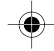


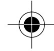
2
The Evolution of Governance Mechanisms in China's State Sector

For the purpose of this study, we define corporate governance as the set of instruments and mechanisms (contractual, legal, and market) available to shareholders for influencing managers to maximize shareholder value and to fixed claimants, such as banks and employees, for controlling the agency costs of equity (see box 2.1). This chapter places the current focus on corporate governance in the context of China's overall approach to market reforms, and traces the evolution of SOE reforms that led to the emergence of corporate governance as the core issue of the modern enterprise system.

Corporate Governance in the Context of China's Overall Approach to Reform

Although China adopted new policy direction without political liberalization, the beginning of market-oriented reforms was accompanied by an important shift in ideology. A pragmatic approach focusing on development supplanted the fixation on how the revolution could be prevented from degenerating. The new growth imperative was expressed most forcefully by Deng's (1994) proclamation that "development is the hard truth." China lacked a well-defined strategy or a clear blueprint of how exactly to promote development, but deliberate efforts were made early in the reform process to align government incentives at all levels with the new political focus on growth.

The bureaucratic system was substantially transformed by introducing a mandatory retirement program for the veterans of the revolution, promoting a drive for administrative and fiscal decentralization, and allowing bureaucrats to quit the bureaucracy and join businesses (Li 1998). Powerful incentives were added to promote local economic



BOX 2.1
Corporate Form and Corporate Governance

Modern, large-scale production involves inputs by multiple agents with divergent interests. Specialization typically extends to management and control, with the result that investors commit their resources to the control of specialized agents. In doing so, investors compare the expected benefits of specialization with the agency costs associated with the divergence of interests and the risk that the resources they contribute may be squandered. Investors thus need some assurance that their interests will be protected, and such assurance usually takes the form of laws, contracts, discretionary authority, and informal arrangements. This set of institutional mechanisms governing the exercise of control over resources is the essence of governance of the production process.

Under this general definition, governance issues arise in any economy where the division of labor extends to management and control. However, the institutional mechanisms of governance can differ widely across economic systems. For example, a command economy relies exclusively on administrative mechanisms of control. Resources are combined by fiat and contracts and laws play an insignificant role, the autonomy of various parties is limited, the state sanctions all significant interactions, and risks and rewards are largely socialized. As a result, pecuniary incentives are not emphasized. By contrast, a market economy allocates control over resources primarily through formal and informal voluntary contracts between autonomous agents. The state provides a legal and regulatory framework for private arrangements and an enforcement mechanism for such agreements. The system is flexible and dynamic, whereby different solutions emerge within a common framework as participants combine the basic components of a governance structure to fit their own particular circumstances.

The corporate form has evolved to solve the problems of incentives, monitoring, and information, or in other words, the problem of governance, that accompany the process of exchange for the purpose of joint production. The corporation is a set of contracts that allocate claims on income and control rights. It issues stock in exchange for an investment. Shareholders bear the risk of failure and receive the marginal rewards of success. Equity investors are paid last, after debt investors, employees, and other investors with “fixed’ claims. They have a residual claim in the sense that they get only what is left over. Under normal circumstances, shareholders’ risks are limited to the amount they have invested in the corporation. As residual claimants, equity in-

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vestors bear the marginal consequences of their own decisions and have incentives to monitor the inputs of other participants and to make efficient economic decisions. Therefore allocating control rights to shareholders is efficient as long as the corporation is in a position to keep its promises in the form of fixed claims. However, when losses erode a corporation's equity, limited liability creates perverse incentives for equity holders that can threaten the interests of fixed claimants. Thus fixed claimants have incentives to monitor these agency costs of equity for actions that may expose the corporation to significant risks.

The corporate form thus embodies the basic structure of corporate governance, which largely concerns the mutual monitoring of shareholders and fixed claimants.[1] Corporate governance can therefore be defined as the set of instruments and mechanisms (contractual, legal, and market) available to shareholders for influencing managers to maximize the value of shareholders' stock and to fixed claimants such as banks and employees for controlling the agency costs of equity. Shareholders' main mechanisms are the board of directors, direct shareholder activism, and the market for corporate control. Fixed claimants such as banks and employees rely mainly on elaborate contracts and a bankruptcy regime. All investors rely on information to protect their interests to a varying degree. Thus the structure of information disclosure is a critical component of the institutional arsenal of corporate governance.

While each of these mechanisms taken in isolation is an imperfect instrument for ensuring the efficient management of resources, in combination they can constitute an effective architecture. If the board of directors fails to take corrective action, shareholder activism can exercise pressure on the board. If the board of directors and shareholders are powerless to implement changes, and as a result the company continues to underperform, it could become a potential takeover target. Finally, if none of these mechanisms can effectuate changes, the bankruptcy mechanism is supposed to facilitate changes in ownership, in the board of directors, and in the redesign of contractual arrangements.

1. Within this basic structure, agreements can be wonderfully diverse, matching the diversity of economic activity carried on within corporations. Shareholding structures may be extremely diffused or highly concentrated, managers sometimes hold a great deal of a firm's stock, employees and banks may hold stock in addition to fixed claims, and so on.

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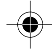

development. These were in the form of a fiscal contracting system known by the nickname "eating from separate kitchens," which replaced the previous system of "unified revenue collection and unified spending." The new system encouraged and rewarded local governments for promoting development of their local economies. The growth and development of local economies became the main criteria for promoting local cadres. As a result, the bureaucracy functions as a "helping hand" for economic development, is directly involved in economic activity, pursues industrial policy, and often has close economic and family ties to entrepreneurs (Frye and Shleifer 1997; Walder 1995).

