCs.

The most important problem in corporate governance

To the question of "the most important problem in corporate governance", 67.26% of the PLCs responded as the effective involvement of shareholders' general meeting, directors, and managers in decision-making" while 7.08% said "the intervention from the board of directors and the lack of independent decision-making power for the managers." So it seems that what is needed for most PLCs is to base the market oriented corporate governance on the scientific mechanism of balance and control of powers.

Table 1. The corporate governance pattern of listed PLCs (%)

Question	Proportion
CEO responsibility under the leadership of the board of directors	75.42
The Party Committee responsibility with the board of directors in the role of decision-making and daily management.	11.86
CEO responsibility under the supervision of the board of supervisors.	10.17
CEO responsibility under the leadership of the Party Committee.	2.55

Note: All the companies that have given definite answers are taken as a whole and the proportion each item accounts for is calculated.

Table 2. The most important problem in corporate governance (%)

Question	Proportion
Intervention from the board of directors and lack of independent decision-making power for the managers	7.08
Effective supervision and control of the management by the board of directors	23.01
Effective involvement of shareholders' general meeting, directors, and managers in decision-making.	67.26
Others	2.65

The person forwarding the proposals when making decisions

To put forward a proposal is the first step in making a decision. According to the investigation, 79.21% of the companies gave this right of "calling for the meeting of directors" to the directors and the managers.

Table 3. Who calls for the meeting of directors (%)?

Question	Proportion
The directors or managers	79.21
Others	20.79

To call for the board meeting, the directors (including senior managers who are also directors) usually put forward the proposal to the chairman of the board (accounting for 90.56% of the PLCs). A small proportion of the directors put the proposal to a special committee in the board or in other forms. Senior managers who are not on the board of directors usually raise the proposal to the chairman of the board (accounting for 57.14% or to the CEO (accounting for 34.45%) . The agenda of the board meeting is in three aspects: strategy crafting (accounting for 40.35%); company operation assessing (33.77%) and new appointment, achievement evaluating and management monitoring (24.13%) (Table 4), which is similar to functions of the board in the developed countries (comparing to the corporate governance in UK and USA). But the proposals raised by the directors from government authorities are different from those by the directors representing employees. The former usually covers the strategies of business operation (accounting for 46.67%), the appointment of the senior management (20%), the fulfillment of state targets (20%), the employees' salaries and welfare (3.33%).

Table 4. Agenda of the board meetings (%)

Question	Proportion
Crafting strategies	40.35
The companies operation assessing	33.77
New appointment, achievement evaluating and management monitoring	24.13
Others	1.75

The latter concentrates more on the daily management decisions (38.1%), important management strategies (28.57%), salaries and welfare (23.81%), new appointment (9.52%) (Table 5). The different viewpoints among the directors indicate that directors from different sources focus their attentions on different aspect of company management and the introduction of employee directors will improve the decision-making mechanism.

Table 5. Differences in the proposals forwarded by different directors (%)

Question		Proportion
The appointed directors from government authorities	Crafting strategies	46.67
	Appointment of the senior management	20
	Fulfillment of the state targets	20
	Employees' salaries and welfare	3.33
	others	
The employee directors	Daily management	28.57
	Crafting strategies	38.1
	Employees' salaries and welfare	23.81
	Appointment of the senior management	9.52
	others	

The procedure of negotiations

Negotiation is the process of discussing and bargaining among all parties concerned. So the role played by the negotiators and the balance of powers directly influences the result of the negotiation. The topic can be investigated from the following aspects:

Whether CEO is also the chairman of the board of directors

It is not unusual in China that CEO is also the chairman of the board of directors. But the trend is decreasing in PLCs. The investigation shows that only 28.57% of the companies have the concurrent holding of the two offices while up to 71.43% of PLCs do not allow this (see Table 6).

