# CHINA'S SOE REFORM: A CORPORATE GOVERNANCE PERSPECTIVE

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**Abstract**

This paper argues that Chinese state enterprise reform has been relatively successful in solving the short-term managerial incentive problem through both its formal, explicit incentive mechanism and its informal, implicit incentive mechanism. However, it has failed to solve the long-term managerial incentive problem and the management selection problem. An incumbent manager may have incentives to make short-term (but hidden) profits, but at present there is no mechanism to ensure that only qualified people will be selected for management. The fundamental reason is that managers of SOEs are selected by bureaucrats rather than capitalists. Since bureaucrats have the authority to select managers but do not need bear the consequences of their selection, they have no proper incentives to find and appoint high ability people. Since good performance does not guarantee that the incumbent manager will stay long, the manager does not have long-term incentives. The paper also argues that these built-in problems of state ownership cannot be solved by state-dominated corporatization. Bankruptcy has not played a role in disciplining managers because the state-owned banks have neither the incentive nor the ability to enforce debt contracts. To ensure that only high ability people will be professional managers and that managers can be well disciplined, the authority of selecting management must be transferred from bureaucrats to capitalists. This calls for privatization of both state enterprises and state banks. China is well on its way to privatization of state enterprises, but privatization of state banks is yet to come.

**Keywords:** SOE, China, privatization, management

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The state-owned enterprise (SOE) reform has been on the top of the China's economic reform agenda since 1984. Is China's SOE reform a success or a failure? The answer to this question is almost two-point distributed among economists. One argument, mainly from foreign economists concerned with China ("outsiders"), is that the reform has been quite successful in terms of improvement in total factor productivity (TFP). Influential research, among others, include Chen et al (1988), Gordon and Li (1989), Dollar (1990), Jefferson, Rawski and Zhen (1992), McMillan and Naughton (1992), Hay et al (1994), Groves et al (1994, 1995). According to these studies, the annual increase in TFP has been 2-4% since 1979, much higher than in the pre-reform period.[1] Based on this finding, some economists even argue that private property rights may not be necessary for efficiency.

But, most Chinese economists ("insiders") think that the reform has not been successful, at least in terms of profitability of SOEs. It is widely reported (and most people believe) that one third of SOEs make explicit losses, another one third make implicit losses, while only one third are slightly profitable.

Why are the judgments so divergent? There are several possible explanations. One is that the outsiders use econometric models to draw their conclusions, while the insiders are used to making judgment based on their daily experience and intuition. When aggregated data are used to analyze the performance of the reform, it is quite possible to ignore some important phenomena. On the other hand, when intuitive judgment is used, one might see trees but not the forest. The second possible reason might be psychological. Chinese economists are "forward looking", and they compare today's situation with the ideal model in their minds, and they feel unhappy whenever they find there are some undesirable gaps between reality and ideality. In contrast, foreign economists are "backward looking", comparing today's situation with the past. They feel happy whenever they find today is better than yesterday.

Certainly, this cannot be the whole story. The most important question is: What criteria should one use in evaluating the SOE reform? For China's SOEs , both TFP and profitability are heavily distorted indictors (but TFP is better than profit). In my view, the proper criterion should be a "qualitative one". "Corporate governance" is such a candidate. Corporate

[1] However, the study by Woo *et al* (1994) based on survey data for 300 SOEs found that TFP growth was zero at best during 1984-1988. More recently, in a comparative analysis of Chinese industry using a survey data set including 967 SOEs, Huang and Meng (1997) also calculated negative TFP growth for SOEs in the 1985-1990 period.

governance is a concept characterizing the contractual relation between difference members of the firm. It is structured for solving the two basic problems inherent within the firm. The first is the incentive problem; that is, how to motivate all participants of the firm to contribute to the firm's output, given that output is a collective outcome and individual contribution is hard to measure? The second is the management selection problem; that is, what kind of mechanism can ensure that only the most entrepreneurial people are employed to fill in the management position, given that entrepreneurial ability is hard to observe?

From the point of view of corporate governance, my basic argument is that: China's SOE reform has been relatively successful in terms of solving the short-term managerial incentive problem; but more importantly, it has not been successful in terms of solving the management selection mechanism and the long-term managerial incentive problem. That is, the variety of reform measures adopted since 1978 (basically the management contracting system) have provided the incumbent management of SOEs with moderate incentives to make short-term profits, but the authority of selecting management is still held by the communist party's personnel departments and the industrial bureaucracy, who have inadequate incentives, and also lack the information, to find and to seat the entrepreneurial people for managerial positions. The fundamental reason is that bureaucrats, unlike their capitalist counterparts, do not bear risks for their selections.[2] Because of this, managerial tenure is little dependent on the performance of the enterprise, and this in turn eliminates the manager's long-term incentives to run the enterprise efficiently. In addition, state-owned banks have neither the incentive nor the ability to enforce debt contracts. To solve the management selection problem and the long-term managerial incentive problem, the authority of selecting management must be transferred from bureaucrats to capitalists. This calls for privatization of both state enterprises and state banks.

This paper is organized as follows. Section 1 provides a theoretical framework of corporate governance, and discusses how management is selected and disciplined by shareholders and debtholders in the capitalist firm. Section 2 discusses how successful or unsuccessful China's SOE reform has been in solving both the managerial incentive problem and the management selection problem. I provide a number of explanations for why neither the management contract system nor the state-dominated corporatization can achieve their assumed goals, and why bankruptcy has failed to play an effective role in disciplining SOE managers, from a corporate governance perspective. Section 3 points to new developments of SOE reform, that is, ongoing privatization of SOEs.

## 1. Analytical Framework: What Does Corporate Governance Do in a Capitalist Firm?

### 1.A. The Origin of the Classical Capitalist Firm and Capital-Hiring-Labour

The best way to understand the problems facing the state-owned enterprises is to begin with the origin of the capitalist firm and its contractual structure.

The firm is a cooperative organization of different participants (factor-owners). From the point of view of functioning, all participants can be grouped into three types of members: the marketing member, producing members and capitalists. The marketing member makes decisions of "what to do and how do it" (Knight, 1921), or "discovering the relative prices" (Coase, 1937); the producing members execute these decisions by transforming inputs into outputs physically; and the capitalists finance decisions made by the marketing member. Because of alienability of physical capital, the capitalists may not stand by their capital and therefore can be "outside members". In contrast, both the marketing member and the producing members are always "inside members". A necessary condition for a capitalist to be an insider is that he also works either as the marketing member or as a producing member. In other words, an inside capitalist must play dual functions. For obvious reasons, I often refer to the marketing member as the decision-maker and the rights to undertake marketing as decision rights. The importance of marketing comes from uncertainty facing the firm (Knight, 1921). In fact, without uncertainty, there would be no need for the firm. Uncertainty makes marketing or decision-making play the dominant role in determining the return of the firm. The firm is more likely to go bankrupt when it produces a "wrong" product at low cost than when it produces a "right" one at high cost. Ability to make decisions is commonly referred to as entrepreneurial ability. Although everyone may possess some entrepreneurial ability, the observation is that individuals differ in their entrepreneurial ability. This is so not just because different people face different costs of collecting and processing information, but mainly because entrepreneurial ability greatly depends upon the person's "alertness" (Kirzner), "imagination" (Shackle), and "judgment" (Casson). All these personal characteristics are at least partially innate and uneducable. The optimum requires that marketing or decision rights should be assigned to the one who has the highest entrepreneurial ability. However, the problem is that, unlike capital, entrepreneurial ability is not easy to observe. Given this constraint, for the firm to survive and to be profitable, there must be a mechanism to ensure that only a sufficiently (if not the most) qualified person will be the marketing member. This is the "management selection problem".

The dominance of the marketing member does not mean that the producing members and capitalists are irrelevant or unimportant. The return to the firm is a

[2] More precisely, risks that a bureaucrat bears are very different from risks that a capitalist bears.

joint stochastic outcome of actions and services supplied by all members. Because of uncertainty and teamwork, it is impossible to reward all members with fixed contractual payments corresponding to their respective contributions to the total return (Alchian and Demsetz, 1972). This creates an incentive problem: some party may take an action (e.g., shirking) which benefits himself but costs others. To deal with this problem, there must be a mechanism which makes each member as responsible for his actions as possible. This is the "incentive problem".

The above two problems are interacted with each other, because the return to the firm is jointly determined by both ability and actions. Zhang (1994) showed that the observed organizational structure of the capitalist firm can be understood as an optimal response to these two problems. Briefly speaking, the two problems are solved by assigning a principalship. Here principalship is defined by residual claimancy and control rights. As the term suggests, the residual claim is an entitlement to claim the residual (total return minus contractual payments). Control rights, roughly speaking, refer to the rights of selecting and monitoring other agents.[3] From the incentive point of view, the residual claim should be assigned to the marketing member. This is not only because the marketing member plays the dominant role in determining the residual, but also because his behavior is more difficult to monitor than others' (asymmetry of monitoring).[4] The dominance role implies that the loss of the marketing member's incentive is more costly than that of any other members' incentives, and therefore it pays to sacrifice the latter for the former. The asymmetry of monitoring implies that assigning the residual to the marketing member will incur much less "aggregated" incentive losses.[5] [6]The two factors together ensure that the welfare loss when the marketing member is the residual claimant is lower than when the producing members are the residual claimant. Thus the marketing member becomes the "entrepreneur" and the producing members become "workers".[7] However, given that entrepreneurial ability is not well observable, free choice of occupation implies that there would be too many unqualified people claiming to be entrepreneurial. The reason is as follows. Because of the limited liability (more generally, the non-negative consumption) constraint, the low-bound net residual, and therefore the net expected return of being an entrepreneur instead of being a worker is higher when one's personal wealth is low rather than high. This implies that a person with lower personal wealth is more likely to over-report his entrepreneurial ability than a person with high personal wealth. In other words, in so far as entrepreneurial ability is concerned, the rich are more likely to be honest and credible, when they choose to be the entrepreneur. Priority in being the entrepreneur is given to capitalists because the choice of the rich is more informative than the choice of the poor in the sense of signaling entrepreneurial ability. This legitimatizes the institutional characteristics of the classical capitalist firm: an entrepreneur is also a capitalist and the residual becomes profit of capital. Thus, the observed capital-hiring-labour can be understood as the "self-selection" mechanism of entrepreneurship. Under such a mechanism, only those high ability would-be entrepreneurs can become actual entrepreneurs.