Because of decentralization, the powerful incentives to promote development were supported by a significant capacity to design and implement policy initiatives at the local level. Since 1958 the Chinese economy has been organized around a geographical principle known as regional organization.[1] A regional system has the important advantage of flexibility: it can experiment with reforms locally because regional entities are self-contained and different ingredients of reforms can be tested without disrupting the organization as a whole.

Thus in the absence of a clear blueprint for reforms at the national level, and given the strong incentives to promote local development in the context of significant decentralization, China has developed an approach to market-oriented reforms that emphasizes gradual experimentation at the local and sectoral levels (Gelb, Jefferson, and Singh 1993; Harold 1992). In line with this gradual approach, several years may elapse from the time a reform experiment starts in one of the provinces until the central government endorses it or other provinces imitate it. Another characteristic of reform has been the use of partial reforms within sectors, known as the dual-track approach. The first time this tactic was used was with two-tier pricing, which was introduced in rural areas in 1979 along with the household responsibility system. Later it was applied to other sectors: industry (through the contract management responsibility system), the national budget (through the fiscal contract responsibility system), external trade and payments (through the sharing of foreign exchange between central and local governments, trade contracting, and foreign exchange trading centers), and labor markets (through the contract system for new hires in the state sector).

1. By contrast, organization in the former Soviet Union was much more centralized, and was along sectoral lines (Qian 1999).

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This dual-track approach is perhaps the most important aspect of Chinese reforms, because at the time it was an innovative solution to the political constraints on the direction and speed of reform. The adoption of a new policy direction without political liberalization and under the same political structure ruled out experiments that would have created losers on a large scale within the bureaucracy. Consequently, the experiments had to be of the dual-track type, so as to preserve the vested interests of the bureaucracy and a level of political stability. Although the reforms were controversial, the experimental dual-track method of introducing them enabled reformers to bypass the formal ideological debate usually required for public legislative sanction of reforms.

In pursuing market-oriented reforms, China had to be creative in borrowing and applying market concepts that were relatively free from ideology and could easily be adapted to fit existing ideological constraints. For instance, the reformers introduced market institutions such as stock markets and special economic zones by emphasizing their universal, technical, and pragmatic aspects (Deng 1994). New market institutions have been introduced without first dismantling old practices, and have often emerged from existing institutional arrangements. The coexistence of new and old institutions has been a distinctive feature of China's process of institutional transformation.

Introduced partially and gradually and surrounded by institutional relics, the new institutions were imperfect, but were generally a sensible response to existing problems. Because China adopted new institutions in response to actual, narrowly defined problems, these institutions were being put to use as soon as they emerged. As they were being used, these institutional arrangements were evolving, gaining strength, and assuming new functions. In the process, new constraints to the existing institutional structure were emerging. Over time, the ideological landscape has become more hospitable to new, market-oriented concepts and initiatives.

In a similar vein, the current emphasis on corporate governance is another instance of creative borrowing of market concepts to design policy responses to issues that emerged following partial reforms in the state sector. Corporatization and ownership diversification have not resulted in a fundamental change in ownership patterns, but have created a web of new agency problems and the rudiments of a corporate governance structure. New institutions have emerged alongside old structures and are groping their way to becoming functional. In

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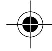

the process they are creating a demand for new laws, regulations, and other institutional arrangements. These institutions are still weak and will remain imperfect in the presence of dominant state ownership and party control over managers; however, if they succeed they will prepare China for fundamental changes in these two areas.

The significance of the current emphasis on corporate governance thus extends far beyond state enterprise reform. China's transition to a market economy is incomplete and will remain so if preserving a dominant share of state ownership remains an objective. As long as the constraints of dominant state ownership are imposed on the economy, China will not be able to have fully functioning factor markets. As a result, the institutional arsenal of corporate governance will remain limited without efficient capital and labor markets. In this context, China's current corporate governance approach to enterprise reform can be viewed as the prelude to the final stage in its transition to a market economy. Given China's gradual approach to reforms, a historic perspective on the process of SOE reform that led to the current emphasis on corporate governance is useful.

From *Danwei* to the Modern Enterprise System

Based on distinctive levels of enterprise autonomy, we can distinguish three phases in the recent evolution of governance mechanisms: the collectivist prereform period, the second period from 1978 to 1992, and the third period from 1993 to the present.

Vanished Economics: The *Danwei*. The main problem of the prereform system was its overwhelming reliance on administrative control and central planning. Given the insurmountable information problems associated with this system, it was inherently incapable of allocating resources rationally. Economic and efficiency considerations were subordinated to political and social exigencies. The complete socialization of risks and benefits implied a lack of incentives to discover and pursue business opportunities.

The basic cell of economic life during the prereform period was the working unit or the *danwei*. The *danwei* system had multiple functions. It was foremost a political institution, one that extended the party's and state's presence to the grassroots level. It was also an administrative body that exercised control on behalf of the party and state. The *danwei* was an economic producer that provided social

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welfare to workers and was attached to a central or local planning agency. The *danwei* had little economic independence and no clearly defined legal boundaries. They received production quotas, guaranteed outlets for products, and were given the necessary resources from the budget to reach production targets. Whatever "profits" the *danwei* made had to be remitted to the supervising state authority. The *danwei* system was designed not only to produce but also to deliver goods to members of its community. Having SOEs function as social welfare providers both attenuated the gravity of the short supply of goods and underlined the workers' need to rely on the *danwei* system. Permanent employment and membership in the social community were implied.

