Chapter Three

China's Transformation Economy

Introduction

Chapter 2 discussed the CPE of China from 1949 to 1978. After the reforms started at the end of 1970s the informal institutions based on Confucianism continued to characterise the Chinese economic system although the ideology and mental maps of the agents slowly changed in the decades after the end of the 1970s. Much clearer were the changes in the formal institutions: the laws and regulations that opened doors to the market economy. Because in an explanatory framework of institutional change (Chapter 6) the drivers will be an important element we start this chapter with a discussion of the economic and political drivers behind the changes in China. In Section 3.2, we will discuss the changes in the formal institutions and focus in Section 3.3 on the changes in governance structures. Special attention is paid to the reforms of SOEs and the emergence of private business.

3.1 Drivers of Change

The drivers of change are of an economic and political nature with a close interdependence between the two. The economic drivers find their origin in inefficiencies of the Centrally Planned Economy, whereas the political drivers were related to the death of Mao Zedong. Since 1949, China's development had been almost uniquely influenced by Mao Zedong's personal prejudices and specific view of how best to realize the country's development potential. In China, because of his longevity and close involvement in major strategic initiatives, Mao Zedong's passing was needed to give room to the economic pressures (Nolan and Ash, 1995).

3.1.1 The economic drivers

China, like many other command economies, faced severe problems at the outset of the reforms at the end of the 1970s: all investment capital was controlled by the government, administered prices did not reflect relative scarcities, the domestic economy was separated from the world economy, a poor export performance, a lack of competition in product markets, and poor distribution networks. The long-term shortage in goods, especially in the consumption goods, gave rise to a seller's market. The range of products was very small and narrowed to those, which were easy to produce without regarding their quality (Kornai, 1992; Nolan and Ash, 1995).

The origin of China's reform after 1978 was located in the economy's disappointing performance since the end of the First Five-Year Plan (1953-1957) and in the structural economic problems. The official data showed a rather positive picture of the performance of the Chinese economy between 1949 and 1978 but there was evidence to suggest that the Chinese national accounting statistics were overstating China's achievements (Nolan and Ash, 1995; Qian, 2002). For example, no allowance was made for the fact that many goods produced were often of the wrong type. In the words of Bell et al. (1993, p.6):

> *"the economy faced chronic and fundamental economic difficulties … including a distorted pricing system, inefficient resource allocation, concentration of investment in heavy industry at the expense of basic infrastructure, … stagnation in agricultural production, … a pervasive emphasis on quantity rather than on quality, … with acute shortages of many consumer goods and housing."*

3.1.1.1 The agricultural sector

China was a traditional agricultural country and thirty years of planned economy did not change this feature. At the beginning of the reform in 1979, 71% of the labour force in China worked in the agricultural sector. Agriculture contributed to 31% of GDP though its share in GDP declined steadily and slowly (World Bank, 1982). The structural characteristics are shown in Table 3.1. China's large population pressure caused a steady decline of the per capita availability of farmland to a level that was amongst the lowest in the world. In 1979, average arable land per head in China was 0.1 hectare, while the number in Japan was 0.04 hectare, India was 0.26 hectare, US was 0.86 hectare and former Soviet Union was 0.89 hectare (Nolan and Ash, 1995). This required a system of intensive farming. China's advanced irrigation systems, a higher labour input per unit arable area and rapidly increased the use of inputs (especially chemical fertilizers) generated higher yields per arable and sown hectare. However, the growing scarcity of arable land and the attainment of such high yields pointed to the need for continued investment in the farm sector – a need which would become even more urgent when post-1978 reforms generated rises in income and demands for a better diet. On the eve of the reform, the level and quality of nutrition in China lagged well behind those of the former Soviet Union, let alone the USA (Nolan and Ash, 1995).

Agricultural policies in China have been based on the erroneous belief that farming, like industry, should seek to realize economies of scale in all its activities. It was on this basis that the decision to collectivise was taken. Methods of organization under collectives and state farms were the source of serious inefficiencies (Qian, 1999). Farmers were remunerated on the basis of a work points system where the supervision of labour in agriculture was according to the farmer's working time but not according to their output. In fact, there was relatively little relationship between an individual's productivity in a job and the reward they received (Pyle, 1997).

Table 3.1 Structural Characteristics of China's and Other Economics (1980)

	China	Former Soviet Union	Low-income Economies	Middle-income Economies	Industrial Market Economies
As percentage of GDP					
Agriculture	31	16	45	15	4
Industry	47	62	17	40	34
Services	22	22	38	45	62
As percentage of employment					
Agriculture	71	14	73	44	6
Industry	17	45	11	22	38
Services	12	41	16	34	56

Source: World Bank (1982)
Note: Low-income economies exclude China and India.

3.1.1.2 The industrial sector

The extreme inefficiency with which a command economy used investment resources meant that China required a relatively large input of intermediate goods to generate a unit of final output. The World Bank (1982) presented some relevant selected comparative indicators (Table 3.2). The quality of much of heavy industrial output, especially machinery, was below that required to compete in world markets. Therefore, the potential of enhancing efficiency in the utilization of input and the improvement of the quality of capital goods was considerable.

Table 3.2 Intermediate Input Levels per Dollar of GNP (1979-1980)

	Steel *(grams)*	Sulphuric acid *(grams)*	Cement *(grams)*	Energy *(kilograms of coal equivalent)*
China	146	31	319	3.21
Former Soviet Unions	136	21	116	1.49
USA	42	17	27	1.16
Japan	109	7	47	0.56

Source: World Bank (1982)

A striking feature of the industrial structure of China was the pre-eminent role played by large plants. In the early 1980s, large plants (over 1.000 employees) accounted for 64% of the total value of industrial fixed assets and 48% of industrial gross value output (Qian, 1999). These plants were characterised by a high degree of vertical integration, stemming from the complexity of material balances planning (Nolan and Ash, 1995). Because of the strategy of forced industrialisation, the focus of the national investment was on the heavy industry and most large plants were set up in the inland provinces. All this tended to generate attempts to maximise self-sufficiency within enterprises in order to obviate shortages of materials and fuel inherent in the command system. For example, in 1978 some 80% of the 6.057 engineering factories produced their own iron castings (Ma, 1982, p.231). Far from benefiting from large-scale production, many spare parts and machinery requirements were produced within large plants, while general-purpose machine tools were used at low utilization rates to produce a wide variety of inputs in small quantities. The result was a relatively costly way of production and transportation. Large-scale industry did not benefit from economies of scale, nor did it derive the advantages of specialization and exchange. Material consumption was high and much of the output it produced was of low quality.