### 1.B. The Origin of the Joint Stock Company and Functions of Corporate Governance

The above discussion shows that the function of capital-hiring-labour is to exclude inferior candidates from entrepreneurship. However, the capital constraint is double-edged. Because the distribution of ability and the distribution of personal wealth in the population are the same in reality, liquidity constraints also exclude those with high ability but low assets from being the entrepreneur. On the other hand, the capital owned by high ability people earns its factor price plus a pure profit (rent) from signaling, while the capital owned by the low ability people can earn only its factor price because they has no ability to signal. This implies that there is a profitable opportunity for cooperation between high-ability-low-capital people and low-ability-high-capital people. Although a rich person with low ability cannot make a profit by directly marketing, he may increase his return by using his capital to signal someone else's ability, if he knows some high ability people (e.g., his relatives), or if searching for high ability is not too costly. On the other hand, a high ability person can also increase his return if he can convince the rich that he is really good at marketing. Furthermore, the incentive for each party to search for the other party is an increasing function of their respective recourses (ability or wealth), because the more personal wealth (/entrepreneurial ability ) one has, the more rent one can earn, if

[3] According to Grossman and Hart (1986), control rights result from contract incompleteness and therefore are residual rights. In the present paper, control rights are more loosely used. They consist at least of two components: one is rights to make business decision and the other is rights to select and monitor the marketing member.

[4] Asymmetry of monitoring is quite intuitive. A glance at the producing members will reveal whether they are working, while a stare at the marketing member may tell little about what he is thinking about.

[5] This argument can be sharpened by the following example. Suppose that there is a working team of two people, A and B. They work only during the night when the moonlight shines. The production technology requires that person A works in the light while person B works in the shadow. The output cannot be attributed to each individual's marginal effort. Then, obviously, it is preferred to let person B claim the residual rather than person A, because person A cannot see what person A does while person B can easily see whether person A works hard or shirks. In the context of the firm, the marketing member is a worker-in-the-dark, whereas the producing member is a worker-in-the-light.

[6] Yang and Ng (1995) argue that management claiming residual is indirect pricing of managerial services.

[7] Here following Knight (1921), we understand that the entrepreneur has dual functions: making decisions and bearing risks.

searching is successful. As a result, they become joint entrepreneurs: the high ability person is called the manager by doing marketing, and the rich are called claim-holders (shareholders or debtholders by claiming the residual and taking the responsibility for selection of the qualified manager). This is the origin and the nature of a joint-stock company.

A joint-stock company as a cooperation between ability and wealth causes several agency-type problems, however. First, because of imperfect observation as well as the time-taking process of revelation of ability, a capitalist inevitably makes some mistakes in picking a manager. Someone who was initially thought of as high ability may prove a lemon as the cooperation proceeds! If this is the case, a chance should be given to the capitalist to correct his mistake (of course, correction of the mistake can only minimize rather than eliminate the cost of the mistake, otherwise nobody cares about mistakes). The mistake can also occur the other way: a high-ability manager may be blamed for being a lemon by the capitalist's misjudgment. Because sacking a manager sends on average bad news of ability, the high-ability manager will be unfairly harmed. There should be a mechanism to protect the manager from such a mis-treatment. Second, because of the dominant importance and poor monitorability of managerial activities, there is a serious incentive problem on the manager side. This suggests that managers should be motivated by some effective incentive mechanism. Third, when the capitalist is an outside member of the firm, capital itself is more vulnerable to abuse;[8] and also the revenue may not be verifiable for outsiders so that it might be consumed as perks or invested in unprofitable projects by the manager rather than paid out to investors. Because abuse of capital and mis-use of revenue can benefit the manager in various ways, it is necessary for the capitalist to have some voice regarding the use of funds. Fourth, when capital demand is high, investors will be diversified. This creates an incentive problem of monitoring on the capitalist side, because the cost of monitoring is concentrated while the benefit of monitoring is spread. There should be some mechanisms to mitigate this free-rider problem. Corporate governance is assumed as such a mechanism which addresses all these agency problems within a joint-stock company. It governs relationships between different factor-owners of the firm, and in particular between capitalists and managers through allocation of residual claim and control rights by both explicit and implicit contracts.[9]

What is an efficient corporate governance system? In this regard, economists have come to the following conclusions:

First, and most fundamentally, the residual claim and the control right should be matched as much as possible, i.e., whoever has claim to the residual and assumes risks should also have rights to control, or conversely, whoever has rights to control should assume risks. Frank Knight (1921) might be the first economist arguing for this matching.[10] More recently, Harris and Raviv (1989) argue that the claim residual should match the rights to control (voting rights) because otherwise "cheap vote rights" would lead to unqualified people being more likely to take over control of the firm. Dewatripont and Tirole (1994) argue that residual claim is incentive schemes for controlling parties to take appropriate course of action. Of course, full matching between residual claim and control rights is impossible, and otherwise there would be no agency problem at all. Second, managerial compensation should be more closely linked to performance of the firm, rather than fixed by contract. In other words, the manager should bear some risks! This argument has been well discussed in the literature of principal-agent theory.[11] In fact, this argument can be taken as a corollary of the first argument since, by his functioning as the marketing member, the manager holds "natural" control rights of business decisions, and therefore must be motivated by residual sharing, given that his actions are difficult to monitor and to contract upon. In particular, in order to motivate the manager to improve long-term productivity of the firm, not just to increase total sales revenue and current profits, managerial compensation should be more strongly tied to long-term stock price performance. In particular, it is desirable for the manager to hold a considerable stake in the firm as an inside owner, since only by so doing can the manager's interest be more concurrent with the outside share-holder's interests (Jensen and Meckling 1976).[12] Third, as discussed earlier, the authority of selecting and monitoring management should be assigned to capitalists (Zhang, 1994). This argument can also be taken as a corollary of the first argument, since, by nature, capitalists are inevitably the eventual risk-bearers, and only they have adequate incentives to select good managers and dismiss bad managers, and to monitor managerial performance. Fourth, the optimal corporate governance should be characterized by a state-contingent control structure; that is, the control rights should be contingent on the state of nature such that different claim-holders control the firm in different state. (Ahgion and Bolton, 1992; Dewatripont and Tirole, 1994). The reasoning is that,

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[8] Capital abuse by management can take various forms, one of which is "overinvestment" for career concerns (see Holmstrom and Richart i Cost, 1986). For more, see Shleifer and Vishny (1997).

[9] Focusing on corporate governance mechanism in this paper does not mean that product market competition is not important in disciplining management.

[10] "with human nature as we know it would be impractical or very unusual for one man to guarantee to another a definite result of the latter's actions without being given power to direct his work. And on the other hand the second party would not place himself under the direction of the first without such a guarantee." (p.270)

[11] For an excellent survey, see Hart and Holmstrom (1987).

[12] The evidence of strong correlation between the managerial payment and the firm's performance suggests that the actual residual stake held by the manager is more than proportional to his nominal stake (for a survey and synthesis, see Rosen (1992)).

in a world of incomplete contracts, only state-contingent control can best generate (partial) manager/claim-holder congruence. In particular, Dewatripont and Tirole (1994) argue that (1) because of contractual incompleteness, monetary incentive schemes based on firm profitability are not sufficient to discipline managers, and endowing outsiders with control rights is desirable because they can take actions managers like (dislike) after good (bad) firm performance; (2) the firm's outsiders must be given incentive schemes in the form of securities to intervene appropriately in the firm; (3) the firm's managers should be rewarded by low interference by outsiders when performing well, and be punished by substantial outside involvement when performing poorly; and therefore, (4) under some conditions, control should be given to equity-holders when the firm does well and to debtholders in harsher times because the equity-holders are more passive than the debtholders in intervening in the firm.[13]

Fifth, in order to mitigate the free-rider problem of investors, concentration of ownership with large investors is preferred (Shleifer and Vishny 1997). When control rights are concentrated in the hands of a small number of investors with a collectively large cash flow stake, concerted actions by investors are much easier than when control rights, such as votes, are split among many of them. There are several distinct forms that concentration can take, including large shareholders, takeovers, and large creditors. A substantial minority shareholder has the incentive to collect information and monitor the management, therefore avoiding the free rider problem. He also has enough voting control to put pressure on the management in some cases, or even to oust the management through a proxy fight or a takeover (Shleifer and Vishny, 1986). Large shareholders thus address the agency problem in that they both have a general interest in maximization, and enough control over the assets of the firm to have their interests respected. Similarly, by combining substantial cash flow rights with the ability to interfere in the major decision of the firm, large creditors can also more effectively discipline the management through their contingent control rights than small creditors.[14][15]

### 1.C. Capital Structure and Bankruptcy Mechanism

Both in theory and in practice, capital structure is one of the most important aspects of corporate governance. Efficiency and effectiveness of a corporate governance system much rely on capital structure. This is because shareholders and debtholders differ in both control rights and cash flows. They are "state-contingent owners" of the firm in different states. When the firm is solvent, shareholders are owners: claim residual and control management; and debtholders are only contractual return claimants. However, when the firm is insolvent, debtholders take over control of the firm from shareholders. Because the switching point of control is determined by capital structure, and shareholders and debtholders exercise their respective control rights differently, capital structure has important implications for managerial behavior. The optimal capital structure is one which can most effectively solve both the managerial incentive problem and the management selection problem.