1978–92: Reintroducing Incentives. The focus during this first period of reforms starting in 1978 was on reintroducing markets and incentives within the domain of direct state ownership and control. Market forces started to operate alongside plans and administrative orders through a dual pricing system. In addition, the government allowed new structures such as collectives and private enterprises to develop and compete with state enterprises. Various types of performance contracts created a link between market success and compensation. Some rudimentary forms of penalties associated with failing the market test began to emerge: bank loans started to replace budget grants, a bankruptcy system was established for SOEs, and for the first time enterprises could fire workers.

Even though China did not introduce comprehensive price liberalization like some East European countries did, it created a two-tier system under which companies could sell output produced in excess of the plan, initially at prices up to 20 percent above planned prices. Since 1985 companies have been able to sell their excess output at prices determined by markets. Markets for industrial products expanded in the early 1980s. By the late 1980s the share of output directly marketed by firms had become quite substantial for most industrial producer goods, and even higher for consumer durables. Accompanying the rise of the share of the market was a decline in the proportion of goods subject to allocation under the state plan. By the second half of the 1980s market prices for industrial producer goods were common in numerous cities, and the evidence indicates that these prices were not subject to systematic controls (Byrd 1992, p. 7).

Overall, even though the adjustment of government-controlled prices was usually limited and was hindered by the opposition of vested

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interests, China made considerable progress in releasing prices from central planning and control. The government further liberalized the prices of producer and consumer goods in the early 1990s. As table 2.1 shows, 80 percent of producer goods were sold at market prices in 1994, compared with only 36 percent in 1990. The share of consumer goods sold at market prices also increased dramatically, from only 3 percent in 1978 to 53 percent in 1990 and 94 percent in 1993.

The introduction of market forces had to be accompanied by appropriate reforms in the financial incentives of SOEs. Early reforms focused on restoring enterprises' ability to retain profits. On the basis of earlier local experiments, notably in Sichuan province, the government introduced a profit retention scheme in mid-1979 whereby it allowed a few enterprises to retain a share of the profits made on sales of items that were part of their government-mandated quota, but in other cases they could only keep profits on those sales they made after they had fulfilled their quota. Although profit retention was only intended to be a limited experiment, it spread rapidly, and by the end of 1980, 6,600 industrial SOEs, accounting for 60 percent of total industrial output and 70 percent of total profits, had instituted some form of profit retention. However, incentives were still weak because of low and unstable retention rates (Byrd 1992, pp. 3–4).

In 1981–82 the government instituted various forms of the "economic responsibility system," under which enterprises contracted to

TABLE 2.1
Producer Product Market,
Market versus Regulated Prices, 1990–94
(percent)

Year	*Fixed prices*	*Guided prices*	*Market prices*
1990	44.6	19.0	36.4
1991	36.0	18.3	45.7
1992	20.0	—	80.0[a]
1993	15.0	5.0	80.0
1994	14.7	5.3	80.0

— Not available.
Note: When market participants are free to determine prices within administratively set parameters, these are referred to as guided prices.
a. Includes guided prices.
Source: IMF (1996).

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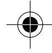

hand over only a certain percentage or fixed amount of their incremental profits. This system specified targets for profits that enterprises turned over to the government, with high retention rates for above-quota profits that often amounted to 60 to 80 percent, and sometimes even 100 percent.

In 1983 the government introduced a scheme that substituted tax payments for profit remittances, and SOEs paid a profit tax at a uniform rate of 55 percent. However, because of price distortions and other "objective factors" that caused profits to vary across firms and industries, the government also imposed an enterprise-specific adjustment tax on most large and medium enterprises.

The early profit retention schemes were "soft" and negotiable, and weakened rather than strengthened financial discipline. Different rates of tax or profit retention led to considerable bargaining between enterprises and the government and weakened the incentives generated by profit retention.

China was the first of the transition economies to introduce performance contracts.[2] Beginning in 1987, the government introduced a variety of contracts under the "contract responsibility system," which included the leasing of smaller firms, the contract management responsibility system, the enterprise management responsibility system, and the asset management responsibility system. While the details of these programs varied, they shared some common elements. First, all of them involved a contract-based relationship between the enterprise, usually represented by its director, and its supervisory agency. Second, the directors faced substantial risks and rewards as a result of participating in these programs, because their performance was linked to their enterprises' performance. Third, these schemes involved open selection (as opposed to direct administrative appointment) of enterprise directors. Finally, most of these systems had multiyear targets and incentives in order to weaken ratchet effects.

2. Shirley and Xu (2001) analyzed China's experience with performance contracts in roughly 500 SOEs. They found that, on average, performance contracts did not improve performance and may have made it worse. However, they noted that China's performance contracts were not uniformly bad, and actually improved productivity in slightly more than half of the cases. The negative effects of performance contracts were caused by the large losses associated with poor design. Successful performance contracts featured sensible targets, stronger incentives, longer terms, and managerial bonds and were in more competitive industries.

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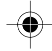

Directors of enterprises that had entered into these contract responsibility systems were given greater control over their enterprises' operations in return for meeting profit remittance targets. Many contracts also gave enterprises greater autonomy over sales and permitted managers to give bonuses to their employees and to hire temporary labor. Beginning in 1986, most newly hired workers in SOEs were given fixed-term, usually three-year, contracts. This measure was intended to put an end to the "iron rice bowl" system, under which workers were effectively guaranteed the right to keep their jobs for their entire careers, regardless of their performance. Under this new system workers whose performance was unsatisfactory could, in principle, be terminated when their contracts expired. The new system was also expected to increase labor discipline and strengthen performance-based incentives for workers. In practice, however, workers were rarely terminated and fixed-term contract renewal became largely automatic (Byrd 1992, p. 8).