Table 6. The proportion of the concurrent holding of the offices of the CEO and the chairman in PLCs (%)

Question	Proportion
Concurrent holding	28.57
Non-concurrent holding	71.43

The presence of non-executive directors and the nomination procedures

The presence of non-executive directors and the nomination procedures are important indicators of corporate supervising mechanism. In China the role of non-executive directors is not functioning well. Many companies do not have non-executive directors. As indicated by the investigation, companies with non-executive directors account for 50.52%, just a little over one half, while 49.48% of the companies do not have any non-executive directors. As to the nomination procedure, non-executive directors are nominated in 50% of the PLCs by a special committee in the board of directors and then appointed by the general meeting of the shareholders. In 28% of the companies the non-executive directors are nominated and appointed by the general meeting of the shareholders. So the nomination procedure is on the approach to standardization.

The presence of employee directors and directors appointed by the government authority at higher levels

Most PLCs in China, similar to the cases of the SOEs, are usually under the control of the related government authorities. According to the questionnaire, about 52.04% of them are under the control of related authorities and 47.96% of them are not. But it is not often for the authorities to send non-executive directors to the board.

Table 7. Non-executive directors and the nomination procedure (%)

Question		Proportion
Are there non- executive directors?	Yes	50.52
	No	49.48
The nomination procedure	Nominated by a special committee in the board of directors and then appointed by the general meeting of the shareholders.	50
	Nominated and appointed by the general meeting of the shareholders	28
	Nominated and appointed by the chairman of the board of directors	8
	Nominated by the government authority at higher levels	14

Table 8 shows that only 20.39% of the related authorities have nominated non-executive directors, which is inconsistent with the proportion of the companies under their supervision (52.04%). It shows that nominating directors to the board is not the only way the authorities participating in the corporate governance. But the vacancy of the proprietor has encouraged to a certain degree the insider control.

About 22.55% of the companies have employee directors, while 77.45% of them do not (Table 9), which shows that the employees' function in decision-making has not been paid much attention to and the decision-making mechanism of the board is yet to be improved.

Table 8. Is the company under related government authority (%)?

Question		Proportion
Is the company under related government authority?	Yes	52.04
	No	47.96

Table 9. The proportion of employee directors and directors nominated by the related government authorities (%)

Question		Proportion
Are there directors nominated by the related government authority?	Yes	20.39
	No	79.61
Are there employee directors?	Yes	22.55
	No	77.45

Implementation of the negotiation result and its monitoring

The implementation of the negotiation and its monitoring can be reviewed from the following points:

Whether directors have the right to inquire the implementation of the strategies at any time and how it is conducted. Revealed by questionnaire, the directors at 86.67% of the companies are able to inquire the implementation of the strategies at any time. The directors in 44.32% of the companies can ask for the information on business operation at any time and in 23.86% of the companies, the directors can visit the site and inquire the staff at any time. In 17.61% of the companies, the directors are able to call for meetings of the board and inquire the managers on a business operation. In most cases the directors have access to the first-hand information. Only in 14.21% of the companies the directors are only able to get the information from outside auditors (such as accounting firms) (see Table 10). Two problems may exist here: the subjectivity of executive directors in handling the information and the limitation of executive director in handling the information. So as a way of solving the problems the independence of non-executive directors should be reinforced. Introducing professional non-executive directors such as experts and scholars from outside can enhance the monitoring power the board.

Whether the company has an independent auditing committee and for whom is it responsible

The auditing committee is in charge of examining and supervising the enterprise's operation and management. The questionnaire shows that 73.79% of the companies have them as independent branches. Among these branches, 42.53% are responsible for the board of the directors, 26.44% for the general manager, 25.29% for the board of supervisors and 5.74% of them for the Party Committee (see Table 11). As in most companies the auditing committees are responsible for the board of directors, it is important to reinforce the role of the board of directors, especially the boards' independence and objectivity in supervision. The cases in which the auditing committees are responsible for the Party committee should be considered as abnormal.