It is widely recognized that the board-of-director-control ("voting-with-hands") and the stock market ("voting-with-feet") are two major mechanisms through which shareholders exercise their control rights to deal with managerial agency problems. They are complementary but also substitutable. On the one hand, the decision for replacing the incumbent by "voting-with-hands" is generally based on the score from "voting-with-feet". On the other hand, an efficient stock market surely makes direct control less important. This is analogous to frequent patrol by the police making the prisons less crowded! In reality, which mechanism is more important depends on the level of development of stock markets as well as the concentration of shareholding. For instance, in the United States and Britain where stock markets are well developed and ownership is very diversified, take-over through stock markets playa a more active role than in Germany and Japan where stock markets are less developed and ownership is more concentrated (Berglof, 1990).

While shareholders have the ultimate control over the manager when the firm is solvent, the control rights shift to debtholders when the firm becomes insolvent. The rationale for this shift is that in the latter case debtholders become de fact residual claimants and thus are better motivated to make adequate decisions. In general, debtholders' control is harsher for the manager than shareholder's control, because the incumbent is more likely to lose his job in the case of debtholder's control than in the case of shareholders' control. For this reason, debt can serve

[13] The Dewatripont-Tirole model uses the well-known facts that the debt-holder's welfare is a concave function of the firm's profit and the equity-holders' welfare is a convex function of the firm's profit. The part in control of the firm, then, uses a non-verifiable, i.e., non-contractible, signal as the basis for deciding whether to allow the firm to continue or stop. The manager prefers to continue rather than stop, since he enjoy the private benefit from continuation. When continuing, the firm's profit distribution is more "risky" (in the sense of second-order stochastic dominance) than when stopping. For this reason, the "risk-averse" debtholders will dismiss the manager more often than the "risk-preferring" equity-holders.

[14] However, unlike equity, debt in a peculiar way may be tougher when it is not concentrated. If a borrower defaults on debt held by a large number of creditor, renegotiating with these creditors may be extremely difficult, and the borrower might be enforced into liquidation (Gertner and Scharfstein, 1991; Dewatripont and Maskin, 1995; Bolton and Scharfstein, 1996.)

[15] Costs of concentrated ownership are potential expropriation by large investors of other investors and stakeholder in the firm. For this reason, as argued by Shleifer and Vishny (1997), a good corporate governance system should combine some type of large investors with legal protection of both their rights and those of small investors.

better to discipline the manager (Grossman and Hart 1982).

Because of the collective action problem of debtholders, debtholders' control is usually conducted and governed through a law-provided bankruptcy procedure (Jackson, 1986; Hart, 1995). Most bankruptcy laws in developed economies offer two options for debtholders' control of the insolvent firm, i.e., liquidation or reorganization. Liquidation means, in most cases, that the firm is dissolved, and assets are sold piecemeal; some times, however, the firm is sold as a going concern. Whichever occurs, the proceeds of the sale are divided between debtholders according to absolute priority rules determined by law (usually secured debt, then various priority claims, then unsecured debts, then subordinate debts, and finally equity), and the incumbent manager loses his job. Reorganization is a process through which the claim-holders negotiate on whether and how to restructure the debtor firm's liabilities and assets, possibly with the objective of maintaining the company as a going concern. Restructuring of liabilities typically entails the exchange of debt for equity, extension of maturity, reductions in principal and interest, and injecting new capital. Asset restructuring may involve divesting unproductive units, eliminating unprofitable product lines, introducing new managerial practice, changing marketing orientations, and adopting more appropriate production technologies. Reorganization of the insolvent firm may also involve replacing the management team. But in general the probability that the incumbent keeps his job is higher in the case of reorganization than in the case of liquidation. For this reason, liquidation is harsher for the manager than reorganization. The Choice of liquidation and reorganization often depends on the concentration of debtholders because of the transaction cost problem. If debts are more concentrated in the hands of a fewer large debtholders (such as banks), reorganization is more likely to occur; otherwise, liquidation is more likely to occur. Bankruptcy can result either from the manager's incompetence, or managerial slack, or some exogenous shock beyond the manager's control. No matter which reason it is, in many cases, the firm is worth more as a going concern after reorganization than if it is sold piecemeal. Thus, ex post efficiency might call for the incumbent management of a bankrupt company to be retained. However, anticipating this, management might have little incentive to avoid bankruptcy, and an incompetent manager might not be replaced punctually, given that the exact reason for bankruptcy is not easy to identify. The optimal bankruptcy procedure must balance between realizing ex post efficiency and ex ante disciplining management (Hart, 1995). Although our discussion of the creditor's control has focused on the bankruptcy state, debt financing can mitigate the managerial agency problem in various other ways. For instance, debts force the manager to pay out funds to investors rather than to himself, force the sale of unproductive assets and limit the manager's ability to make unprofitable, but power-enhancing, investments (Jensen, 1986; Hart, 1995). By triggering the investigation when debtors default on debt payments or when the firm needs refinancing overdue debts, debt contracts help to reveal information of the firm so that the manager can be better monitored and disciplined by investors (Harris and Raviv, 1990).

It should pointed out that the capital market and bankruptcy are not only mechanisms to discipline management but also mechanisms to constrain capitalists' behavior. For instance, transferability of shares ensures that the capitalist can easily correct his mistakes in judging the manager's ability, while inability to withdraw real capital can protect the high ability manager from unfair harm by an individual shareholder's mis-blame; the market valuation of stocks does not only value the performance of the manager, but also values the performance of the shareholders. The replacement of management is often preceded by the replacement of the shareholders; the shareholders are harmed before the manager. Similarly, debt contracts, on the one hand, restrain the debtholders from intervening in management in good time, and, on the other hand, punish the debtholders for lending to the wrong people (entrepreneurs or managers) and financing the wrong projects. After all, it is capitalists who take responsibility for selecting and disciplining managers. If they do not pay for their careless mistakes, who will?

### 1.D. Summary

In this section, I present an analytical framework of what corporate governance does in a capitalist firm. I argue that corporate governance is a mechanism assumed to address both the managerial incentive problem and the management selection problem through the allocation of residual claim and control rights. In particular, capitalists' control is crucial for selecting the most entrepreneurial people for managerial position, and for motivating and disciplining managers since, as "natural" risk-bearers, only they have adequate incentives to select good managers, replace bad managers and monitor managerial performance (either as shareholders or as debtholders). Given that the existing literature almost exclusively focuses on the managerial incentive problem, and the role of capitalists in disciplining management, I emphasize that the management selection problem and the function played by capitalists in selecting high ability management might be more important for efficient corporate governance of the firm. After all, everyone can be motivated to work hard by proper incentive schemes, but only a small fraction of the population is qualified for entrepreneurship and management. From the point of view of resource allocation efficiency, a hard-working but less competent manager is definitely worse than a highly competent but more discretionary manager. In the next section, we apply this framework to analyze state-owned enterprise reform in China.

## 2. Evaluation of the State-owned Enterprise Reform in China

### 2.A. Introduction: The Most Serious Agency Problems of SOEs Are on the Side of Governmental Bureaucrats

The most distinct feature of state-owned enterprises (SOEs) from capitalist firms is that, by definition, the role of principals in state-owned enterprises is played by the "state" (government) rather than by natural capitalists: it is the government who appoints, motivates and disciplines managers, and finances firms' projects. This has substantial implications for corporate governance of the enterprises. First, it implies that the investor of the firm is completely an outsider, and there exists no inside ownership at all. Because the owner is far away from the management team, and the manager has no stake in the firm, the agency problem of SOEs on the management side is potentially far more serious than of any capitalist firm where the CEO normally holds a considerable stake and is therefore an inside owner. Second, because the state (or government) is a pseudo-player rather than physical entity, principalship of the state has to be delegated to and exercised by governmental bureaucrats through a hierarchical structure (Zhang, 1993).[16] Bureaucrats hold the de facto, extremely concentrated, control rights of the firm under name of the state, but they are not residual claimants (at least in a legal sense) because the residual belongs to the state; that is, control rights are separated from residual claim in the first place. Moreover, these bureaucrats typically have goals that are different from social welfare, and are dictated by their own political and economic interests. This creates another agency problem, i.e., how to motivate and monitor bureaucrats in order for them to behave like capitalists in selecting, disciplining and motivating management? In any realistic sense, this second agency problem is far more serious than the first one.[17] For this reason, many Chinese economists have come to a conclusion that the problem of SOEs is mainly that of the principal rather than that of agents (Zhang Weiying, 1995; Fan, Gang, 1995; Zhang, Chenyao, 1995; Zhang, Chunlin, 1995, 1997). During the pre-reform period (before 1979), both the residual claim and control rights of SOEs in China were almost completely held by the governments (in most cases at the central and provincial levels). The whole economy of the state sector was organized like a single giant company with almost all decisions of production, investments and employment centrally planned (Wu, 1994). Revenue and cost Budget were also centralized by the state treasurer. The so-called "enterprise" was nothing but a production plant. The enterprise had a director but no "manager" , in the sense of business decisions; the director (normally acted by the party secretary) was nothing more than a special worker, whose main task was to coordinate and supervise ordinary workers to implement the production plan made by the government, rather than marketing. All inside members of the enterprise were compensated through a centrally set hierarchical wage-fringe benefit system, which was little related to firm performance. If there was anyone who had incentives to make the economy better, it was the central government leaders and top bureaucrats, because they were virtually the partial residual claimants (both politically and economically, and legally and illegally) (Zhang, 1993).