A more important development occurred in the mid-1980s, when the government gave managers the authority to rationalize their work force by allocating surplus labor from production to other tasks or to training. In 1992 a government directive stipulated that contracts under the responsibility system could give managers additional autonomy, including the rights to make production decisions, negotiate prices for outputs and inputs, purchase goods and materials, make investment decisions, hire workers, and determine wages and bonuses.

The contracting responsibility system achieved some success in that it increased the autonomy of SOE directors and improved their ability to manage effectively. It might have provided incentives for good performance, but it failed to penalize bad performance (Pannier 1996, p. 15), although some elements of hard budget constraints began to emerge during this period.[3] In relation to funds for investment in SOEs, budgetary financing and subsidies began to give way to bank financing and to financing from retained profits. Since 1979 bank loans have increasingly replaced budgetary grants, and interest charges have gradually increased. In 1983 the government formally established the PBOC as the country's central bank by removing its commercial banking activities. Four specialized state-owned banks were created to take over the functions involved in financing enterprises.

3. For more details about performance contracts in general see World Bank (1995), and for more details about performance contracts in China specifically, see Shirley (2000).

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China has made progress in curtailing subsidies to SOEs: budgetary subsidies fell from 7.5 percent of gross domestic product (GDP) in 1992 to 2.3 percent in 1994. However, other forms of subsidies continued, including soft loans from state banks and subsidies from local governments, which control the majority of SOEs (Broadman 2001b; World Bank 1996, p. 15). The Bankruptcy Law for SOEs was enacted in 1986 and became effective in 1988. In 1991 the Civil Procedures Law introduced rudimentary provisions for the bankruptcy of legal persons in general. Nevertheless, the period 1988–93 averaged only 277 bankruptcy cases per year.

The government introduced incentives without making fundamental changes in the ownership of SOEs. However, it allowed new forms of ownership to develop. Township and village enterprises (TVEs) dominated the growth of the nonstate sector throughout the 1980s. "Appearing from nowhere," as Deng Xiaoping was reported to have said in 1987, TVEs became important players in the economy. China's market reforms during this period also resulted in the emergence of a significant private sector. Private business was revived after the Cultural Revolution as a quick way to respond to the mounting pressures of unemployment and economic stagnation. It was first allowed on the fringes of the economy and was initially regarded as a supplement to the state and collective sectors (Gregory, Tenev, and Wagle 2000). Foreign investment, especially foreign direct investment, began to flow into China in the early 1980s, when it started to open up its economy to foreign investors. Investment from Chinese expatriates, mostly from Hong Kong, dominated the initial flow of foreign investment.

The competition from these new ownership forms has become an important component of market control over SOEs. More important, the coexistence of various ownership forms and growing state enterprise autonomy have created the conditions for a hybridization of state and nonstate enterprises. This hybridization has become a distinct feature of China's market-oriented reforms. The process has taken the form of breaking up existing enterprises to form "secondary legal entities" (or subsidiaries), often disguised as collectives; joint ventures with foreign and/or domestic partners; limited liability companies; and joint stock companies.[4] This has been one way for SOE managers to gain further autonomy from supervising government agencies.

4. Over time, hybridization has resulted in complex organizational structures (see Broadman 2001b).

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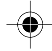


Initial experiments using stock to raise funds also led to some ownership diversification. In 1984, 11 SOEs became shareholding enterprises though a process called *gufenhua* or shareholding transformation. By the late 1980s another handful of SOEs had undergone *gufenhua*. Stock exchanges emerged in a number of cities, and in 1990 and 1991 the first official stock exchanges were established in Shanghai and Shenzhen as an experiment.

1993–Present: Reemergence of the Corporate Form. The period since 1993 has been marked by important changes in China's overall approach to reforms. While experimentation continued, a coherent strategy of transition to a market system began to emerge. An important development was the reemergence of the corporate form, a relatively ideology-free concept that the government found useful for redefining the broad relationship between economic actors, including between autonomous economic entities and the state. The introduction of the corporate form was associated with further ownership diversification, rapid capital market development, and the beginnings of unified treatment of state and nonstate economic entities. This, in turn, created a demand for a broad legal and regulatory framework consistent with a rules-based environment.

The new wave of economic reform started with Deng Xiaoping's visit to south China in 1992, when he called for a continuation of the reform effort. In November 1993 the Third Plenary Session of the 14th Party Congress issued the Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure. This decision outlined a 50-point agenda for economic reform to be undertaken through 1999, including some important policies regarding SOE reform (Broadman 1995, p. 27). Two points were particularly important. The first was the creation of a "modern enterprise system," with its corporate structure, governance, and management based on the principle of corporatization, and with provisions for full separation of the state's exercise of ownership rights from the enterprise's exercise of legal person property rights. The second encouraged the development of diversified forms of enterprise ownership, including "privately owned, individually owned, and foreign-invested" enterprises.

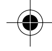
The Company Law, promulgated in November 1993, provided the legal underpinnings for the concept of a modern enterprise system. The new legislation provided, for the first time, a firm legal foundation for the establishment and operation of companies. It provided

rules for the incorporation of all enterprises of different ownership types into limited liability and limited liability shareholding companies and specified governance structures, rules regarding the transfer and sales of shares, and procedures for mergers and bankruptcy.