3.1.1.3 Living standard

Per capita indicators on consumption show a gloomy picture. Table 3.3 shows the living standards and its comparison to the global level at the end of the pre-reform period. Economic indicators show the low living standard of Chinese people vis-à-vis that of the whole world. They suggest that after a quarter of a century of planned economic development China remained a poor country.

Furthermore, the picture was gloomier for China compared with the achievements of its neighbours, such as the Republic of Korea, Singapore and

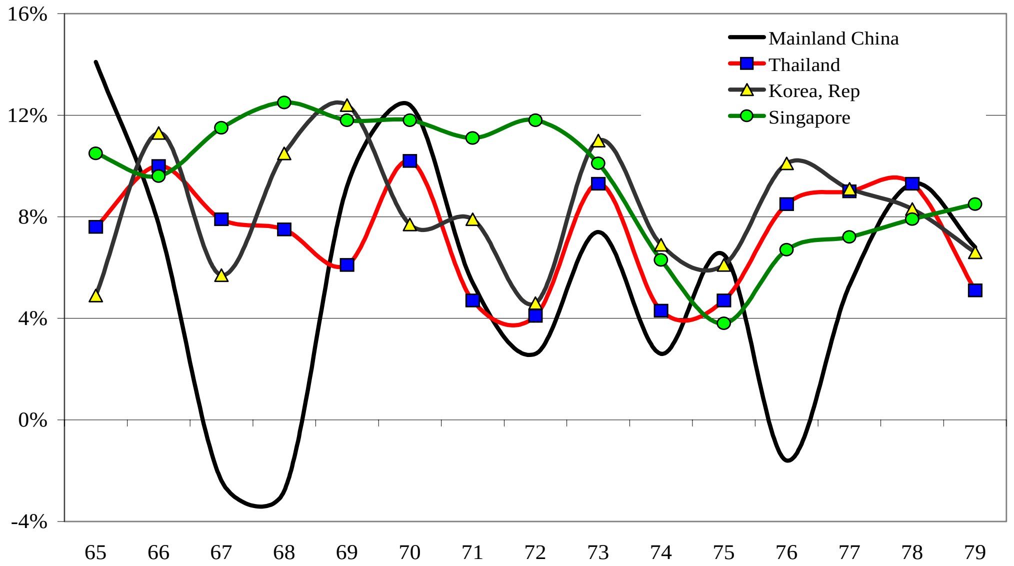
Thailand. From 1961 to 1979, the average growth in Real GDP in China was 3,26%, while it was 4,52% at the global level, 6,65% in Asia (excluding the Middle East), 7,06% in Thailand, 7,68% in Korea, and 8,53% in Singapore. In short, China's growth record looked reasonable in absolute terms, but negative compared to other Asian countries.

Table 3.3 China's Living Standard per Capita in 1978

	GDP *($)*	Meat Consumption *(Kilograms)*	Calorie supply *(kilocalories/day)*	Electricity Consumption *(Kilograms of oil equivalent)*	Energy Consumption *(Thousand metric tons oil equivalent)*
China	151.5	11	2241	18.7	0.6
World	1940.40	29.6	2527.7	127.8	1.6
Percentage to the global level *(%)*	7,81	37,16	88,66	14,63	37,5

Source: GDP per capita: *World Development Indicators 1999, World Population 1950-2050 (The 1998 Revision)*; Meat Consumption per capita and Calorie supply per capita: *Food and Agriculture Organization of the United Nations*; Electricity Consumption per capita and Energy Consumption per capita: *International Energy Agency (IEA).*

Figure 3.1 The Growth Rate of China's Planned Economy



Source: Data are from http://earthtrends.wri.org (cited October 12th 2003).

3.1.2 Political drivers

Next to economic factors there were also political and social factors that propelled China into the era of reform. In particular it was the political catastrophes of the previous two decades, which had brought China to the brink of collapse. For a long time, the Chinese Communist Party (CCP) focused on the "class struggle" to prevent the capitalists coming back to China. Helped by "a Chinese traditional political culture deferential to authority", Mao Zedong, the chairman of the CCP, was absolutely powerful in controlling the party and the country (White, 1993, p.38). Mao claimed in 1965 that the main task of the party was the rectification of "those people in positions of authority within the Party who take the capitalist road" (Mao, 1977, p.103). He thought that China was embarked on a road towards revisionism (a route he was convinced that the Soviet Union had already travelled) that led him set powerful forces into motion in an attempt to overthrow the revisionists within the CCP. Furthermore Mao was alarmed at the return to what he thought were capitalist methods in agriculture and the emphasis on reforms based upon material incentives. He believed that the greatest threat to "his" socialist state was the rise of revisionist elements within the CCP and government bureaucracy. The only way to free China of these evil elements was to wage a class struggle from below. The base, chosen by Mao for the revolutionary movement, was a peculiar amalgam of high school and college students and urban workers, which were the so-called Red Guards.

Far from saving the country, the mass movements "degenerated into violence, factionalism and chaos" (Harding, 1993, p.149). The Red Guards chose as their targets teachers and school administrators, university professors and others whom they regarded as sources of the "four olds" – old ideas, old culture, old customs and old habits. The homes of the targeted groups were ransacked, their books burned, and they were often deported to "re-education camps", where they lived in miserable conditions. A climate of deep mistrust was created; it was no exception that children betrayed their parents.