The benefit of central planning was that the agency problem of managerial theft and expropriation of funds at the firm level was tightly restricted since management had little freedom to make discretionary decisions. However, the cost was the losses of resource allocation efficiency, and of managerial incentives to improve production efficiency and technology efficiency, and also a serious agency problem of bureaucrats.[18] The Chinese SOE reform first introduced in 1979 can be characterized with a continuously evolutionary process of shifting decision rights and residual claim from the government to the firm level. The reform started with no intention to abolish state ownership. Rather, it was intended to improve efficiency within state ownership. Nevertheless, reform has been directed by a doctrine which is potentially conflicting with the conventional doctrine of state ownership. I call this new doctrine "the reform doctrine", according to which, both the decision rights and the residual claim should be shifted to the inside members of the firm (i.e., the manager and workers). The argument for shifting the decision rights to the manager of the firm is based on the assumption that decisions made at the firm level are more efficient than at the central agent level because of the information/communication problem.

[16] Theoretically, it is "all people" who are the principal (owner) of the firm, and the state is only a representative of all people. But in this paper, I will go to discuss the relationship between the original owner and the state. See Zhang (1993).

[17] In a capitalist firm, the monitor is monitored by residual claim (Alchian, 1972). This cannot be a case in the state enterprise.

[18] Bureaucrats enjoy considerable freedom to expropriate public funds through various ways. One such way was to make investment in their hometown. This can be sharpened by the following example. Suppose there is the total fund of 100 millions and there is a railway to be constructed, which costs 90 millions and generates 99 millions benefit for the public if it does not pass the bureaucrat's hometown, or costs 100 millions and generates 95 million benefit for the public plus 5 million private benefit for the bureaucrat if it passes his hometown. If the bureaucrat can pocket his rent of 10 millions, his best choice is to donate it to his hometown for building a school, which generates him 11 millions benefit; the remaining 90 millions can only be used to construct the railway not passing his hometown; and the net return rate of the total investment is 10%. However, because it is impossible for the bureaucrat to pocket the rent, his second best choice is to invest all 100 millions in constructing a railway passing his hometown, which has the net rate of the return is 0%. This misallocation is possible because it is impossible for the public to understand what is the optimal routine or it is too costly for them to stop the decision ---5 millions net surplus might be the maximum they could get from monitoring; on the other hand, the investment generates 5 millions for him, which is better than nothing, it pays for the bureaucrat to hire some experts to prove that the detour is the best for the public's interest.

The theoretical legitimacy of this assumption dates back to Hayek, while Chinese economists mainly base their argument on the observed poor performance of the traditional centralized planning system. The argument for shifting the residual claim to inside members of the firm is based on incentive considerations. Although the modern theory of incentives was introduced into China much later, the pre-reform Chinese experience seems sufficient for both Chinese economists and reform-minded leaders to understand how essential the incentive system is for economic performance, although it has come much later for them to understand that the incentive system is primarily dependent on property rights and ownership structure. The reform doctrine can be summarized by a popular official slogan that "the goal of the reform is to make the firm independent, autonomous, and responsible for the profits and losses". If this doctrine were fully implemented, state ownership would no longer exist in any economic sense; the government would be left nothing more than a bondholder. However, for a long time, this inconsistency between the reform doctrine and state ownership has not been well recognized by economists and practitioners. As a result, they are puzzled by the fact that, on the one hand, bureaucrats still enjoy considerable administrative intervention in the firm even after more than decade reform, and on the other hand, the economy suffers from managerial insider control (Wu, 1995). In practice, shifting decision rights and residual claim has been conducted through various policies. In the early stage of reform, the basic policy was "fangquan rangli" (granting autonomy and sharing profit). From 1986 to the early 1990s, the dominant policy was the management contract system. From 1994, the state-dominated corporatization of SOEs was officially adopted as a substitute for the management contract system. In the remaining part of this section, I will first analyze the effect of the management contract system (analysis applies to the policy of "fangquan rangli"), and then give a personal view of corporatization policy. Finally, I will discuss why changes in the financial structure of SOEs and bankruptcy have failed to play a role in disciplining managers. As pointed out in the introduction of the paper, from corporate governance perspective, my basic argument is that: China's SOE reform is relatively successful in terms of solving the short-term incentive problem, but it has failed to solve the long-term managerial incentive problem and the management selection problem. These two problems cannot be solved without a fundamental change of ownership.

### 2.B. How Has Management Contract System Improved the Short-Term Managerial Incentive?

The management contract system (MCS) evolved from, and was seen as a remedy to, the early loosely defined administrative policy of "fangquan rangli" since, as often claimed, "fangquan rangli" granted managers autonomy but failed to bond them with responsibility. It is not easy to identify where and when the first contract came into existence. What we know is that the MCS was initiated by local governments, and spread nation-wide after 1987 following the State Council's "Decisions on Deepening Enterprise Reform and Invigorating Enterprises" announced in December 1986. By 1989, a large majority of SOEs had adopted the MCS.[19]

The MCS has various names in China, such as the profit (or loss) contracts, factory management responsibility system, the asset responsibility system, and leasing contracts. The basic content of the MCS was to set profit sharing rules and delimit decision rights through contracts negotiated by the firm and the group of governmental agencies (normally including line department, and financial department; sometimes contracts are signed directly between management and mayors). The contract normally lasted for 3 to 4 years. The details of contracts varied across enterprises, regions and industrial sectors. The following are commonly identified as typical contract form: (1) the increasing profit remittance contract (shangjiao lirun dizheng baogan) (base profit remittance plus a pre-set annual increasing rate); (2) the fixed profit remittance contract (shangjiao lirun dinge baogan) (the firm retains all extra profit after fulfilling the fixed remittance target); (3) the base profit remittance with above-target profit sharing (shangjiao lirun jishu baogan, chaoe fencheng); (4) the loss reduction (or fixed subsidy) contract for loss makers (kuishun qiyi jiankui/butie baogan); (5) the enterprise management responsibility contract (qiyi jingying zerenzhi) (normally setting total profit target and profit growth rate); (6) the asset responsibility contract (zhichan jingying zerenzhi) (main targets are asset preservation and enhancing); (7) the profit and tax guarantee contract (with total wage linked to the realized profit and tax) (liangbao yigua zhonghe chengbao). Typically all contracts contain indicators of profit and tax target, utilization of retained profits, debt repayments, asset appreciation, product and technology innovation, product quality improvement, and enterprise rating. In some cases, contracts also include output target, product cost target, and even fulfillment of the state plan. However, in most cases, only profit target are weakly enforceable, and other terms can only be taken as references. It also should be pointed out in many cases the contracts differ only name rather than content.[20]

[19] One survey shows that even by the end of 1987, 78% of all SOEs with independent accounting systems and 80% of large and middle sized SOEs adopted the MCS (Liu, 1995).

[20] For details of contracts and case studies, see China Enterprise System Reform Research Group (1988).

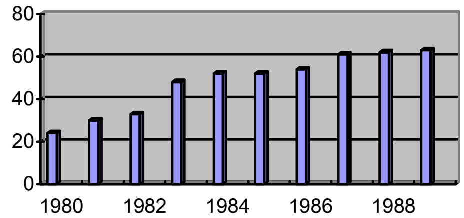


**Figure 1.** Ex Ante Profit Retention (1980-1989)

Source: Groves et al (1994)

From the above description, we see that the MCS mainly deals with residual sharing. Under the MCS, the firm obtains considerable residual share of current profits. According to a survey conducted by the Institute of Economics of China Academy of Social Science, marginal profit retention rates steadily increased over the 1980s, rising from a mean (across firms) of 24 percent in 1980 to a mean of 63 percent in 1989 (Groves, et al, 1984; see Figure I).[21] However, it should be pointed out that only a tiny fraction of the retained profit legally accrues to management team.

From the point of view of decision rights, the MCS has an enabling feature in the sense that management's autonomy is restricted by government intervention mainly from other sources rather than from the contract per se. Although suffering from considerable administrative interventions, through the MCS, together with other reform polices such as price liberalization and output plan reduction, managers have gradually obtained considerable decision rights.

Table 1 presents details of the realization of managerial decision rights.[22] From the incentive point of view, although suffering from the re-negotiation problem and the ratchet effect, the MCS does provide relatively strong incentives for management to make short-term profits. As I argued in early papers (Zhang, 1995, 1997), under the management contract system there are two kinds of incentives working for management. One is formal and explicit, and the other is informal and implicit. The formal and explicit incentive comes from the fact that managers (and worker) can legally claim part of the residual according to the signed contract. Granting autonomy of business decisions makes the manager become a natural holder of part of control rights. By granting the partial residual to him, the residual claim and control right can be better matched at the firm level. This better matching certainly gives better motivation for the manager to make profits (Groves, et al, 1994; Xiao, 1997). However, given that ownership is absent and the manager has little stake in the firm, managerial autonomy has also generated various agency-type problems, including profit diversion and asset stripping. These agency problems are often referred to as "insider control" problems (Wu, 1995). This is partly because the government has inadequate information for monitoring the firm, but more importantly, because the concerned bureaucrats have no correct incentive to do so. In many cases, managers collude with bureaucrats in cheating the state.

Nevertheless, in contrast to the conventional wisdom that managerial discretion is harmful for firm performance, I argue that, in the state-owned enterprises--at least in Chinese state-owned enterprises, insider control might do more good than harm. Given that there is no natural owner to motivate the manager, and that the residual that managers can legally claim is tiny,[23] how can those most important but least monitorable people be motivated to work harder? It is the illegal expropriation of profits that motivates them to work harder. In other words, given the ex ante inefficient ownership structure, the insider control can be an ex post efficient remedy. It can be a Pareto-improvement because, unlike in a capitalist firm, nobody is made worse off but management becomes better off. This is why I call it the "informal and implicit incentive".[24] The informal and implicit incentive exists because, by manipulating account ("hiding profit") and stripping assets, managers can illegally but safely claim more virtual residual than specified in the contract. Hiding profits and stripping assets are possible since, as management possess more autonomy of decision making, it is very hard for the state to have judicial and administrative checks on their behavior. Although managers can not freely pocket the money, they have many ways to spend money.