The introduction of the corporate form built on the shareholding experiments of the 1980s and the existence of the two stock exchanges. Local governments operating under increasingly hard budget constraints appreciated the feature of limited liability as an opportunity to distance themselves from continuously underwriting SOEs' liabilities. The government assuaged ideological concerns through such means as controlling state ownership stakes, not allowing state shares to be traded, and molding old institutions into the corporate form. It this way it could present the diversification of ownership through corporatization as a mechanism for the state sector to play a leading role in relation to other sectors at the enterprise level in a mixed economy. With the fast growth of listed companies in the 1990s, the corporate form became widely accepted, culminating in 1997 with the broadening of the official definition of public ownership to include publicly held private companies.

The government subsequently introduced a series of complementary reforms to build the institutional mechanisms for control consistent with the corporate form. While increasing the autonomy of SOE management, the government was also seeking to strengthen the supervision of state property, but in ways consistent with the new form of enterprise autonomy. In 1994 the government issued supervision regulations that provided the legal basis for the emerging network of state-owned bodies designed to supervise SOE property (Broadman 2001a; World Bank 1997, p. 23). The tendency, although not yet fully realized, was to move toward an indirect, delegated form of control in line with the tenet of separation between ownership and management.

The government introduced accounting reforms to ensure that owners, boards of directors, and managers were provided with reliable information for monitoring company performance. In July 1993 the Ministry of Finance issued the Accounting Standards for Business Enterprises (ASBE). These standards embody general principles modeled on internationally accepted practices. They also distinguish between taxable income and profits, and are thus designed to measure corporate efficiency and performance rather than revenue generation (World Bank 1997, p. 65).



Increased enterprise autonomy required corresponding changes in the banking sector, which was still an extension of the administrative apparatus. Furthermore, local governments had strong incentives to use the national banking system as a vehicle for localizing the benefits and socializing the risks of local investment projects. The banking reform program consisted of four major components: (a) separating policy lending from commercial lending by setting up policy banks, (b) deregulating the banking sector and establishing new banks, (c) improving the legal framework of the financial system, and (d) developing financial markets.

The government established three policy banks in 1994, designated as the main vehicles for policy-based lending in the future. In addition, it started to deregulate the banking sector and lower barriers to entry. This resulted in the establishment of new nonstate commercial banks. In 1996 the All-China Federation of Industry and Commerce, an association of private enterprises, created the Minsheng Bank, China's only national, private commercial bank. More foreign banks and financial institutions entered China's market, and some of them were permitted to conduct domestic currency transactions.

In 1998 the PBOC underwent significant restructuring, aimed at reducing provincial and local government intervention in credit allocation and monetary policy and improving the soundness of the financial system by strengthening financial supervision. The most important change was the replacement of the 31 provincial branches with 9 regional branches. The old provincial branch network had been based on administrative jurisdiction. Under that system, provincial governments had a strong influence over the decisions made by the provincial branches under their jurisdiction. The move from a provincially based branch system to a regionally based branch system was expected to minimize such influence and improve the central bank's independence.

In 1998 the government also took a major step in the reform of credit allocation by phasing out the credit quota system that was applied to the four state-owned commercial banks and replacing it with asset liability management. The new system applies to both fixed assets and working capital loans (World Bank 1999, p. 34). The credit plan has been a powerful tool for controlling the money supply and allocating credit to SOEs and high priority sectors. As the economy becomes increasingly market oriented and the nonstate banks make up a bigger share of the banking system, controlling the total credit of state-owned commercial banks has become less effective.

The 1997 Asian financial crisis raised concerns among policymakers about the possibility of a banking crisis in China because of the large volume of nonperforming loans and the low level of capital. To deal with the problems of a large number of nonperforming loans in the state-owned commercial banks and the high leverage of SOEs, the government established asset management companies (AMCs) for the four state-owned commercial banks.

Despite the large number of loss-making SOEs, labor concerns continued to prevent many bankruptcies. In 1996 the conflict between social security and creditors' rights became apparent in decree number 492, which gave labor and pension expenses priority claims on land use rights even when the SOE had mortgaged these rights, notwithstanding the basic principles of the Bankruptcy Law. Policies designed to deal with the social dimensions of bankruptcy have the potential of exacerbating financial instability and underscore the urgent need to establish a modern welfare system (World Bank 2001a).

Both the central and municipal levels have made progress in delinking social safety net functions from commercial operations by pooling pension, unemployment, and health obligations and transferring them to government agencies. At the central government level, the process of unbundling took off in earnest in March 1998 with the creation of the Ministry of Labor and Social Security. The ministry inherited responsibility for social insurance for urban workers from the Ministry of Labor and authority over social insurance for civil affairs agencies, rural insurance, social security insurance, and medical insurance from other ministries.

The Ministry of Labor and Social Security was established with a view to introducing a comprehensive new social security system and facilitating welfare transfers through the redistribution of resources. Following the 1997 State Council Decision on the Establishment of Unified Pension Insurance for Enterprise Employees, the government has adopted a three-pronged approach to pension reform, namely: (a) a mandatory pooled fund to include all SOE employers administered by cities or provinces, (b) mandatory individual accounts managed by cities or provinces and funded by employer and employee contributions (transferable and fully vested in 15 years and fully funded after 40 years), and (c) voluntary supplemental accounts set up by enterprises. In February 2001 the government established the National Social Security Fund and the National Social Security Council to create, in effect, a supplementary pension system. The National Social Security

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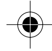

Fund will be professionally managed. There are plans to sell state-owned shares of listed companies to raise funds, in which under an initial public offering (IPO) the government would sell its shares (up to 10 percent of an IPO), and these proceeds would be used to fund the National Social Security Fund. This initiative would establish an important potential link between social security reforms and capital market development.