Mao's revolution succeeded in eliminating the old regime, but let only chaos and disorder in its place (Nolan and Ash, 1995). China was thrown into a power struggle between on the one hand the so-called "Gang of Four", headed by Mao's fourth wife Jiang Qing, and Deng Xiaoping with his supporters on the other. Order would not be restored until Mao's death and Deng was able to finally seize complete control in the PRC.

The Cultural Revolution (1966—1976) caused a number of personal tragedies and violence. People were murdered, others committed suicide. Liu Shaoqi, the former president of China, died in prison because of the deprival of food and medical attention. The estimated number of deaths directly attributable to the Cultural Revolution varied, but ranged between 400.000 and 850.000 people with the most likely figure being perhaps half a million (Nolan and Ash, 1995).

In purely economic terms, industrial output fell dramatically in 1967 and agricultural output declined in 1968 as a result of disruptions, but these changes lasted for only one year. It seems that the effects of the Cultural Revolution were quite short-lived. However, Riskin (1987) questioned the reliability of the production figures for this period. In the Cultural Revolution, a large number of young people stopped their studies and were relocated from the cities to the countryside. Pyle (1997) reminded us of the long-term depressive effects that the Cultural Revolution had on those who were banned from schools and universities and whose education and training was not just disrupted but terminated. In other words, the human capital stock was reduced below what it would otherwise have been for many years to come.

All kinds of groups in society wanted a change from the Maoist dogma of the 1950s, 1960s and 1970s. These included the rural peasants who felt constrained by the commune system, manual workers in state enterprises who were frustrated by a system of rewards that did not relate pay to effort or skill, and an educated middle class who had suffered greatly during the Cultural Revolution. Their combined forces generated a mood in favour of change. White (1993) argued that the economic reforms were undertaken in order to please the dissatisfied population and take some of the attention away from the CCP. It was thought that economic gains would help to rebuild the credibility of the CCP and the government and to restore the confidence of the people in the ability of the party to govern.

The reform was by no means an accident; it reflected the deep feelings of politicians and the people about the terrible failure after the ten-year-Cultural Revolution, and the striking contrast between China's economic disaster and the outstanding economic performance of the newly industrializing countries nearby (Qian, 1999). As Deng remarked later: "We have a consensus on the policy of reform and opening up. This should be attributed to the 10 year Cultural Revolution, the lessons from this disaster are too profound" (May 25th 1988). "Without the lessons from the Cultural Revolution, there would be no new policies (since 1979).... The Cultural Revolution has become our wealth" (September 5th 1988). So here we see a fruitful combination of large parts of the population supporting political changes that were also in the interests of the powerful. For the latter the issue was how to keep control while reforming.

However, Deng did not generate a clear plan of how exactly economic and political reform should proceed. Indeed, the wishes and hopes of different groups about the kinds of changes that might take place were not necessarily consistent. On the whole, the people didn’t like what they had, but that didn’t mean that they knew what they wanted.

3.2 Formal Institutions

"*Cross the river by groping for the stones under your feet*" was the strategy of China's economic reform at its beginning stage, or in Deng Xiaoping's widely quoted phrase "anything may be tested as long as it is beneficial to the increase of social productivity, the country's overall strength and the peoples' living standards". As a result, China has pursued both an experimental and a gradualist approach to economic reform, which was in stark contrast to the "big bang" approach adopted by the countries of Eastern Europe in the 1990s. There was no real blueprint of how economic reform would proceed (Jefferson and Rawski, 2000; Pyle, 1997). It was not until 1992 that China established the goal of a socialist market economy and after that a new set of formal institutions was installed gradually.

3.2.1 Setting the goal for a market system

Before 1992 there was a widely held debate in China on whether the market economy was socialistic or capitalistic. During his southern trip in the spring of 1992, Deng made the point that "both plans and markets are economic means", saying: "Do not debate on this issue any more". "Carry out a reform so long as it is beneficial to the increase of social productivity, the country's overall strength, and the peoples' living standards". Following his remarks, the big ideological breakthrough occurred at the 14th Party Congress in September 1992 when the Party, for the first time, endorsed the "socialist market economy" as China's reform goal. "Market economy" is set as the goal and "socialist" in an adjective. It is different from "market socialism" which was advocated by some Eastern European reformers in 1970s and 1980s. In market socialism, the market is a simulated one to serve the purpose of socialism based on public ownership (Kornai, 1992).

In 1992, a grand strategy for the transition to a market system was firstly set out, which covered areas of taxation, the fiscal system, the financial system, enterprises and foreign trade. The final output was the "*Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure*" (Hereafter referred to as "Decision"). This document was so important that it has become the turning point on China's road to markets. Qian (1999) argued that this landmark document made four major advances in the areas of the reform strategy, a rule-based system, the building of market-supporting institutions, and the establishment of property rights and ownership structures.

Firstly, unlike the previous strategy of groping the way to reform that was considered optimal to China's transformation, the "Decision" document, for the first time in the history of China's economic reform, described the future road to the transition of Chinese socialist market economy. It emphasised the importance of coordination among various aspects of reforms, known as the "combining package reform with breakthrough in key areas" (Qian, 1999).

Secondly, the document called for the creation of a rule-based market system, replacing the system that is subject to the bargaining relationship between enterprises and the government. Chinese enterprises began to adopt the Western accounting rules. The foreign exchange rate and tax rates were equal for all enterprises regardless of ownership.

Thirdly, the document focused on the building of market-supporting institutions to incorporate best international practices, such as formal fiscal federalism, a centralised monetary system, and a social safety net.

Fourthly, the document addressed the enterprise reform issue in terms of property rights and ownership, rather than, as before, one of "expanding enterprise autonomy". It intended to transform SOEs into "modern enterprises" with "clarified property rights, clearly defined responsibility and authority, separation of enterprises from the government, and scientific internal management" ("Decision", 1992). It also, for the first time, opened the door to the privatisation of SOEs: "As for the small state-owned enterprises, the management of some can be contracted out or leased; others can be shifted to the partnership system in the form of stock sharing, or sold to collectives and individuals" ("Decision", 1992).