[21] However, as pointed out by Groves, et al., the average numbers conceal considerable variation across enterprises in marginal profit retention rates. While some enterprises were retaining 100 percent of their marginal profits by 1989, others were still remitting all their profits to the state.

[22] The SOE Law (1988) identifies 14 right to define the SOE sphere of autonomy.

[23] According to the survey by China Entrepreneur Survey System, the average monthly income of management is 1024 yuan in 1995, just 2.2 times of the average of urban workers. See *Almanac of China's Economy* 1996, p.955.

[24] This idea is similar to one in which corruption and bribes can improve efficiency given that the government controls firms (Shleifer and Vishny, 1994).

Pervasive phenomena of drinking foreign wines, feasting, karaoke, prostitution, and gambling that we see among managers are all reflections of a de facto claim to the residual. Typical forms of hiding profits and stripping assets include setting up independent or so-called subsidiary companies with little government control, making investment in and transferring profit through sale or purchasing prices to these companies, putting all perks into costs calculations, diverting profits to private or quasi-private accounts (xiao jinku), inviting relatives and friends for banquet and holidays, purchasing luxury cars, and so on. All these might be called implicit privatization. As a result, the correlation between personal benefit and total "real" profit is much stronger than official statistics show and the formal contract allows. Casual observation suggest that managers of better performing firms have a much luxurious life than those of poor performers. This strong correlation has greatly improved managerial incentive to make profits, although it has negative effects as well.

**Table 1.** Realization of Enterprise Autonomy (%)

| Decision Rights | 1993 | 1994 | 1995 |
|---|---|---|---|
| Production decision | 88.7 | 94.0 | 97.3 |
| Pricing decision | 75.9 | 73.6 | 85.4 |
| Sale decision | 88.5 | 90.5 | 95.9 |
| Purchase decision | 90.9 | 95.0 | 97.8 |
| Export/import | 15.3 | 25.8 | 41.3 |
| Investment decision | 38.9 | 61.2 | 72.8 |
| Use of retained funds | 63.7 | 73.8 | 88.3 |
| Disposing asset | 29.4 | 46.6 | 68.2 |
| Joint and merging with others | 23.3 | 39.7 | 59.7 |
| Hiring and firing labour | 43.5 | 61.0 | 74.8 |
| Personnel decision | 53.7 | 73.3 | 74.8 |
| Wage and bonuses | 70.2 | 86.0 | 93.1 |
| Internal organization design | 79.3 | 90.5 | 94.4 |
| Refusal of proration | 7.0 | 10.3 | 17.4 |

Source: Survey results of 2752 managers by China Entrepreneur Survey System, quoted from Almanac of China's Economy 1996. Note that the sample consists of 72.9% SOEs, 12.8% collective enterprises, 7.4% joint ventures and 6.9% other enterprises (including private). Therefore the indicators overestimate the realization of autonomy for SOEs.

I bet that without implicit privatization, Chinese SOEs on the whole would have performed much worse. "Telling good news" was a dominant strategy in pre-reform China. But now the fashion has changed. Today China's SOEs have strong incentives to tell "bad news". Although there are some loss-makers which still overreport, most state enterprises underreport profits, because reported profits belong to the state, whereas hidden profits accrue to management.[27] This can partially explain why the statistically reported profit index of the SOEs is so discouraging. It suggests that the actual financial situation of SOEs is much better than statistics shows. If this was not the case, one could hardly understand why both goods and service markets are so bullish in China. Using accounting profits to judge performance of Chinese SOEs is very misleading. After all, when the firm manager can manipulate accounting statements, accounting profits are nothing more than a book number. Apart from underreporting profits, there are another three reasons for profits falling. The first is competition between the non-state and the state sectors as well as among the SOEs, which has destroyed monopoly profit (Naughton, 1995, and Rawski, 1994). In this sense, the fall in profit is good news since it signals more efficient allocation of resources. The second is the change in financial structure. The debt/asset ratio of the whole industrial SOEs was raised from 18.7% in 1980 to about 67.9% in 1994 (Wu Xiaolin 1997). This change converted the previous profits into financial costs. The third reason is "profit-tax conversion", which also converted profits into costs (taxes). Therefore profits are a very misleading indicator for SOE's performance.

The above theoretical predictions are consistent with recent empirical studies. For instance, Hayashi and Wada (1997) find that, in a sample of 796 SOEs from 1991 to 1995, the ratio of production cost/sale changed little, but both administrative costs and financial costs increased by large amount. This suggest that profits of SOEs are mainly eroded by the administrative costs and financial costs. I conjecture that much of the increase in administrative costs comes from management's expropriation of real profits.[28]

However, although the reform has improved the management's incentive to make current profits, the long-term incentive problem has yet to be solved. Casual observation suggest that managers of SOEs

27 The author collected many examples of underreporting stories. In one case, the manager of a SOE in Shenzhen told me that the company make 1.04 billion profit in 1994, but it reported 600 millions to the government. In another case, a state export/important company made more than one billion profit, but it reported a loss of 4 millions.

28 The social security payment is also an important factor for increase in administrative costs.

prefer to distribute retained profits to employees or make investment in quick revenue-generating projects rather than to make investment in long term productivity-enhancing projects and R&D (Huang, Woo, Kalirajan and Duncan, 1998). In many cases, abnormal short-term profits are made at the large expense of long-term productivity (Broadman and Xiao, 1997). Asset stripping is also harmful for long-term growth. The problem becomes particularly serious as managers approach retiring age.[29]

The reason for management myopia is that, given that there is no personal capital stake, the manager's enjoyment of benefits from the firm cannot beyond his firm tenure. He is very uncertain whether he will still be in the position even next year.[30] This is because his firm tenure is mainly dependent upon bureaucratic preferences which are little related to firm performance. This leads us to the management selection problem. Although I argue that the reform has greatly improved the short-term managerial incentive mechanism, there is a fundamental problem which has not been solved for Chinese SOEs; that is, selection of high ability managers. The reason is that SOE managers are appointed by government bureaucrats rather than capitalists.[31] This has important implications. First, because of the adverse selection problem, selecting good management is hard work. It requires that selectors must have adequate incentives to find information about candidates' abilities and to install high quality candidates. Adverse selection is most serious in China, because, with no personal stake to signal ability, too many people pretend that they are qualified for management. But worse is that bureaucrats, unlike capitalists, have the right to select, but do not bear consequences of their selections. This implies that, not only would-be managers, bureaucrats themselves also have the adverse selection problem. They have no adequate incentive to search for good managers, and even if they know some are capable, they still lack the adequate incentive to install them. Observation suggests that bureaucrats too often base their selections on personal connections (guanxi) rather than merits. Appointing friendly managers is the most effective way for bureaucrats' rent seeking.[32]

Second, in contrast with the capitalist firm where the manager tries to become a capitalist, SOE managers too often try to be promoted to bureaucrats. This is because as long as managers are appointed by bureaucrats, the latter are always in the superior position to the former, and promotion to a bureaucrat is the best reward for managers. As a result, SOE managers behave more like professional bureaucrats than professional managers. For managers, the firm is nothing other than a plate for them to jump to bureaucrats. This induces managers to care only for short-term and easy-measured performance, and it also explains why many "excellent" firms fell down once their managers are promoted to government.

Third, with bureaucrats making selection of management, good performers are just as equally likely to be removed as bad performers, if not more. This is because once a firm becomes highly profitable, bureaucrats have every incentive to collect rents by replacing the incumbent with their favorite. Thus, the best way for the incumbent to secure his position is to make the firm not too good and not too bad.[33]

Empirical investigations give strong support for the above theoretical arguments. A survey by China Entrepreneur Survey System shows that 67.3 percent of the managers pay their "first concern" to their bureaucratic superiors' evaluations (Beijing Youth Daily, 11 March 1998). From 1987 on, China Entrepreneurs Association has conducted a nation-wide "Excellent Entrepreneurs (managers) Assessment", and every year there are 20 SOE managers selected as Golden Ball Prize Winners. According to China Entrepreneur Magazine, by the end of 1997, only 4 of the first 20 winners were still in the position of original enterprises. Among the other 16, 3 had been promoted to government, 5 had retired for normal aging, 4 had been dismissed, 1 escaped to Philippines after diverting assets, and 1 died from illness. The total of 159 winners (up to 1995) followed a roughly similar pattern. Those still in the position are very worried about their future (China Entrepreneur 1997 No.9). This phenomenon of "good managers are short-lived" has attracted much attention among academics and managers.[34] I do not deny that the quality of SOE managers has made some progress compared to the pre-reform period. From the early 1980s, the government tried to strengthen managerial

[29] Chinese retiring age is 60 for man and 55 for women. Chinese courts find that economic criminals of 59 year-old managers are disproportionately high. This is called "59 phenomenon".

[30] Although the contract lasts 3 to 4 years, the government is not bound by the contract in replacing the manager.

[31] Some source says that over 80 percent of the managers are appointed by industrial bureaus (Groves, et al 1995). In fact, 100 percent are appointed by industrial bureaus.

[32] It should be pointed out that bureaucrats are multi-task principals (Holmstrom and Milgrom, 1991; Dixit, 1997). Even if they are "benevolent", they still need to balance between different tasks. It is hard to imagine that they consider only the manager's ability of enhancing profitability in their selections.

[33] For example, a SOE manager of Wuxi City in Jianshu Province increased the firm's assets from 2 million to 700 million within a few years. Then he was called into the government line department office and told that because he had no university degree, he was not qualified for running such a big firm. He was then replaced and got a new position in a much smaller firm.