The implementation of these plans has encountered a number of obstacles and issues. To begin with, the implied pension deficit has been rising. The existing system has not generated enough reserves nationwide for the transition to a fully funded system, and because of mounting arrears many SOEs have withdrawn from current pension systems. In addition, a comprehensive national system is still not in place because the central government offered cities a choice of different options, and because economic growth rates and labor market conditions vary across regions. The provinces and cities remain in charge of all new programs. Administration is another issue. The National Social Security Council will administer some national programs, local social security offices will administer others based on a combination of national and local regulations, and enterprises will continue to have a role in pension administration. Finally, because of pressure from financial institutions with stock market exposure, the government had to suspend sales of state shares in IPOs to fund the National Social Security Fund.

Agency Costs of Local Government Ownership and Enterprise Autonomy

The agency costs associated with local government ownership and enterprise autonomy have been an important factor in determining the speed and direction of the market reforms that led to the current emphasis on corporate governance. Because of China's distinctive approach to reforms, local governments emerged as dominant owners and powerful regulators of companies under their jurisdiction. While bureaucratic entrepreneurialism at the local level generated much of the growth dynamism in the early years of reforms, tensions between powerful local incentives and national interests have been growing.

One area where such conflicts of interest have become apparent is the national banking system. Local governments have used their power to influence credit decisions in order to localize the benefits

and socialize the risks of investment projects. To some extent the high level of nonperforming loans in the banking system reflects this discrepancy in incentives. Local protectionism has also become rampant. Local governments have been enacting internal trade barriers through their tax and price policies. This has resulted in higher prices, less efficient investment, and excess capacity in many sectors. Interprovincial trade has fallen from 37 percent of national retail trade in 1985 to about 25 percent today. Despite a huge expansion of the national transport infrastructure, the average distance traveled by a freight shipment fell from 395 kilometers in 1978 to 310 kilometers in 2000. Some economists have argued that double-digit export growth partly reflects local companies' inability to sell domestically, just as China's huge inflows of foreign investment partly reflect the diversion of much of the country's savings into inefficient state enterprises (World Bank 2001b). Local protectionism is also evident in discriminative employment policies in almost every large Chinese city, and results in inefficient allocation of labor resources.

Interprovincial investment has been deterred by biases in the judicial system. Prosecutors and judges overwhelmingly favor companies in their districts. According to an analysis by Pei Minxin, a scholar at the Carnegie Endowment for International Peace, a local litigant enjoys a two-to-one advantage in Chinese courts over a nonlocal party (May 1999). Even when a local company is found guilty, it often can escape the consequences, because local authorities have appointive and financial power over judicial and law enforcement departments, and may obstruct the enforcement of court judgments (Yang 2000). Many of the reform initiatives at the national level are intended to reduce the negative impact of such agency costs related to local government ownership and development incentives.

Another problem of China's market-oriented reform was how to increase management's autonomy while making managers accountable to the state as the owner of the assets, or in other words, how to control the agency costs of enterprise autonomy. Over time, SOE reforms have resulted in a significant degree of insider control as SOE managers have gradually acquired considerable discretion over the use of state assets. The agency costs of this increased autonomy have manifested themselves in various incentives for managers to maintain or acquire private benefits of control through on-the-job consumption and other rents related to investment and expansion. Among these incentives the tendency for overinvestment is perhaps the most important from an economic standpoint.

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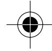

In the Chinese context, the incentive to invest has been enhanced by the motivation of SOE managers to gain further autonomy from their supervising agencies, typically through a series of organizational transformations, for example, by breaking up existing enterprises to form subsidiaries, joint ventures with foreign and/or domestic partners, limited liability companies, or joint stock companies. Additional motivations could include the possibility of undertaking new business opportunities without losing existing connections to and benefits from the state, shifting bad debts and surplus labor burdens onto parent companies, and so on.

The coexistence of different ownership forms has created additional incentives and opportunities for managers to realize private benefits from their control over state assets. With the rapid development of the nonstate sector, managers or their relatives and friends often have their own businesses, which provides opportunities for diverting state assets to private benefits. A large body of anecdotal evidence indicates that asset stripping, or siphoning resources into structures where the controller has both majority control and income rights, is widespread. Furthermore, the "grafting" of nonstate property onto the state sector also offers opportunities for asset stripping, for instance, by using the appraisal and valuation process to form joint ventures or using bankruptcy to liquidate state assets at low prices and divert them for private use, which explains why some enterprises are enthusiastic about bankruptcy.

Many key aspects of China's approach to market and SOE reforms have been partly motivated by the need to control such agency costs. For example, initially and for some time thereafter enterprise managers were given the right to use state assets and to enjoy some of the income generated, but no formal rights to dispose of state assets. Also, the sequencing of market development, with product markets being allowed first and factor markets later, played an important role in controlling agency costs (Naughton 1995). This discouraged redistribution, because the only way to transform factors of production into income was through new production and not through speculative activities. In addition, siphoning resources into privately controlled activities was discouraged by discriminating against private sector activities. Also, activities that are particularly prone to and effective in redistribution and rent-seeking, such as distribution and trade, are still out of the reach of most private entrepreneurs. Furthermore, the Communist Party's control over the rights to appoint and dismiss top SOE managers may have served as an important counterbalance to

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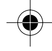

managerial discretion (Qian 2001). While this type of control has other distorting impacts on managerial incentives, it may have restricted the opportunities for egregious asset stripping, as insider control in China has never reached the degree it attained in Russia and other transition economies (box 2.2).