Setting the goal for the "socialist market economy" promoted the reform of China's ownership structure. The 15th Party Congress of September 1997 and the Constitutional Amendments of March 1999, made the major breakthrough on ownership issues. In the 15th Party Congress, state ownership was downgraded to a "pillar of the economy" and private ownership was upgraded to an "important component of the economy". Public ownership can have many "different realization forms", such as joint stock corporations with investment by many owners. At this time, the official ideology toward private ownership finally became "friendly" (Qian, 1999). Later, private ownership and the rule of law were incorporated into the Chinese Constitution in March 1999. An amendment of Article 11 of the Constitution placed private businesses on an equal footing with the public sector by changing the original clause "the private economy is a supplement to public ownership" to "the non-public sector, including individual and private businesses, is an important component of the socialist market economy" (China Daily, March 16th 1999). After the amendment, local governments started to relax local restrictions on private enterprises. Furthermore, Article 5 of the Constitution was amended to include the principle of "governing the country according to law" (China Daily, March 16th 1999). These Constitutional amendments demonstrated China's commitment to a full market system based on the rule of law.

3.2.2 Establishing the rule of law

The goal of the “socialist market economy” needed a fundamental change of the rule of the game. Ultimately, changing the government - business relationship into an arm's-length type required the establishment of the rule of law. Interestingly, the Chinese government separated legal reform from other “political reforms”, which allowed it to make considerable progress in a few years (Qian and Wu, 2000).

In 1996, China's parliament passed the “*Lawyers' Law*”, which was considered by many as a milestone for the legal reform. Public hearings, open trials, and even live TV coverage were made possible to broadcast the trial, although still at a limited scope. The Constitutional Amendment of March 1999 that incorporated the principle of the rule of law was another major development. It called for China's commitment to a market system based on the rule of law.

The rule of law is important not only because it reflects the government's will, but also because it sets the fundamental rule of the game in a modern economy, which leads to the reduction of transaction costs and the increase of the economic efficiency (North, 1990). “The economic advantages of the rule of law over ad hoc arrangements are transparency, predictability, and uniformity, which reduce idiosyncratic risks, rent-seeking, and corruption” (Qian and Wu, 2000, p.42).

There are two economic roles of the rule of law: constraining the government and defining the role of the government in the market economy (Qian and Wu, 2000). For thousands of years, China was subject to the “rule of the government” rather than the “rule of law”. If the role of the rule comes true, it will be a great help to China’s transformation from a power-based planned economy to a rule-base market economy. The *Administrative Procedure Law* (1989) and other Administrative regulation provided a foundation for a limited government by reducing government discretion and limiting corruption and rent seeking. Under those laws, individuals have the rights to sue the government. Recently, private businessmen and farmers began to use legal means to protect themselves against excess government fees. Furthermore, the rule of law announces that the government needs to protect private property rights, to enforce contracts, to create a fair business environment for competition, and to regulate the market if necessary. To achieve this goal, the government needs to become a neutral third party, abandoning its role of manager or administrator of economic activities under central planning (Qian and Wu, 2000). From 1998, a series of reforms in the government bureaucracy have taken place: the number of ministries in the central government was trimmed from 45 to 29, the number of civil servants was cut from 8 million to 4 million and the enterprise management functions were removed. With China's accession to the WTO and its commitment to grant market access to foreign banks and insurance companies, there is more need of prudential and transparent regulation.

In the past 25 years there were many changes in Chinese legislation. China has laws and regulation now for most of the economic behaviour. However, as in many other transition and developing countries, the most troubling aspect for China is not enacting laws, but enforcing them. Xiao Yang, former Chairman of China's Supreme People's Court, considered local protectionism as one of the main reasons for the weak enforcement in China, leading to what he called "judiciary localism" (People's Daily, September 3rd 1999). Judiciary local protectionism biases the judgment in dispute resolution in favour of the party belonging to the local community.

3.2.3 Macroeconomic policy

Since the reform got underway, China has experimented several stages of the change in maceroeconomic policy, which were quite closely associated with the reform process itself. Starting in 1994, a set of well-planned radical changes in macroeconomic policy was launched, avoiding the mistakes made in other transitional economies (such as the instability brought by “shock therapy economics”). So far, China’s progress has been steady.

3.2.3.1 The tax and fiscal system

Under central planning, all taxes were collected by local governments and then turned over to the central government. However, after the 1979 reform, local governments often used their authority to reduce or exempt taxes that were supposed to be paid to the central government (Qian, 2000). The fiscal contracting system was introduced between 1980 and 1993. Under that system, the central government collected the centrally fixed revenue, such as custom’s duties and taxes from SOEs that were supervised by the central government. All other revenues, which fell under the heading “local revenue”, were shared by the central and local government according to predetermined formula. However, the distribution of “local revenue” was not based on a general rule but on the predetermined formula, which was negotiated between the central and local government year by year. In fact, many local governments retained 100% of extra revenue. On January 1, 1994, China introduced major tax and fiscal reforms more aligned with international practices.

This reform introduced a clear distinction between national and local taxes and established a national tax bureau and local tax bureaus, each responsible for its own tax collection. The reform also established fixed tax rules between the national and local governments. For example, under the new system, the value-added tax (VAT) became the major indirect tax shared by the national and local governments at a fixed ratio of 75:25.

"*Budget Law*", which took effect in 1995, prohibits the central government from borrowing from the Central Bank and from deficit financing its current account[6].

[6] The current account shows international transactions that involve currently produced goods and services.