[34] The survey by the Institute of Economics of China Academy of Social Science consisting of a sample of 769 SOEs over the years 1980-1989 shows that only 11 percent of managers serving at the end of the period had been appointed before 1980, and 44 percent had been appointed since 1985. Among the current managers, less than a quarter (23 percent) replaced retiring managers. For the remaining group, 38 percent replaced managers who were promoted, 46 percent replaced ones who were moved laterally, and 16 percent replaced ones who were demoted. This data was mis-interpreted by Groves et al (1995) as an indicator for development of managerial labour markets in China. In fact, in China, SOE managers are frequently reappointed every 3 or 4 years. Turnover of managers has little to do with managerial labour markets.

quality by setting some "hard criteria", such as education level and ages, for management qualification.[35] As a result, for instance, the average education level of SOE managers has increased.[36] In addition, competition has also made the managers more market-oriented in making their production decisions. However, as we all know, managerial capability is far beyond being measured by any hard indictors, let alone that, in China, even hard indicators can be manipulated.[37] It is most important to provide selectors with good incentives to find good managers case by case; otherwise, even the hard criteria can be mis-used for excluding good managers (as in the example cited in footnote 33).

### 2.C. Can the State-Dominated Corporatization Solve the Management Selection Problem?

The MCS-dominated reform has revealed that SOEs are confronted with a fundamental dilemma. On the one hand, when the government controls the enterprises, managers have no incentive and little autonomy to make efficient decisions, and on the other hand, when the government looses its control, the insider control generates enormous agency problems. This dilemma makes it impossible to separate governments from enterprise business in any practical sense. Even worse is that, with this dilemma, bureaucrats enjoy considerable administrative freedom to intervene in the management for their own interests rather than the state's interest. The state sector has evolved into one characterized with insider control under administrative intervention (C. Zhang, 1995)

Having recognized that this fundamental dilemma could not be solved by MCS in a traditional way, some economists proposed "state share-holding system" as an alternative as early as 1984, based on the assumption that the dilemma is rooted in the integration of the owner-government with the regulator-government, and therefore as long as the owner-government is separated from the regulator-government, so that the owner-government plays only the role of stock-holder, all the problems can be solved.[38] The basic framework of the state share-holding system can be described as the following multitiered network structure. On the top, a national state asset management committee (NSAMC) is established by the People's Congress or the State Council; the NSAMC is delegated by the state as the owner of all SOEs. Below NSAMC, a number of state asset holding companies (SAHC) are set up as acting stock-holders, each of which holds the stocks of the SOEs and appoints board members and supervisors to these SOEs. Then the stocks of SOEs can be traded in stock markets. Within this multitiered structure, SOEs become legal entities with full managerial autonomy over business decisions and corporate assets, and the SAHC can discipline the managers through both "voting-with-hands" and "voting with feet", just like in a Western-type market economy. In practice, in the past few years, many local governments, including Shanghai, Shenzhen, and Beijing, have established such a multitiered network within their jurisdictions. In all these examples, SAHC were typically formed either from transforming the original line departments, or from upgrading the giant SOEs. In a few cases, SAHC are completely newly organized entities.[39] Figure 2 describes Shanghai's multitiered structure of state asset management system.

**(Insert Figure 2)**

Although a systematic implementation of the state share-holding system described above has been delayed at the national level (and may not come forever), the state-dominated corporatization of individual SOEs has been wide-spread. The experiment began as early as in 1984. By the end of 1991, there were about 3220 so-called "joint stock experiment companies" (cited from Wu, 1994, p.223). In 1991, two local stock exchanges were established in Shanghai and Shenzhen, both of which were later endorsed by the central governments and have now become national stock exchanges. In 1993, the Company Law was enacted, and then the "modern enterprise system" was officially adopted by the Chinese Communist Party Congress as the organization mode of SOEs. In 1995, the State Council selected 100 large SOEs for corporatization experiments. As of 1996, approximately 5,800 industrial SOEs had been corporatized, some of which are listed in the stock exchanges (World Bank, 1997).[40] Can the state share-holding system solve the problems of SOEs as assumed? My answer is NO. My overall criticism of such a way of thinking is that you cannot make a zebra from a horse simply by brushing white stripes on its back. First, the state share-holding system cannot solve the management selection problem. The reason is that the officers of NSAMC and SAHC are still bureaucrats rather than capitalists. No matter what you call them, shareholders or managing directors, bureaucrats are bureaucrats, and

[35] More recently the government launched an MBA program for managers of large and middle SOEs.

[36] In 1995, 79.6 percent of managers has the college and university degree, compared to 33.4 percent in 1985. See *Almanac of China's Economy*, 1996, p.955.

[37] Many managers and government officials have obtained their university certificates through cash pay or by using their administrative privilege.

[38] To my knowledge, Wu and Jin (1985) were the first to make the proposal of the state share-holding system. A similar idea were also proposed by the World bank China Mission. Professor Li Yinin Peking University has been famous for his shareholding-dominated reform proposal (see Li, 1986).

[39] In Shenzhen, two of the three SAHC were formed from upgrading the giant companies, and one was newly established. In Shanghai and Beijing, most of NAHC were transformed from the original line departments.

[40] By the end of 1997, the total number of listed companies reached 745, most of which are the incorporated SOEs, with a total market capitalization of US$222.4 billion (*Security Market Herald* No.1, 1998).

you cannot turn them into capitalists simply by renaming. They have rights to select boards of directors and managers of SOEs, but bear no consequences of any risks from their selections. Therefore, voting rights in their hands are typical "cheap vote rights" (Harris and Raviv,1988).[41] Because of this, they still have no good incentives to find and appoint good managers, and those lemons can still easily occupy the management positions by bribing officers of NSAMC and SAHC.

In reality, what we have seen is that, although the managers of corporatized SOEs (including those listed companies) are appointed formally by the board of directors, all the decisions of appointments are actually still made by the line governments and the Communist Party's personnel departments as before, let alone that all board members are from governments departments or other SOEs. As a result, there is little fundamental change in corporate governance.

Most Chinese economists agree that it is important to have a managerial labour market, but few realize that markets for managers are essentially capital markets. The key question is who purchasing the services of managers. If it is government officials who are the buyers, then managers have to please government officials, and professional managers will not emerge. Second, the state share-holding system still cannot separate the government from enterprises. As I pointed out earlier, the proposal of the state share-holding system is based on the assumption that the core of inseparation of the government and enterprises lies in the integration of the government as a regulator and the government as an asset owner. It is argued that as long as the government as a regulator is separated from the asset owner, let the Sate Assets Management Committee represents assets owners, and the State Council represents the government, the government will be separated from the enterprises accordingly. Such thinking is very naive. Any owner has to supervise management through control rights. The State as a (and in most cases the only) stockholder will naturally intervene. The key problem is how to determine the boundary of such intervention. The prevailing theory has a misconception, i.e., there seems to exist a very well-defined division of rights between stockholders, the board of directors, and management, and thus it is clear to everyone who should do what. This is definitely not true. Of course, part of the relationship among the three parties is well-defined, but much of it is not. There exists a public domain in control rights where it is the tacit understanding that determines who should move one step forward and who should move one step backward. For instance, according to the Company Law and the corporate charter, the share-holder meeting has the power to make decisions on "important issues". But what constitutes an important issue is moot. Should we call an issue important when a sum of 10 million dollars or 5 million dollars is involved in a transaction? For a true stockholder or board member who bears the risk of transactions, his decision of whether to intervene depends on how much trust he places on the manager. If he trusts the manager, he will not intervene even if the manager is doing something that fundamentally alters the enterprise. If he does not trust the manager, even if the manager is doing something trivial, he may still intervene.

The problem is that the tacit understanding between a real stockholder and management in dealing with the public domain of control rights cannot be duplicated between a state stockholder and management of SOE. It is more likely something that would be important to a real stockholder is viewed by the state stockholder as trivial, while something that would be trivial to a real stockholder is viewed by the state stockholder as important. This is because the government official acting as a state stockholder does not bear the consequences of risks. The other possibility is that managers can bribe the state stockholders to make them totally give up their intervention. Thus, it is very likely that we will constantly shift between excessive administrative intervention and insider's control without reaching any real tacit agreement to solve the problem of separating the government from enterprises.

In reality, it seems that managers of corporatized SOEs have more complaints about bureaucratic intervention than before. Once the bureaucrats become legal "bosses", they have legitimate control rights to intervene in the firm. The managers frequently echo that popo jia laoban (the government-plus-boss) has made worse rather than better.[42]

Third, state share-holding cannot protect the state asset from being expropriated by the management. As a stockholder, the state is a legal residual claimant. However, it may not have effective way to collect residual. How much residual the state can collect depends not only upon the incentives for management to make profits but also upon the firm's financial statement. Because of the problems of hidden actions and hidden information, the state as a residual claimant has to monitor if it wants to obtain any residual. The effectiveness of monitoring is determined by two factors. One is information and the other is incentives. The modern theory of the firm has proven that monitoring by stockholders requires

[41] Here the "cheap vote rights" refers to the vote rights the holders of which bear no responsibility for voting results. For example, if the Chinese people were to select an American President, the vote rights that the Chinese hold are the cheap vote rights. Whoever becomes the American President does matter little to the Chinese citizens.