BOX 2.2
Evolving Role of the Communist Party in SOE Management

The Communist Party's role in SOE management has changed over time. In the prereform period the party secretary of the factory was the ultimate decisionmaker and managed the factory's day-to-day operations. Managers have been given greater autonomy in managing factory operations since 1984. Even though early reforms gave firms greater latitude in making decisions, the question of who would exercise this power remained unanswered. The general trend of reform since the mid-1980s has been to have the factory director become the ultimate decisionmaker and represent the enterprise when dealing with outside agencies.

In 1986 the government issued the Regulations on the Work of Factory Directors in State-Owned Industrial Enterprises, which gave factory directors final operational authority. Most important, directors were given decisionmaking power over personnel within their enterprises. However, SOEs' party committees still played important roles, especially as concerned personnel issues.

In theory, managers in the corporatized SOEs are either elected or appointed by the board of directors, but in practice, they are more often appointed by the Communist Party's Organizational Department. For large SOEs or enterprise groups, the general manager is often also the secretary of the party committee. The party's standing committee usually consists of the general manager and senior managers, and is the ultimate decisionmaking body for important issues. The Communist Party Central Committee or provincial committees still control and determine the appointment, promotion, or dismissal of senior managers of large SOEs or enterprise groups.

The central government's and party's willingness to permit decentralization and delegate control power to enterprises is probably related to the fact that the party's control over appointments and dismissal is being preserved. However, direct control and ownership by the party have been largely eliminated. In late 1998 the government ordered all party and government administrative organs to sever their links with the enterprises they control (World Bank 1999, p. 32).

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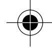

China has found it difficult to control the agency costs associated with the incentives to overinvest. Initially, inefficiencies were limited by the low level of development and the niches created by the command economy: identifying positive net present value projects was relatively easy. Competitive product markets and competition from the nonstate sector also played a positive role. However, the dynamics of the process were unsustainable. Over time inefficiencies tended to accumulate and began to manifest themselves in overcapacity and a high level of nonperforming loans in the banking system.

The need to restructure in response to these challenges has prompted additional reform measures: the corporate form offered the promise of limited liability to the government; the local governments found that privatization was the only way to staunch the bleeding of small and medium state-owned and collective enterprises; the listing of enterprises on the stock exchanges seemed like a convenient way to raise funds for restructuring; and the financial system is also being reformed to introduce market principles in this area. These are some of the initiatives that led to a diversified ownership structure and have, in the process, transformed the initial problem of how to make managers accountable to the state as an owner into one of corporate governance.

Current Approach

The system for managing state assets has been evolving in the direction of separating ownership and regulation, as well as streamlining the administration of state ownership rights. The current oversight system is not completely unified and is still undergoing experimentation. Reforms aim at consolidating fragmented oversight and the conflicting goals of stakeholders with the intention of providing a single reporting line to SOE managers by integrating party and government functions into one agency. Many experiments have taken place, and decisions have reflected compromises made between different centers of power within the government (box 2.3).

The system for managing state assets at the central government and local government levels is evolving differently, with several large city governments more advanced than the central government in introducing a more streamlined and unified system of SOE oversight. The central government has been encouraging local governments to experiment with different approaches to managing state assets and to

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BOX 2.3
EVOLUTION OF THE STATE ASSET MANAGEMENT SYSTEM

Between 1987 and 1998 the government started the process of separating the management of ownership from the management of government. In 1987 Shenzhen, one of the earliest special economic zone cities, set up the nation's first specialized state assets management institution, the Shenzhen Municipal Investment Administration Company, to manage all the city's assets. In 1988 the central government established a separate state asset management agency, the National State Asset Administration Bureau, which reported to the State Council and was under the guidance of the Ministry of Finance. Both the bureau and the ministry were named as the general representatives of the owner of state assets.

In the early 1990s, almost at the same time, some big cities, including Beijing, Shenzhen, and Shanghai, began to deepen their state asset management system by separating regulatory matters and ownership oversight from governance and management. For example, in 1992 Shenzhen set up the State Asset Management Commission, which specializes in the supervision and governance of the ownership of state assets. The former Municipal Investment Administration Company has been transformed into the State Asset Management Company to manage state assets.

At the central level, the efforts to gradually eliminate the ownership functions of line ministries and to transfer their powers to the National State Asset Administration Bureau and the Ministry of Finance to establish a unified and separate agency responsible for state assets met with strong resistance from line ministries. Several comprehensive government ministries, such as the State Economic Restructuring Commission and the State Economic and Trade Commission (SETC), also tussled with each other and the bureau to become the unified agency for asset management. In addition, debate on what models of state asset management system China should follow has been ongoing. A compromise was reached in 1998 during the government reorganization, whereby, on the one hand, most line ministries were merged into the SETC and their ownership functions were removed, and on the other hand, the bureau was dissolved and merged into the Ministry of Finance. Ownership functions were then separated and transferred to different comprehensive government ministries. From the point of view of a recombination of regulatory and ownership functions, this was a retrograde step.

SOURCE: Zang (2001).