The central government can only have deficit financing in its capital account[7] although it had to finance the deficit with government bonds. It also imposed more stringent restrictions on local governments: Local governments at all levels were required to have their budgets balanced (as before), and furthermore, the law strictly controlled their bond issuance and restricted their borrowing in the financial market (a change from the past). To ensure enforcement of the "*Budget Law*", an independent auditing system was introduced. For example, in 1996 the State Auditing Agency audited the Ministry of Finance's implementation of the state budget for the first time since the founding of the People's Republic in 1949 (Dong, 1997). The 1994 tax and fiscal reforms were perhaps the most profound and comprehensive institutional transformation made in the time period and it made local governments' budget constraints much harder (Qian, 2000). After that, the share of the central government's tax income to national GDP increased from 12% to 18% over the past 25 years (The Economist, March 20, 2004).

3.2.3.2 The monetary and financial system

Before 1994, local branches of the Central Bank were jointly supervised by the headquarter of the Central Bank and local governments of the regions in which they resided. The local governments heavily influenced the bank system. For example, the local government usually forced the bank to give loans to local enterprises that performed poorly. After 1994, the Central Bank centralised its operation and the headquarters of the Central Bank became the sole supervisor of its local branches. Later in 1998, the Central Bank further replaced its 30 provincial branches with 9 cross-province regional branches and then minimized the local governments' influence on monetary policies. In the meantime, "*Central Bank Law*", which took effect in 1995, gave the Central Bank the mandate for monetary policy independent of the local government. These reforms substantially reduced the local government's influence on monetary policy and credit allocation decisions (Qian, 2000). The overall budget constraints of local governments became much harder.

"*Commercial Banking Law*" took effect in 1995. The banking system provided Chinese businesses with nine-tenths of their funding and whose total loans have ballooned to 145% GDP (The Economist, March 20th 2004). China's four state-owned banks, which accounted for more than 80% of total outstanding loans, have been corporatised. These banks began to adopt the international accounting standard for bank assets and risk management, and became more conscious of profitability and the quality of loans. They also started to compete with each other when their business dealings overlapped. Their operations came one step closer to conventional commercial banks after the Central Bank in 1998 abandoned the credit allocation ceilings and replaced them with standard reserve requirements,

[7] The capital account registers the flow of capital between China and other countries.

assets-liability management, and interest rate regulations (Qian, 2000). Following the old US model along the lines of the Glass-Steagall Act, commercial banking was separated from investment banking and insurance. No commercial bank was allowed to hold any share of stock in companies. Three different government agencies, the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC), now separately regulated commercial banks, security firms, and insurance companies. Meanwhile, the competition from foreign banks became tougher day by day. No foreign banks were allowed to conduct local currency business before 2002, but things have greatly changed after China's accession to the World Trade Organization (WTO) on December 11th 2001. Up to 2004, in nearly 200 foreign banks operating in China, 88 have got the approval to do RMB service. According to the commitments made by the Chinese government to the WTO entry, foreign banks will be permitted to go in RMB-dominated business in some Chinese cities beginning December 11th 2004. Moreover, for the first time ever, China allowed eligible foreign banks to provide Renminbi services to domestic enterprises from December 1st 2003. Previously, foreign banks were only allowed to provide Renminbi services to foreign enterprises and individuals as well as Hong Kong and Macao citizens. Meanwhile, the government signalled a welcome to "qualified strategic investors from abroad” to participate in the reforms and restructuring of Chinese financial institutions by announcing an increase in the equity share of a single foreign investor to 20% from the previous 15%. In 2003 foreign banks’ total assets accounted for 1,4% of total banking assets in China, up by 29,7% on a year-on-year basis. Their outstanding foreign currency loans in China amounted to US$16.4 billion, accounting for 13% of the nation's total (China Daily, December 1st 2003).

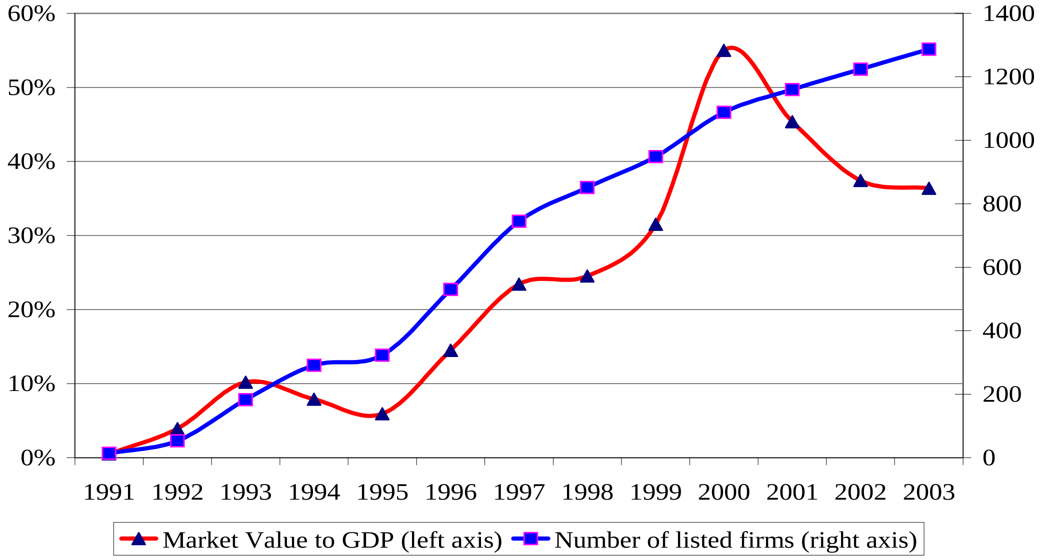
However, the governance (see Section 3.3) of the four state banks was not significantly improved after the commercialisation. In 1998, for the first time, several banks and investment companies, such as Hainan Development Bank and Guangdong International Trust Investment Company (GITIC), went bankrupt and were closed down. It is well known that the amount of non-performing loans (NPLs) in China’s banking is very high. This caused the delay of reform in SOEs and the governance of state banks. Lack of reform led the non-performing loan problem became worse and worse. According their 2003 annual reports from four state-owned banks, the total NPL problem was around US$232 billion, or 20,4% of 2003 total loans or about 16,5% of 2003 GDP.