Table 10. Whether the director has the right to inquire into the implementation of the decisions and the way it is conducted? (%)

Question		Proportion
Does the director have the right to inquire into the implementation of the decisions?	Yes	86.67
	No	13.33
How is it conducted?	The director can forward a proposal to call for a meeting of the directors and inquire the managers on a specific business.	17.61
	The directors can ask for the information on the business operation at any time.	44.32
	The directors can visit the site and inquire the staff at any time.	23.86
	The directors are allowed to get the information from outside auditing offices (or the accounting firms).	14.21

Table 11. Whether the company has an independent auditing committee and for whom it is responsible (%)

Question		Proportion
Does the company have an independent auditing committee?	Yes	73.79
	No	26.21
For whom is it responsible?	Board of directors	42.53
	General manager	26.44
	Board of supervisors	25.29
	Party Committee	5.74

(3) The channel through which the board of supervisors gets information

According to the questionnaire, the board of supervisors gets information from different sources. About 31.6% the board of supervisors obtains information by attending the meeting of the directors, 26.06% of them by reading reports from the board of directors, 24.1% of them by inquiring the directors and the managing staff and 31.6% of them by collecting information on the site (see table 12). In consideration of its role of monitoring the implementation of the strategies, the first-hand information that the board of supervisors has access to is rather low in proportion. The supervision of the board is generally reactive instead of proactive.

Table 12. The channels through which the board of supervisors gets information (%)

Question	Proportion
Attending the meeting of the directors	31.6
Reading reports from the board of directors	26.06
Inquiring the directors and the managing staff	24.1
Collecting on the site	18.24

The professional auditors on the board of supervisors and their background

The questionnaire shows that 53.85% of the companies have professional auditors on the board of supervisors. Among these auditors, 77.59% are from within the companies and 22.41% are from outside (see Table 13). The situation here together with those mentioned above in (2) and (3) affects the effectiveness of the board. So the power of the board is in need of strengthening. Executive supervisors (like employee supervisors) are needed for the board to access first-hand information and non-executive supervisors should be introduced to enhance its independence.

Table 13. The professional auditors on the board of supervisors and their background (%)

Question		Proportion
Are there professional auditors on the board of supervisors?	Yes	53.85
	No	46.15
Their background	Auditors from within	77.59
	Auditors from outside	22.41

Evaluation of the performance of the board of directors

(1) Whether the company has the evaluation system to the performance of the directors and what it is ?

Currently 20.19% of the companies have set up this system while among class-A companies (in which shareholding body fully control the company), the figure is 50%. But the majority of the companies investigated (about 79.81%) do not have the systems. Different procedures are taken to evaluate the director's performance. In 38.16% of the companies, the directors are required to report on their work, which is reviewed and evaluated by the board. In 12.72% of the companies the directors should report on their work and then the general meeting of shareholders evaluates the report. In 21.19% of them, the directors are to report to and evaluated by the Workers' Congress. In 27.93% of them, related government authorities examine the directors' reports (see Table 14). The questionnaire indicates that a systematic evaluation of the directors' performance has not been on the agenda of most companies. Even in the companies that have set up this system, it is far from being standardized. The cases in which the directors' reports evaluated by the related higher-level authorities and the Workers' Congress do not match the dominant position of the board of directors in the market-oriented corporate governance.

Table 14. The evaluation system to the director's performances and the way it is conducted (%)

Question		Proportion
Does the company have an evaluation system the directors' performance?	Yes	20.19
	No	79.81
The way it is conducted.	The directors are required to report on their work, which will be reviewed and evaluated by the board of directors.	38.16
	The directors will report on their work, which will be evaluated by the general meeting of shareholders.	12.72
	The directors are to report and will be evaluated by the Workers' Congress.	21.19
	The directors will report to and be examined by the related higher-level government authorities.	27.93
	Others	

(2) The director's term of office

The term of office is an important indicator in regulating the behavior of the directors. The investigation shows that 87.74% of the companies have a fixed term for the directors. But 89.13% of the companies do not have job rotations during the director's term of office, which reduces effectiveness of the system. In addition, most of the companies (about 80%) with job rotations for the directors do not have specified conditions for the practice, while even in the 20% of the companies with the restrictive conditions, they are only applied to the employee directors and professional non-executive directors (see Table 15). It indicates that the PLCs in China are not aware of the importance of the job rotation in the board's function of supervising and decision-making.