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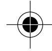

continue to follow the path of separating ownership from the government's regulatory function. Several relatively developed cities, including Shanghai, Shenzhen, Qingdao, Wuhan, and Xiamen, pursue a system that can be referred to as the Shenzhen-Shanghai model. In the Shenzhen-Shanghai model the municipal government is authorized by the next highest level of government to manage the state assets assigned to the city, and a three-tier management structure is set up to manage the state assets. The first tier is a state management commission, which consists of major city-level leaders and heads of relevant municipal government departments, and functions as the general board of directors for the city's state assets. The second tier comprises holding companies and enterprise groups authorized by the government to manage state assets. These are special corporations that enjoy ownership rights to the state assets under their jurisdiction. The third tier consists of enterprises wholly or partly owned by the state.

At the central level the state management system is still fragmented, with many government ministries involved in managing SOEs. The main features of the current system for oversight of SOEs at the central level are described in box 2.4. From the standpoint of facilitating effective SOE oversight, the system has the following major defects. First, ownership, and as a result responsibility, have been fragmented. Under the current system ministries can issue orders to enterprises according to their role, but none is fully responsible for the results. Second, the comprehensive ministries, such as the Ministry of Finance, the State Economic and Trade Commission (SETC), the State Development and Planning Commission, and the PBOC, are also the most important regulators of the whole economy. Thus the potential for conflicts of interest is considerable. These government agencies could apply policies and resources in a way that was favorable to SOEs and deter the creation of a level playing field for nonstate enterprises. Third, from the viewpoint of enterprises, they now face multiple principals in the line ministries. Transaction costs increase because they need to negotiate different management matters with different ministries. However, enterprises can also avail themselves of loopholes and escape from owners' supervision and control more easily. Finally, too many SOEs exist for direct control to be effective. Currently 4,000 enterprises are directly under the control of the central government, including 600 key enterprises and groups, making effective control a difficult task.

At the Chinese Communist Party's 15th Congress held in September 1997, the Central Committee endorsed both the corporatization

BOX 2.4
SOE Management at the Central Government Level

The SOE oversight function at the central level is fragmented, as demonstrated by the following:

- The Financial Working Commission, the Economic Working Commission, and the Ministry of Personnel manage the appointments and dismissals of senior officers. Both the commissions are newly established subordinates under the Chinese Communist Party Central Committee, while the Ministry of Personnel is a government ministry under the State Council. These three organizations are responsible for the personnel issues of different groups of SOEs. The Financial Working Commission is responsible for state financial institutions, including state banks, insurance companies, and security companies; the Economic Working Commission is responsible for 39 of the most important and largest enterprise groups; and the Ministry of Personnel is responsible for other important and large enterprises or groups.
- The Ministry of Finance is responsible for the administration of capital, for example, the definition and registration of property rights of state assets and the supervision of state asset evaluations and transactions, along with the supervision of revenue collection.
- The newly established Special Inspector's Commission is responsible for financial auditing. Even though the commission is headquartered in the Ministry of Personnel, it is an independent agency that reports directly to the State Council. Usually one special inspector works with five or six assistants and is in charge of five or six enterprises. Special inspectors are supposed to audit enterprises at least twice a year and are not allowed to interfere in enterprise management. After auditing, special inspectors provide an assessment of the management's performance and make suggestions about the retention, promotion, or dismissal of incumbent senior officers. Special inspectors' reports are sent to the SETC for review before being passed on to the State Council.
- The SETC and the State Development and Planning Commission are responsible for the supervision and control of enterprises' business activities, including financing, investment, sale of assets, and internal restructuring.

Source: Zang (2001).

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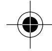

of large SOEs and the restructuring of small SOEs, and decided to accelerate the speed of reforms. The central component of the reform program was *zhuada, fangxiao*, or “grasping the big, and enlivening the small” (see Broadman 2001a for more details). The notion of grasping the big involves two related sets of reforms. First, the government is creating a number of large enterprise groups with extensive cross-ownership by encouraging mergers in core industries. Second, the government is encouraging those enterprises performing better to be listed on the stock exchange to promote ownership diversification and raise funding for restructuring. By the end of 2001 about 1,200 companies were listed on the Shanghai and Shenzhen stock exchanges. The concept of enlivening the small provides for further experimentation with ownership reform in small and medium SOEs. The government has used various mechanisms to let go of small enterprises, including restructuring, entering into alliances, encouraging mergers and acquisitions (M&As), and forming shareholding companies (World Bank 1999, p. 31). In August 2001 the SETC announced that by the end of 2000 more than 81 percent of the 63,490 small SOEs that had existed at the end of 1996 had been reformed, mainly through sales.

Conclusion

China’s current emphasis on corporate governance is largely a policy response to the issues that emerged following partial reforms in the state enterprise sector. Market reforms have transformed the problem of state control over the agency costs of enterprise autonomy into one of corporate governance. The current approach takes the process of emancipation of economic agents from the state and politics to a higher level by focusing on the institutional framework within which participants can shape the governance structure of production through market transactions. While the potential for institution building is vast, the effectiveness of the new institutions of corporate governance is likely to be limited in the context of dominant state ownership and of party control over managers. However, based on the dynamics of China’s reform experience, the new institutions will likely facilitate changes in the areas of state ownership and political control over economic activities. Such changes are necessary for China to develop fully functioning factor markets, without which the effectiveness of corporate governance institutions will remain limited. In this context, the current emphasis on corporate governance can be seen as a prelude to China’s final stage in its transition to a market economy.

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