3.2.3.3 The development of the Chinese stock market

The enterprises were no more than workshop/production units under the centralized system (Tam, 1999). The *General Civic Law of the People's Republic of China* (1987), for the first time, stated that SOEs and collectively owned enterprises were to be turned into legal persons (Article 41). But there were no concrete plans until 1993 when the government called for the creation of a modern enterprise system (*Xiandan Qiye Zhidu),* which meant an enterprise system that has "clearly clarified property rights, designated authorities and responsibilities, separated government and enterprise functions, and scientific management". The *Company Law* (1994) introduced the legal basis for the establishment and operation of companies as legal persons. 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 rules for mergers and bankruptcy.

The experiment of the corporate form built on shareholding started in 1980s. The origin of the stock market in the People's Republic of China (PRC) can be traced back to 1984. In that year, Shanghai Municipal Government approved regulation at provincial level on securities and later a household electronics company in Shanghai was given permission for issuing shares for the very first time since the foundation of People's Republic of China since 1949. In the following few years, more and more SOEs were corporatised, but their shareholders were confined solely to the employees and stock trading was prohibited. In December 1990, Shanghai Stock Exchange (SSE) was set up and five corporations were listed. Shenzhen Stock Exchange (SZSE) opened in April 1991. Initially the government defined the stock market as the financing channel to SOEs and claimed the capital market should serve SOEs' reform. So most Chinese listed firms are re-formed from SOEs and the state holds controlling rights. Later, the corporatisation and share-issuance of privatised large SOEs became the central element of the Chinese strategy towards the creation of a "modern enterprise system" (Berkman et al., 2003). Since the opening of two national stock exchanges, the Chinese stock market developed rapidly. *Securities Law*, which went into effect as of July 1, 1999, was enacted in order to standardise the issuing and trading of securities, to protect the lawful rights and interests of investors, to safeguard the economic order and public interests of society and to promote the development of the socialist market economy. The stock market has been used to support national industrial policy and to subsidise SOEs restructuring. The total number of listed companies increased from 14 in 1991 to 1287 in 2003. At the same time, a large number of firms is waiting to be listed. The ratios of the market value to GDP increased from 0,5% in 1991 to 55% in 2000 and then decrease to 36% in 2003 because of the growth of GDP and the decrease of the stock price, amounting to around $500 billion (see Figure 3.2). From 1991 to 2003, the China stock market absorbed over RMB 700 billion (about US$84.54 billion), being about 0,86% of GDP. The amount of financing is just lower than that in US over the world.

Figure 3.2 The Development of Listed Companies in China (1991 – 2003)



Source: Calculated from the statistic of China Securities Regulatory Commission (CSRC) (cited March 20th 2004)

The ownership structure of listed companies in China has some unique features. The government maintains ultimate control of the vast majority of these listed firms (Berkman et al., 2003). All shares are classified as domestic (A-shares) and foreign (B-, H-, N-) shares. B-shares are available exclusively to foreign investors and some authorised domestic securities firms. In 2001, the government allowed domestic investors who had foreign currency to buy B-shares. The B-share market is separated from the A-share market, with SSE B-shares denominated in US dollar and SZSE in Hong Kong dollar. H-Shares are issued and traded at the Hong Kong Stock Exchange; N-shares are listed on the NYSE. A-shares are divided into four subcategories: the state-owned shares, the legal person shares, the tradable shares and the employee shares. Only the tradable shares and B-shares are traded in the two open markets. The state, legal persons and individual investors are the three dominant groups of shareholders. The state shares are the largest part in the stock structure.

The shareholders of SOEs and the legal person shareholders are two types of controlling block holders. Both the state-owned shares and the legal person shares cannot be traded in the open market, but they can be transferred to legal and natural persons within and outside China under the permission of the China Securities Regulatory Commission (CSRC), the regulator of the securities market. According to the *Commercial Banking Law* of China, banks are not allowed to underwrite, hold and trade shares of firms.

Company Law (Article 152), which came into effect on July 1st 1994, defines the public company as follows: the number of shareholders, who hold shares of a par value totalling at least RMB 1.000, should not be less than one thousand; the percentage of shares issued to the public must account for over 25% of total outstanding shares for those whose total share capital is not less than RMB 50 million; the percentage should be over 15% for those whose total share capital exceeds RMB 400 million. Until July 1999, individuals were prohibited to hold more than 0,5% of total shares outstanding of any listed company; subsequently, the legal maximum for individual shareholders was increased to 5,0%. The legal maximum for individual shareholdings and the absence of cumulative voting procedures significantly enhanced the control rights of a firm's largest shareholder. These rights are not only exercised in the formal sense. In their report to the World Bank, Tenev and Zhang (2002) concluded that, in China, " . . . large shareholders often overstep the bounds of shareholder meetings and boards of directors and exercise direct effective control" (p. xiii).

3.2.4 The social security system

China's cultural tradition emphasises the importance of the public domain at the cost of the private and personal benefit. The planned economy inherited these values and organised social security inside the firms. Most Chinese worked in the same enterprise for all their lives and depended on the enterprises for their employment, free housing, free medical care and other fringe benefits. It was then not necessary to set up a public social security system. After 1978, the government introduced more market-like reforms of SOEs: bankruptcy and "free"-market-style M&A became possible. However, because there was no social security system for released workers, the experiment of bankruptcy had to fail (see Chapter 4). Moreover, the establishment of the social security system is also essential for the development of non-state-owned enterprises.

Starting in 1994, China's social security system has been set up gradually but is still incomplete. The social security system mainly concerns urban residents and consists of four programs on pension, health care, unemployment insurance, and minimum living standard support respectively. The progress is more slowly in the rural areas. The operation of the social security system follows the "pay-as-you-go" principle. In this principle, the pension should be jointly paid by the employers and employees. The employee will be paid back when he or she retires or leaves the city where the work was located. In 1997, the State Council introduced the following framework: the mandatory amount of 11% of the payroll should go to individual accounts, of which 8% is contributed by employees and 3% by enterprises. But the local governments were allowed to improve the level to the amount of payroll according to the local situation. For example, in Shanghai, employers must contribute 22,5% of the total payroll to the Shanghai Pension Bureau while employees contribute 8% of their total payroll to the Pension Funds. Because deficits of the basic pension fund have to be financed by the local government, a higher payment ratio is usually preferred. The pension is administered by the local government agency, such as the Social Insurance Administration Centres. No private firms, such as commercial insurance organisations, are permitted to administer the social security. Individuals may also join the "fully funded" program held by commercial insurance organisations, in which individuals pay pension and arrange the payback period by themselves.