The above statistics shows that the internal corporate governance of the PLCs in China is roughly up to the requirement of market-oriented governance, but is far from being standardized. First, in terms of decision-making procedures, senior executives dominate the process of forwarding proposals and leading discussions. The employee directors, the board of supervisors and the related government authorities are functioning as supplements. Members of the party committee and workers' congress take part in the decision making by becoming directors of the board. Thus the system with the board of directors (senior executives) dominating the decision making is roughly established. It is not unusual in China that CEO is also the chairman of the board of directors. The problems of concurrent holding of the chairmen and CEOs and the introduction of non-executive directors are being standardized in most of the PLCs.

On the other hand, the presence of outside directors, the employee directors and directors appointed by the related government authorities and protection of the interests of the medium and small shareholders are paid more attention in the decision-making process. Setting up special committees to guarantee the function of non-executive directors should be put on the agenda of board of directors.

Second, in terms of strategy implementation and supervision, the system of managers routine reporting and the directors feedback inquiring have been standardized. Although the board of supervisors is able to play the role of supervision, improvement is needed in the board of directors' involvement into the decision-making process in terms of time, information accessibility, incentive mechanism, and proactive and reactive control. Efforts should be taken to guarantee the board's capability in dependent auditing and sufficient funds and remuneration.

Table 15. The director's term of office and job rotation practice (%)

Question		Proportion
Do directors have term of office?	Yes	87.74
	No	12.26
Is there job rotation within the term?	Yes	10.87
	No	89.13
Are there specified conditions for job rotation?	Yes	20
	No	80
The conditions to job rotation	Non-executive directors should hold positions in charge of auditing and supervising.	
	Positions in charge of forwarding proposals and remuneration should be held by non-executive directors.	
	The Workers' Congress should approve the change of employee directors.	50
	Establishing special positions to be held only by specialized personnel.	50

Third, great efforts are needed to be made in the evaluation of the directors' performance, the directors' job rotation practice with specified role definition and the training, appointing and examining mechanism in accordance with the enterprises' long-term strategies.

ii) Positive analysis of the external governance mechanism

The banks and the stock market are the main actors of external corporate governance in China. The transformation in banking system is on a trend to adopt the distance financing between the banks and enterprises. In July 1997, the issuing of Interim Regulations on the Administration of Lead Banks further stressed the banking function of financial services to the enterprises instead of the supervision and guidance to the enterprises. The classification of the loan assets into five categories by their reimbursability was tried out in 1988 and then widely adopted in 1999. To accompany this classification, the central bank was allowed to open branches across provinces. Measures were taken to consolidate trust companies and credit units, further strengthening the idea of the distance financing. The banks, also SOEs themselves, are going through the transition from the government-oriented governance to the market-oriented governance as well. Similar to transformation experienced by the industrial companies, the banks have undertaken first of all the consolidation of internal governance and standardization of operational mechanism. The stock exchange market in China is in the pioneering role of piloting modern corporate system in the economic structure reforms. Therefore it can be regarded as the most advanced form of external governance, which will be the focus of our analysis in the latter part of the paper. The aim of corporate governance is to give the shareholders satisfactory returns while taking into consideration the interests of the parties involved. But the positive study shows that even the performances of the PLCs with standardized modern corporate system are far from being satisfactory. The overall performance of the PLCs are not promoted with the increasing number of companies listed on the stock market and the increasing volume of capital assets of the PLCs, which made the sustainable development of the listed companies and the effectiveness of the stock market the hot topics in the economic circle. It can be seen that, although some companies grow robust, many are trapped in operational difficulties and the trend is increasing. The assets quality of the ill-performing companies is deteriorating and making great losses. In addition, the aging of companies – the decline in the overall performances of some old listed companies, has aroused wide attention.

Table 16. Performance of the listed companies between 1993 to 1998 in China

Year	Earning per share (¥)	Return on net assets (%)
1993	0.35	14.60
1994	0.32	14.20
1995	0.25	10.80
1996	0.23	9.50
1997	0.235	10.213
1998	0.211	7.801

Source: Guide to the Stock Market, from 1993 to April 1999

Table 17. Number of loss-making PLCs between 1995 and 1998

Year	1995	1996	1997	Mid-1998	End of 1998
Number	17	31	40	73	76

Source: Guide to the Stock Market, from 1993 to April 1999.