[42] In March 4, 1998, *China Security Daily* carried a report of a municipal government's circular on "target management of listed companies", which set up detailed rules of annual budget and resource allocation for 15 listed companies. The targets include investment budget, new issuance of shares and bonds , and asset restructuring. The circular rules that if the set targets cannot be fulfilled, the government will dismiss management. This shows that the 15 listed companies are tightly controlled by the municipal government.

information that is difficult and costly to obtain. The information collection is often dependent on incentives. How much information you obtain is determined to a large extent on how much incentive you have to collect it. Even dispersed shareholders of a capitalist company often lack adequate incentive to collect information. Given that officers of the state asset management committee and of state asset holding companies are only the agents of the state and not ultimate residual claimants, their incentives to collect information is very limited. Moreover, it is very tempting for them to collude with management in expropriating the state assets. Consequently, even if the actual profit is high, the state may not be able to collect it, just as has happened thus far. In sum, my argument is that the state share-holding system as currently proposed and practiced cannot solve the agency problems of SOEs both on the management side and the bureaucrat side. The state is not qualified to be a stockholder, and at most it can only serve as a debtholder who comes into control only when the enterprises are insolvent. Because the rights of debtholders are clearer, and violations or abuse of those rights are easier to verify in courts, management can be better protected from administrative interventions by bureaucrats on the one hand, and state assets can be better protected from expropriation by managers on the other hand. I believe only when the state is deprived of equity ownership of enterprises, can the problems be partly solved.[43]

## 2.D. Why Bankruptcy Has Not Played a Role in Disciplining Management

Chinese economic reform has made fundamental changes in the corporate finance of state enterprises. In the pre-reform period, SOEs were almost completely state-budget financed with few debts. Since the reform, debt finance has gradually taken over budget (equity) finance.[44] The average debt/asset ratio of all industrial SOEs has increased from 18.7% in 1980 to 67.9% in 1994.[45] The ratio is still rising. In particular, there are many "zero-equity firms". This high debt/asset ratio has mainly resulted from that, one the one hand, as the distribution of national income has changed, households have taken over the state as the major source of investment capital, and on the other hand, because direct financing markets are very tightly restricted and underdeveloped, the state banks become the only channel of funds flowing from households to enterprises (Zhang, 1995b).[46]

As a result of debt-financing, many SOEs are at the brink of bankruptcy at any time. Although China enacted the Bankruptcy Law in 1986, which became effective in late 1988, Although in early 1990s, filed bankruptcy cases were few in comparison with tens of thousands of financially distressed firms, since 1994, bankruptcy cases have dramatically increased, following the central government's initiation of an experiment of "capital structure optimization" and specific favored policies designed to enforce Bankruptcy Law.[47] From 1994 to 1996, a total of 6753 bankruptcy cases were filed (ICBC Bankruptcy Research Group 1997). In addition, there have been many out-of-court workouts.

Theoretically, when enterprises become insolvent, creditors will take over the control, and the threat of bankruptcy can discipline the management. Nevertheless, this is not a case in China. Rather, bankruptcy has been widely used by enterprises and local governments as a way to write off debts instead of disciplining managers (ICBC Bankruptcy Research Group 1997). After bankruptcy procedure--either through reorganization or through liquidation, most incumbent managers still run the firms as going concerns, and probably the only major difference is that considerable debts have been canceled (and in some cases the enterprises are renamed). Because of this, managers are more than willing to file for bankruptcy. In contrast, state-owned banks (SOBs) as dominant debtholders have been very passive in dealing with distressed firms. Typically, when debtor firms default on their debt, creditor banks passively accommodate by taking such actions as extending the payment period for loans and capitalizing unpaid interest rather than pursuing their claims through bankruptcy or other active means. Indeed, very few bankruptcies have been filed by banks.[48]

Why has bankruptcy not played a role in disciplining managers? There are several reasons.

The first is that the debt between state banks and state enterprises is not a real debt in a legal sense from its origin. In a legal sense, a debt is a contract between the debtor and the creditor. When the debtor borrows from the creditor, on the one hand, the debtor fully

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[43] Of course, if the state is a dominant creditor, it may expropriate small equityholders and other creditors. Or it may be too soft for management. For a detailed discussion of transforming the state from a stockholder into a debtholder, see Zhang (1995a, 1995b).

[44] For more analysis of changes in corporate finance, see Zhang, Chunlin (1998, this volume).

[45] The debt/asset ratios in 1994 were respectively 75.7% and 74.2% for middle and small sized industrial SOEs. A survey by the State Assets Administration of 123,900 SOEs (including industrial. commercial and financial firms) estimates that the average debt/asset ratio in 1994 was 75.07%, or 83.3% if bad assets were excluded. All figures are cited from Wu Xiaolin (1997).

[46] According to Guo and Han (1991), households' share of national income increased from 64.4 percent in 1979 to 77.5 percent in 1988, while the total share of the government and enterprises decline from 35.6 percent to 22.5 percent. In the same period, the households' share of national saving rose from less than one fourth to nearly two third. Abnormal increase in household's income may partially reflect the fact of profit diversion.

[47] In 1994, the central government selected 18 municipalities for capital structure optimization experiment. The experiment expanded to 58 in 1996, and to 111 in 1997. The experimental cities are granted special favored policies for reducing debts of their SOEs. These policies are also applicable to some selected SOEs including 100 experimental SOEs of modern enterprise system.

[48] According to Asian Pacific Economic Time, 27 may 1997, only about 1.4 percent of bankruptcy cases in 1995-1996 were filed by banks.

understands that he has obligation to repay on due time, otherwise he will face a bankruptcy penalty; and on the other hand, the creditor fully realizes that there is some risk of default by the debtor. The terms of the contract are negotiated between the debtor and the creditor taking into account all these foreseen considerations. Bankruptcy is a procedure of enforcing the debt contract. However, in China, debts between the banks and the SOEs are very different. In the 1980s, when an SOE borrowed from a state bank, on the one hand, the SOE manager just took that as a new way to get funds from the government and he had little sense that the borrowed money would have to be repaid; and on the other hand, the bank just took that as allocating a loan to the state firm on behalf of the government, and it had little sense of risk of possible default. In fact, a large part of bank loans were decided by the government through an administrative procedure rather than negotiated between the firm and the bank. In this sense, "debts" of SOEs were more like equity than debts. The only difference between debts and budget funds was changes of items in the balance sheets. Not until 1990s, when debts had accumulated to a point where the state banks are burdened with enormous overdue bad debts, and when both SOEs and state-owned banks (SOBs) became relatively independent entities with their own interests, was it recognized that bank money does make a difference from the budget funds. For this reason, I call the SOEs' debts "the ex post debts".[49] Because of this ex post nature, bankruptcy of SOEs is more like a procedure of bargaining over the terms of new debt contracts rather than an enforcement of the existing debt contracts. The second reason, related to the first, is that in many cases the incumbent managers of SOEs are not the right persons to blame for default because much of the bad debt did not result from their decisions. Many SOEs are over-capital-intensive, and a large part of the firm's assets are non-performing. But investment decisions that were debt-financed were made by government bureaucrats, rather than managers. When debts are due, and investments have failed, the decision-makers are already gone or are in higher positions in the government. Even if investment decisions were right, bad debts have accumulated through several generations of managers, some of whom have either retired or moved to the government line departments, or even in banks. It is almost impossible to trace who should be responsible for what part of the problem. The incumbents have every reason for arguing that it is not their fault. Indeed, many incumbents attribute poor performance to bad debts, rather than other way. They argue that there are too many non-performing assets which are useless but bear interest; and if there were no such assets in the book, their firms would be profitable (Lu, 1996). There is no good reason to reject their argument. Rather, the argument has been widely accepted by the government as guidance for policy making.

The third reason is that the managers of state-owned-banks care for only accounting numbers rather than the real value of the bank asset. This is because their careers and private benefits (like perks) all depend only on the accounting numbers rather than the real value of assets. They have every incentive to cover up rather than to signal non-performing claims. If non-performing debts show up, they may be replaced and bonuses may be reduced. In contrast, by engaging in accounting tricks to disguise non-performing debts, the bank can overstate its profits and may therefore maintain the ability to pay higher bonuses to employees and to continue a level of loan quotas that would no be possible at lower reported profit levels. Casual observation and empirical studies suggest that the managers of SOBs quite often record their bad loans as accounts receivable, roll over loans with new lending, and write their overdue interest payments as increases in the outstanding principal.[50] Although the incumbent bank manager may know that bad debts will eventually show up, the best for him is to let it happen in his successor's hands rather than in his own hands. This can explain why SOBs are so passive in solving the bad debt problem of SOEs.

The fourth reason is that the bankruptcy procedure is dominated by local governments (Zhang, Chunlin, 1988). In China, the SOBs are owned by the central government, while most of SOEs are owned by the local governments. With decentralization, local governments have obtained considerable autonomy and self -interests. They have every incentive to make use of bank passivity to write off debts of their controlled firms, even if these debts are recoverable. Although the Bankruptcy Law requires that reorganization/liquidation schemes must be discussed and approved by creditors' meeting with a simple majority of creditors and an amount of unsecured debt claim, in practice, local judges and bank branch managers can hardly go against the local government's decisions, because their careers and welfare are virtually determined by the local government. It is very hard and costly for the central authorities and the bank's headquarters to verify the true financial state of a firm. Even worse is that some central government agencies (such as the State Economic and Trade Commission and the State Commission for Restructuring the Economic System) have biases towards debtors against creditors because their delegated task is to "invigorate SOEs" rather than "take care of SOBs".[51] There are many other plausible reasons, such as the government's concern of potential social unrest were bankrupt firms to release too many redundant workers, for why debts have failed to play a positive role in disciplining management. However,

[49] Liu (1996) calls it "pseudo-debt".

[50] A similar problem is also found in other reforming socialist countries. See Mitchell (1993).

[51] This is a typical multi-principal problem in public enterprises. See Dixit (1996).

from the above analysis, we see that the fundamental reason is that both enterprises and banks are owned by the state and controlled by bureaucrats rather than real capitalists. For debts to play a role, ownership of the debtor must be differentiated from ownership of the creditor, the debtor must hold responsibility for its performance, and the creditor must have incentives to enforce the debt contract. These requirements can only be achieved when both the firm and the bank are privatized.