Several years after the introduction of the first social security regulations, quite a few employees in different kind of enterprises, self-employed professionals, and individual business owners have participated in the schemes. At the same time, the government encourages employers to implement supplementary pension schemes. However, several serious problems remain unsolved.

The first is that China does not have a uniform national social security program. Rather, provincial and municipality governments are responsible for implementing their own local programs. The second problem is the compensation for the elderly and retired employees. They contributed a lot with low wages in the old system, but now cannot contribute sufficiently because of their low retirement pay. Many old industrial cities having higher proportions of elderly and retired employees face serious problems in reforming the pension schemes. The experiment of using parts of state assets or government bonds for compensation, such as selling state-owned shares to the public, failed in 2002 and 2003, because stock prices decreased sharply. Consequently the local government has to use the premiums for the pension of new employees to pay the current retirees. The third problem is the high premium for the pension: on average 28% of payroll is needed which has a dramatic effect on the labour costs of enterprises. Consequently many entrepreneurs are unwilling to pay for their employees. In order to keep their position, many employees, especially the ones from rural areas, have to accept their boss’ illegal behaviour, which will certainly create problems for the future.

3.3 The Governance Structure in China’s Transformation Economy

The ever-greater roles played by markets and pecuniary incentives, and the increasing decision-making authority of localities, enterprises and individuals, have been central elements of China’s economic reforms (Putterman, 1996). China is on its way to establish a socialist market economy, in which a radical transformation of property rights, including a *de facto* private agriculture, restructuring of SOEs and the growth of private enterprises, play a crucial role. Now China is moving into the direction of a Western style of entrepreneurship. It is appropriate to pay attention to the ideas that underpin the adequate structures of corporate governance. How should firms be managed, who should take the decisions, who is accountable in what way? Shleifer and Vishny (1997, p.737) stated: “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”.

3.3.1 Corporate governance: some perspectives

The emergence of corporations, characterised by the separation of ownership and control, is considered by the NIE the result of an endogenous, evolutionary process based on voluntary exchanges of private property rights in pursuit of gains from specialization (Fama and Jensen, 1983; Groenewegen, 2004). Various corporate governance mechanisms have been developed to safeguard owners' interests from managerial infringement. In particular, the existence of outside shareholders, a well functioning financial market (market for corporate control) and a sound legal system protecting investors, are crucial to an effective corporate governance (Hart, 1995; Shleifer and Vishny, 1997).

3.3.1.1 The nature of corporate governance in market economies

The Principal-agent Approach

Corporate governance has traditionally been analysed in terms of the principal-agent problem. The principal-agent relationship is defined as a contract under which principals engage the agent to perform some service on their behalf, which involves delegating some decision making authority to the agent (Jensen and Meckling, 1976). Objectives and information are different between the actors. Opportunism and bounded rationality are assumed present. Ideally investors and managers would sign a complete contract that specifies what managers should do with the funds and how returns should be divided. However, the agent will not always act in the best interest of the principal. The principal then has to spend on monitoring cost and/or pay the agent’s bonding cost in order to guarantee the agent not to take actions that would harm the principal (Jensen and Meckling, 1976). On the other hand, the future is hard to predict making complete contracts infeasible (Shleifer and Vishny, 1997). Hart (1995) suggested that governance structures could be seen as a mechanism for making decisions that have not been specified in the initial contract.

The Transaction Cost Approach

Transaction Cost Economics does not conceptualise the firm as a production function or a nexus of contracts, but as a governance structure (Williamson, 1985). Williamson followed Coase (1937) in characterising the firm as a hierarchy in which authority plays a crucial role. Managerial oversight and the possibility to take decisions based on “fiat” reduce the transaction costs of certain types of transactions. When the transaction is well identified (using frequency, asset specificity and uncertainty as dimensions) then TCE can predict which governance structure will minimise the transaction costs. That can be a straightforward market contract, a hierarchy, or a hybrid form. All forms of coordination bear transaction costs: planning, trust relations and markets. "Planning is necessarily incomplete (because of bounded rationality), promise predictably breaks down (because of opportunism), and the pair wise identity of the parties now matters (because of asset specificity). This is the world of governance" (Williamson, 1985, p.32).

Williamson (1985) explained how endogenously the power in the firm would be and should be located in the hands of the suppliers of risk capital: the shareholders should control the firm because of the high asset specificity of their capital supply. In an efficient corporate governance system the shareholders are represented in the board of directors. Moreover, a transparent market for corporate control is needed where firms can be bought and sold by (hostile) bidding (Groenewegen, 2004).

The Stakeholder Approach

In the literature it is common practice nowadays to contrast the "shareholder value approach" with the one of the "stakeholders". Cochran and Wartick (1994, p.9) defined corporate governance as

> *"…an umbrella term that includes specific issues arising from interactions among senior management, shareholders boards of directors, and other corporate stakeholders."*

Kester (1995, p.5) stated:

> *"Corporate governance system means the entire set of incentives, safeguards, and dispute resolution process that orders the activities of various corporate stakeholders, each seeking to improve its welfare through co-ordinated economic activity with others."*

Blair (1995) argued that corporate governance should be regarded as the set of institutional arrangements for governing the relationships among all of the stakeholders that contribute firm specific assets. The idea is that not only shareholders make asset specific contributions to the firm, but also employees, suppliers, local government and customers can do so. Consequently all stakeholders should be represented in the decision-making bodies of the firm in order to protect their stake in the firm. The firm is then considered as a coalition of different interests that has a value and identity of its own. Though it is impossible to satisfy every interest of every stakeholder, it is important that stakeholders are confident that companies will deal with their interests (Kaptein and Van Tulder, 2003). This view of the firm differs from the NIE view of agency theory and TCE because the firm is conceptualised more as an evolving set of capabilities that is path dependent. The flexible world of NIE is then replaced by a world of lock in (see Chapter 1 and 6).