Table 18 shows that earnings per share and the return on net assets are on the trend of decreasing. The losses made by the newly listed companies are also getting serious, especially in the case of Hongguang Industry, where great losses occurred in the same year of going public. Statistics in Table IV show that the average interval between the time of listing and loss making is 34.97 months, less than 3 years. About 50% of the companies went into losses in less than 3 years. Considering the over cosmetic accounting manipulations among the newly listed companies, we see the ill-performance of the old listed companies and the fast loss-making of the newly listed companies as, in a sense, the two sides of the same paper.

Table 18. Comparison of the mid-term performances of the listed companies between 1995 and 1998

Time of going public	Earnings per share (RMB yuan)	Returns on net assets (%)
Before the end of 1995	0.071	2.97
1996	0.112	4.75
1997	0.141	5.30
1998	0.161	6.10

Source: Liu Lang, "A study of the sustainable development of PLCs," Guide to the stock market, Oct. 1998.

Table 19. The loss making companies at the end of 1997 and in mid-1998

Year	Number of loss-making companies	Listed before 1995	Listed before 1996	Listed before 1997
1997	40	31	8	1
Mid-1998	73	53	16	4

Source: Liu Lang, "A study of the sustainable development of listed companies," Guide to the stock market, Oct.1998.

Table 20. The average intervals between the time of going public and making losses

Interval	In 1 year	In 1.5 years	In 2 years	In 2.5 years	In 3 years	In more than 3 years
The number of companies	3	6	9	4	9	31
Proportion (%)	4.838	9.677	14.516	6.451	14.516	50

Source: Mou Xudong, "An Analysis of the restructure of loss-making companies," Guide to the stock market, March 1998.

The overall deteriorating performances of old PLCs and the over cosmetic accounting manipulation of the newly listed companies drew people's attention to the effectiveness of the external governance as well as the internal governance to the companies. The stock market set up rules and regulations on accounting standards and information disclosure to get rid of the practice of profit and information manipulation. With the operational environment becoming transparent, companies, instead of manipulating their profit figures, started to boost their performances by the improvement of management and the external governance. Corporate restructuring is regarded as an effective and efficient way to better the PLCs' performance. As a matter of fact, with the standardization of the stock market, restructuring was the most important strategy to eliminate losses and increase profits in the PLCs in the past three years (1997, 1998 and 1999). Statistics showed that, among the 62 loss-making companies by mid-1997, 32 companies were restructured, accounting for more than 50% of the total. Table 21 indicated the following trends: firstly, the number of loss-making companies increased with the number of the restructuring companies. Secondly, the longer or the earlier the period of the companies' making losses, the higher the proportion of being restructured. Among the 25 STs (special treated companies), which were confirmed loss making a year ago, 11 companies (40.74% of the total) were restructured.

The restructuring is usually taken in the following three forms:

Restructuring dominated by the government

Restructuring dominated by the holding company or the majority shareholders

Restructuring dominated by external dominant shareholding bodies including the state assets management companies, the parent companies or the majority shareholding companies or the majority shareholders. The first and the second are the usual forms of restructuring and the third type is the trend of increasing. Corporate restructuring through the secondary market is rare in China. The transfer of the state or the corporate shareholding by contract agreement is an important way of restructuring, which is closely related to ownership structure of the stock market in China.

Table 21. The restructuring of loss-making PLCs

Loss-making year	1994	1995	1996	mid-1997
Number of companies	2	17	32	36
Number of companies being restructured	2	11	17	15
Rate of restructuring (%)	100	64.7	53.1	41.6

Source: Mou Xudong, "An analysis of the restructuring of loss-making PLCs," Guide to the stock market, March 1998.

Table 22. The change of the stock ownership structure of PLCs in China

Year	93	94	95	96	97	98
State shareholding (%)	47.9	43.3	42.2	40.1	31.52	34.25
Legal person's shareholding (%)	23	24	22.7	14.9	30.7	28.34
Shares circulated on the stock market (%)	29.2	32.7	35.1	35.0	38.08	37.41

Source: China Securities Daily, 1994-1999.