## 3. Conclusion: Privatization Is the Only Way Out

In this paper, I have argued that Chinese state enterprise reform has been relatively successful in solving the short-term managerial incentive problem through both its formal, explicit incentive system and its informal, implicit incentive system. However, it has failed to solve the long-term managerial incentive problem and the management selection problem. An incumbent manager may have incentives to make short term profits, but at present there is no mechanism to ensure that only qualified people can be selected for management. The fundamental reason is that managers of SOEs are still selected by bureaucrats rather than capitalists. Since the bureaucrats have the authority to select managers but do not need bear the consequences for their selection, they do not have proper incentives to find and appoint high ability people. Since good performance does not guarantee that the incumbent manager will stay long, the manager does not have long-term incentive. To ensure that only high ability people will be professional managers, authority of selecting management should transferred from bureaucrats to capitalists. This calls for privatization of the state enterprises. Fortunately, China is well on the way in this regard. Although Chinese economic reform began with no intention to privatize, in the past two decades, and particularly since the early 1990s, both explicit and implicit privatization have accelerated in China. In 1978, at the beginning of the reform, 78% of total industrial output came from SOEs. By 1995, the SOEs' share had shrunk to only one-third (China Statistical Yearbook 1996: 403). A recent survey estimates that more than 70% of small SOEs have been fully or partially privatized in Shangdong and a few other provinces (China Reform Foundation 1997:35).[52] The privatization process has been further speeded up after the Chinese Communist Party's 15th Congress. Today many large- and middle-sized SOEs selected by local governments are on the list for sale.

Although I have argued that the state share-holding system cannot solve the management selection problem, I do have recognized that corporatization of SOEs combined with going public in stock exchanges can serve as a first step of privatization, if it is followed by properly transferring state shares into private hands.[53] Interestingly, the observation suggests that the major players behind the ongoing privatization process are local governments at various levels. Although not all local governments are undertaking explicit, whole-sale privatization program, almost all local governments are considering privatization of their enterprises in one way or another. The question is: What motivates local governments to privatize the enterprises under their control? Li, Li and Zhang (1998) argue that the ongoing privatization in China is a consequence of the cross-regional competition which has followed the decentralization policy introduced at the early stage of reform. Their argument is as follows. When cross-regional competition is sufficiently intense in the product market, each region has to cut production costs significantly in order to maintain a minimum market share for survival. Given that the efforts of managers are hidden, in order to induce managers to reduce enough cost, local governments may have to grant total or partial residual shares to the managers. In general, more intense product competition triggers a higher degree of privatization. It is in the interest of local bureaucrats to give up more residual shares of profits to managers since the induced "incentive effect" more likely dominates the "distribution effect"" as competition intensifies.[54]

The debt crisis of SOEs can also provide a force for privatization. Given that most SOEs cannot continue their operation with the existing debt burden, new equity funds have to be injected. However, the state has no fund for injection. The only way to solve the over-indebted problem is to introduce new, non-state shareholders, that is, privatization.

The observation also suggest that privatization of the state enterprises has been and will continue to be a process of "capitalistization" of (some) incumbent bureaucrats and managers (and even some workers). As the reform proceeds, incumbent bureaucrats find it more and more difficult to capture rents in their current positions, because of the disappearance of monopolistic profits and managerial discretion. Experience teaches them that they can do much better by directly doing business with their remaining political capital of "connection" (before it fully depreciates). They have to make up their minds to "xia

[52] Note that these statistics only account for explicit, not implicit, privatization.

[53] This can be explained as follows. Suppose that you have a horse and are not happy with it. One day you see a zebra and fall love with it. You have an intention to exchange the horse for the zebra. However, other members of your family may not be happy with that. One way you can do is that you first go out to get some paint, and then brush stripes on the back of the horse. If the other members question why you got a zebra, you can argue by pointing out that it is not a zebra, but the horse brushed with stripes. Thus you can eliminate their concern. After a period, you may sell the horse and get back a zebra without anyone even noticing.

[54] Li, Li and Zhang (1998) submit their theory to a vigorous empirical test using China's industrial census data, which covers all two thousand counties and more than 400,000 firms in China from 1993 to 1995. The test strongly supports their postulation that cross-region competition is the driving force behind China's transition from public ownership to private ownership.

hai" (go into business). By doing so, they lose little because the rents they used to enjoy can be embedded into profits which may legally accrue to them in various forms. They have no risk to bear because start-up capital comes from the state (initially the firm is "owned" by the state). Before they leave government office, they will grant full autonomy to the firms with which they will work. They will appoint themselves as chairmen of the board, directors, or executives. Once they pocket some profits, they will buy into the firms. They can do this quietly because once the firms are corporatized, they can easily be sold piecemeal instead of as a whole. This process may be further speeded up by the ongoing government restructuring launched by the new prime minister Zhu Ronji. In addition, the central government may have to sell its stocks because of its budget deficit. The state-owned enterprises gradually evolve into private joint-stock companies. In this stage, it is possible for the government to become a bond-holder who can be protected by private shareholders. Once incumbent bureaucrats become capitalists, they will have incentives to select high ability people for management; they themselves will voluntarily step down if unqualified. The separation of government from enterprises will be achieved accordingly. To conclude, it should be pointed out that although privatization of SOEs is very encouraging and promising, privatization of the state banks is yet to come. There may be good reasons for delaying the privatization of state banks. However, unless banks are privatized, they cannot be expected to play a constructive role in corporate governance of enterprises. This is because only private banks can have adequate incentives to select good managers and good projects for financing, and to enforce debts contracts through the bankruptcy mechanism. As long as banks are owned by the state and run by bureaucrats, and thus the state remains the ultimate rescuer of losing concerns, enterprises, even privately-owned, cannot be financially well-disciplined by the banks, and the fundamental problems of moral hazard and adverse selection cannot be solved as well as in a capitalist firm. This is the lesson China should learn not only from itself but also from Korea and other countries.[55]

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[55] Recently Xiao Geng (1998) proposed that, as a first step, China should separate the bank's deposit business from its lending business by allowing foreign banks to make direct loans to Chinese enterprises with inter-banks' financing from their Chinese counterparts who take deposit directly from households. This sounds like a good idea. But it still faces the potential problem of possible collusion between foreign private banks and Chinese state banks.

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## Appendices

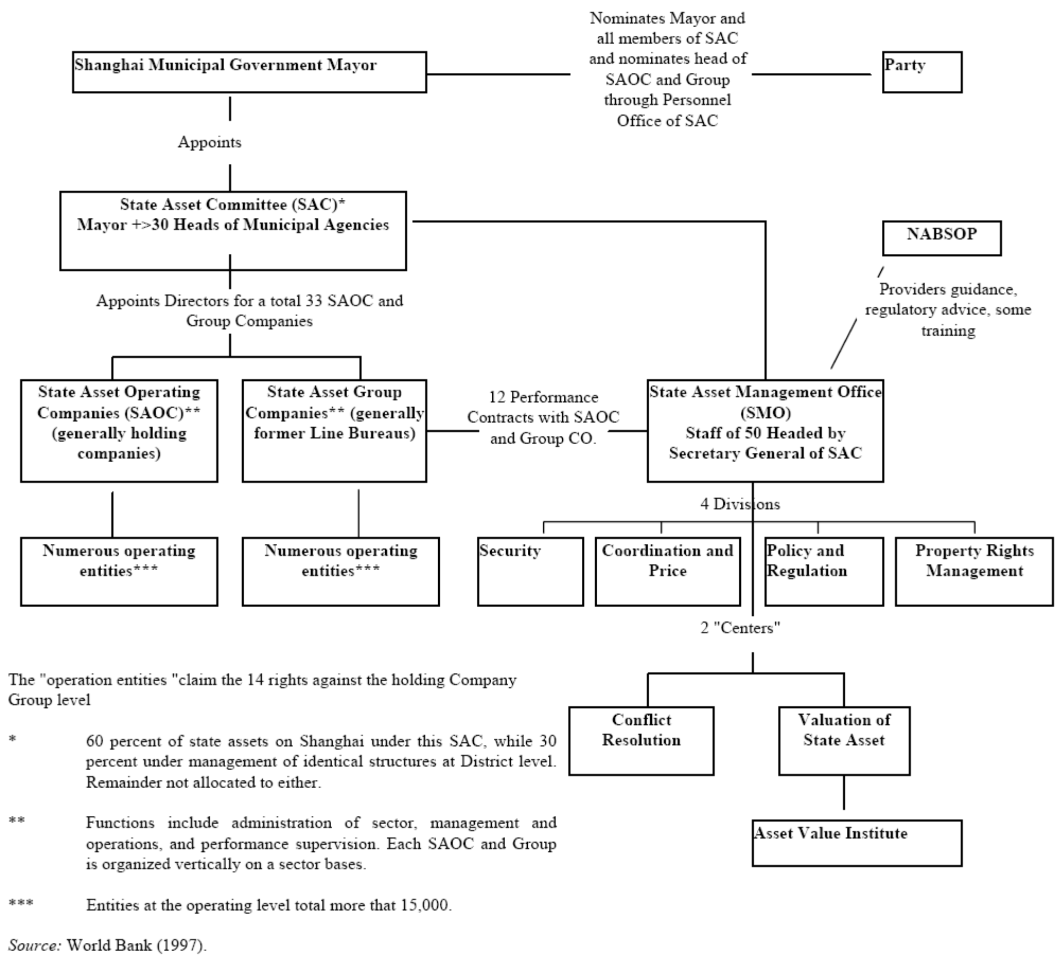


**Figure 2.** Shanghai State Asset Management System