The stock market in China exerts its external governance by the way of corporate restructuring based upon the transfer of the state-owned shares or the corporate shares by contract agreement. The basic features of the practice are as follows:

In the mechanism of market-oriented governance, the external governance usually realizes the replacement of unqualified management by merger and acquisition. Following suit, the restructuring of PLCs in China is by the restructuring of the corporate management, which is also used as signals to stimulate the management of other loss-making companies.

At the immature stage of the stock market development, the transfer of state-owned or the corporate shares which are unable to be circulated on the secondary market is an important channel to separate the right of ownership with that of management and set up the operational mechanism for the capital to be managed by the qualified management.

III. The market-oriented governance model and suggestions

The pilot of the share-holding system in state-owned large and medium-sized enterprises began at the end of 1986 on an overall scale. But due to the insufficient knowledge about the incorporation reforms, the experiment of share-holding system as well as the establishment of modern corporate system was not conducted according to the international standards. Our analysis shows that the PLCs, the models in the system transformation, have many problems yet to be solved.

i) Problems in exploring the market-oriented corporate governance mechanism

First, the control of the shareholding system tends to be government oriented. For some companies, the shareholders on the secondary market are not the ones who care for the performance of the enterprise. What they run for is the price premium that they will get when selling the shares. The supreme authority — the general meeting of the shareholders does not enjoy any right in the appointment of the board of directors except for its limited function in deciding the dividend payment scheme. In many companies the board of directors came into being long before the general meeting of the shareholders was called for. The directors often are from the management of the companies and relevant government authorities. Government authorities usually appoint the chairmen and CEOs. The directors and chairmen selected by the companies can be easily replaced and removed by the local government authorities in some places. The shareholding system is in fact government-oriented, which is against the standard market-oriented governance mechanism.

Second, the external governance is not effective. Government is unable to conduct its monitoring function in an environment of information asymmetry. So the phenomenon of insider control is prevailing.

Third, the mechanism of internal governance is weak. Most shareholding companies lack of internal monitoring mechanisms. Employees have no efficient channels to be involved into the management of the enterprises. So there is no monitoring pressure from the working staff to the management. Supervisors are usually selected among companies' auditors, accountants and administrative staff. They can easily form a conspiracy with the management and have no motivation to supervise.

Additionally, in many companies, CEOs are also the chairmen of the boards, which has weakened the supervision from the board of directors. Although significant steps have been taken on the approach to the market-oriented governance, the present stage of development is far from being satisfactory and complete. Greater efforts are needed to explore more efficient governance pattern and cultivate a market-orientated operational environment to enhance the competitiveness of the enterprises. For the market-oriented governance to be based on the shareholder-dominated system of property right, the following mechanisms have to be guaranteed.

The mechanism of corporate property

The material basis of enterprise behavior is the corporate property consisted of assets from the investors, the right of creditors and the intangible assets. Enterprises obtain independent corporate property rights on the basis of the corporate property and become personified independent legal identity. This helps to eliminate direct government intervention in the corporate management so as to increase the efficiency in decision-making and the flexibility to market changes and solve the problem of separating the functions of the government from those of enterprises. Meanwhile, it has paved the path for assessing the performance of enterprises. The investors can make judgment over the managers' achievement as well. It also helps to motivate the management for long-term development and standardizing operation.

The incentive mechanism

Efficient governance has its in-born incentive mechanism to eliminate moral hazards and align the interest of the owners with that of the managers and the employees. The mechanism alienates any intention or act of irresponsibility or "laziness" which are regarded as incompatible to the common interest.

The mechanism of democracy

The system of efficient democratic management and supervision creates a democratic atmosphere for the management of enterprises. It reduces the conflicts between the management and the employment caused by information asymmetry so as to cut the bureaucratic cost. At the same time the employees will be more motivated to work as team players. The short terms can be avoided to the largest degree and the long-term development is encouraged.

The monitoring mechanism to balance the interest of all parties

The efficient ownership system not only cares for the shareholder's rights and interests but also emphasizes the monitoring of the management by all stakeholders by creating conditions for them to participate in the enterprise supervision. Currently, the government is the only supervisor of the enterprises. But due to insufficient information, the government cannot conduct effective supervision and control, while the involvement of employees into the process of decision-making and supervision is an empty slogan.

Therefore market-oriented governance must assume the following elements:

with incorporation of enterprises as the prerequisite;

with the shareholders dominated property system as basis;

with the core of considering the interests of all parties united by the relationship of shareholding, crediting and other business contracts;

with the market as guidance;

with long-term development strategies as the goal..

ii) The design of market-oriented governance and suggestions

The market-oriented governance can be realized in many governance patterns. The most important consideration is not the choice of certain pattern but establishment of a mechanism that will guarantee the process of crafting long-term development strategies, which can be judged from the following two aspects – whether the strategies are in the interest of all parties concerned and whether they bring about the sustainable development of the enterprises. As the decision-making is in fact a process of negotiation, the governance should include the following:

First, who puts forward proposals?

Second, who implements the decision of the negotiation?

Third, who evaluates the negotiation and the implementation?

Fourth, what is the evaluation procedure?

These details are about the above-mentioned mechanisms of incentives, supervision, control and balance. So the design of market-oriented governance should start by guaranteeing the making of long-term strategies and following the logic of all parties' involvement in the process of governance and decision-making.

The design of internal governance

The building of internal governance should be based upon the many-sided supervision mechanism to realize the joint participation in the decision-making and interaction of all supervising powers. First, the initiative of the employees should be encouraged. Employees' participation in the management benefits long-term strategies and sustainable development of the enterprises, because the employees care most for the job security and dependable endowment scheme. So the important step now is to find an efficient channel to guarantee the employees' participation into the management of the enterprises. The legal system in Germany stipulates the seats for employee representatives on the board of supervisors. Among 100 big companies in Germany, the representatives from the employees and the trade unions accounted for 51.1% on the board of supervisors in 1988.[4] At the same time, the involvement of employee directors is also a key indicator in bettering the governance mechanism. As employee directors come directly from the production line, they know more about the problems in the daily operation and management. Their proposals can be complementary to those of the executive directors and non-executive directors. The introduction of employee directors is related to the legal system. In the countries of civil law system, most have established the system of employee participation in the decision-making on the board of directors. In France, it is stipulated that in companies of more than 50 people, there must be observers from the employees on the board of directors. Although the common law system in USA or UK does require the presence of employee representatives on the board of directors, the powerful Unions in these countries are often in a strong bargaining position to the management of the enterprises. Therefore the participation of employees in the process of decision-making at different levels is the well-accepted

[4] Yin Wenquan, "The Comparison of Corporate Governance in America, Japan and Germany," *Transformation,* March 1994.

practice. So what is needed in China is to standardize the presence and the proportion of employee directors and supervisors on the boards by legislation. The employee directors and supervisors are to be selected at the Workers' Congress. The function of the Workers' Congress can therefore be fully realized in the internal corporate governance.

Second, the control of the enterprises is to be reinforced by introducing non-executive supervisors selected among the professional auditors and accountants outside the companies. As the board of supervisors with members from inside the company is unable to exert efficient supervision over the management, the presence of non-executive supervisors is important to standardize the supervision of companies. The nowadays problems are how to formalize the process of appointing non-executive supervisors with the necessary standing to exert significant influences on the boards. Finally, the independence of non-executive directors is to be strengthened. Different from the board of supervisors that is usually reactive, the influence from the board of directors can be proactive if it contains sufficient number of experts, scholars or experienced entrepreneurs as non-executive directors. Above all, the construction of efficient internal governance mechanism requires the supervision of all controlling power concerned as well as the incentive mechanism to align the interests of all parties involved.

2) The design of external governance

The efficiency of external governance comes from the competition for the agency right, the threat of merger and acquisition, the pressure restructuring and liquidation, which are able to exert sufficient influence and incentives to the insiders. Some preconditions are needed for the governance to function. First an efficient capital market is needed for the corporate evaluation and transfer of control right. Meanwhile, the social service system is also needed to be readjusted, such as introducing competitive entrepreneur market and labor market, etc., as supplementary conditions for the external governance.

First of all, the modern entrepreneur market should be established. Entrepreneurs are the human resources for the modern enterprises. Measures have to be taken to change the reality of government authorities appointing the management of enterprises and establish an entrepreneur market with high efficiency and wide coverage. Relevant regulation and rules should be formulated to standardize the behavior of the entrepreneur market. The entrepreneurs are selected competitively on the market. The open and fair competition and market evaluation bridged the supply and demand of the management talents. Intermediary organizations are to be set up in the entrepreneur market for the recommendation of the management talents. At the same time, the evaluation system is also needed to encourage real entrepreneurship and eliminate the phenomenon of on-the-job corruption.

Second, the banking system should be reformed to create new relationships between the enterprises and the banks. Currently the banks only exert soft monitor on their loans, a practice, which were usually taken advantage of by enterprises. The banking reform can be taken in different ways, such as adopting the system of investment bank following the model of those in Germany and Japan. The point of the reform is to fully assume the banks' supervisory and advisory role in the external governance and to avoid the conspiracy between companies and banks[5]. Due to the fact that the practice of the banks is mostly government-oriented and the capitals are usually loaned out by government orders, the current banking system in China is unable to function in the governance of companies. Reforms are needed to taken in the following two aspects:

Commercialization of the old specialized banks by incorporation to refinance their banking assets by new sources or going public on the stock market;[6]

Opening new commercial banks to cultivate the standardized governance structure, avoiding bad debt problems and loan granting for political considerations by market-oriented practice, breaking the oligopoly of the banking world and exerting pressure on the present banks to better their supervisory function to the enterprises.

Third, the administration of the stock market should be further standardized. Due to the immaturity of trading systems, ambiguity in market regulations, weakness in supervision, the development of the stock market in China is abnormal, overwhelmed by irrational speculations. It cannot exert effective external governance to the PLCs. trong measures must be taken to bring the stock market back to the right track.

On the basis of the above analysis, the theoretical model of the market-oriented governance can be constructed as what follows (see figure below).

For the internal governance, the board of directors is in the key position. Executive directors are to put forward the proposals and non-executive directors supervise and evaluate the whole process of the decision-making and the strategy implementation. The board of supervisors is important for the supervision and evaluation of the performance of the enterprise. With the introduction of non-executive supervisors and employee supervisors, the function of the supervisory board is reinforced. The management at all levels and the employees of the enterprise are the working force to implement the strategies.

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[5] Li Weian, "The function of banks in external governance," *Communication*, Oct. 1996.(Japanese)

[6] See the thesis "Restructuring the relationships between the enterprises and the banks," submitted by Zhou Xiaochuan to the International Conference on *The Next Step of Reforming the Economic Structure in China*, held in Beijing, August 1994, pp.23-25.

As to the external governance, banks conduct their governance of enterprise by their stakes in the enterprises. The corporate stocks construct a consolidated base of structural stability for corporate operation and the sustainable development. The taking-over pressure from the stock market, the competition on the entrepreneur market and the competition for agency right combined together form an effective external governance mechanism.

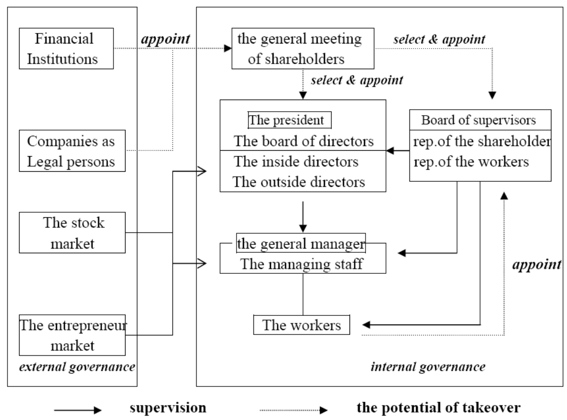

Figure 3. Market-oriented governance patternernance

Source: Li Weian, "Corporate Governance in the Transition to Market Economy in China," Hitotsubashi Forum, No. 5, Vol.117, May 1997. (Japanese)

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