3.3.1.2 Corporate governance in China

In China, the corporate governance issue began to arouse intensive attention in the late 1980s and was introduced to China at the end of 1990s. Chinese policy makers aim at establishing a Modern Enterprise System (*Xiandai Qiye Zhidu*). The way in which Chinese economists define corporate governance (*Gongsi Zhili*) shows a close connection to the world of NIE. A few examples to illustrate:

(1) "Corporate governance means the organizational structure consisting of owners, the board of directors and senior managers. A check and balance relationship is formed within that structure, through which the owner entrusts its capital to the board of directors" (Wu, 1994, p.185).

(2) Corporate governance is the organizational structure consisting of the owner, board of directors and senior managers (Mei, 1994).

(3) Corporate governance can be interpreted to mean a company's system of organization and system of management (Qin and Li, 1995).

(4) "Corporate governance can be narrowly defined as the arrangements concerning the functions and structure of the company's board of directors, and the power of shareholders. Its broader definition refers the entire legal, cultural and institutional arrangements for the allocation of rights over the control of the firm and residual claim…. Therefore under the broad definition, corporate governance structure and the arrangements for firm's ownership rights are identical in meaning" (Zhang, W., 1996, p10).

Interesting is the issue of the "state versus enterprise relations": how to enhance enterprise efficiency by striking a balance between state obligatory plans and the enterprise self-initiative (Lin, C., 2000). On the one hand China remains a controlled economy with the state as the central actor in control of long-term structural developments; on the other hand the reforms introduce more autonomy of firms and the introduction of market type of systems of corporate control.

3.3.2 Privatising agriculture

China's agriculture was collectivised in 1955-56, and the People's Communes were established in 1958. Under the commune system and since 1962, the production team, which consisted of about 50 households, was the basic unit of production and distribution; the commune had the authority for allocating quotas for growing rice or cotton. This system had survived for about 20 years.

Agricultural reform is generally considered to be the first successful reform in China. After 1978, the "household responsibility system" had been widely introduced into China's agriculture. In this system, households were allocated a fixed amount of land and had a specified output target. Riskin (1987, p.288) described this system as resembling "tenant farming with the collective and state as the landlord". It is noticed that the land was distributed to leaseholders primarily on the basis of the household, but not on the basis of the individual. It shows the strong influence of family-ism in Chinese culture. The family has always been a basic working unit of society and the individual's benefit is affiliated to the family. Kojima (1988) reported that 70% of land was distributed to households. Households were allocated a fixed amount of land and could retain any surplus after paying taxes to the state. By the end of 1982, 80% of households had adopted the household responsibility system nationwide, and by 1984, almost all of them had done so. By that time, the contracts of the household responsibility system were all extended to a period of beyond 15 years. The township government had become one of government administration and their former role in economic management of the countryside had largely disappeared.

Under the household responsibility system households became residual claimants and obtained almost all control rights over production, except for the right to dispose of land. In the agricultural product market, the state largely abandoned its monopoly purchasing system and markets played a much more important role. The farmers were obliged to fulfil the quota of grain to sell to the state at the list price. Any purchases in excess of the contract sum were to be sold at the market price, which was normally higher than the list price. Normally 30% would be bought at the list price and 70% at the above quota price (Pyle, 1997). Moreover, the state substantially increased its purchase prices for agricultural products after 1979 following market prices.

China's agricultural output grew at an unprecedented rate: the growth rate of crop output value was doubled after 1978 to 5,9% per year. Economists attributed the growth to the incentive effects of the household responsibility system and increases in agricultural procurement prices. J. Y. Lin (1992) estimated that about 42% of the supply changes in Chinese agriculture between 1978 and 1984 could be attributed to the adoption of the household responsibility system and only about 16% of the response was due to increases in state procurement prices. The remaining 42% goes to the technology improvement, the availability of inputs and other factors. McMillan et al. (1989, p.782) arrived at the conclusion that "78% of the increase in agricultural productivity in China between 1978 and 1984 can be attributed to the new responsibility system and 22% to higher prices".

But there are also critical remarks to be made on the agricultural reform. Perkins (1994, p.28) believed that "households are natural profit maximisers… provided they have the right to keep the income that is earned". In the 1990s, the rate of return in farming decreased because of the inflation of input prices, such as fertilizer. The output growth of grain production slowed down because of farmers' switching from grain production to higher value activities, such as forestry, animal husbandry and fishery. More important is that the absence of a clear property right structure had a negative effect productivity and efficiency. Farms signed a 15-year lease agreement on a plot of land with the government. There were only vague promises that leases would be extended beyond 15 years and that farmers could pass the rights to use the land on to their children. As a result, farmers would be reluctant to invest in improvements of the land due to future uncertainties. The lack of infrastructure investment is one of the most obvious evidences. Liu (1994) argued that a privatised agricultural system in China couldn't produce the required level of investment in land levelling, soil improvement and, above all, irrigation. The distribution of the land was primarily on the basis of households and the market of land was not allowed to work causing China's agriculture to be of a small inefficient size.

A more serious problem was the limited area of arable land, which is the most important item of agricultural fixed capital, declining sharply after 1980s. Ash (1993) attributed it to the encroachment by private and public enterprises, and by house building, abandonment of crop production as well as soil erosion and desertification. As a result, more and more households gave up farming. Some people set up rural industrial enterprises, which became well known as Town and Village-owned enterprises (TVEs), which boomed at the first half of 1990s. But many peasants left their hometown and tried to find new jobs in the cities.

3.3.3 Restructuring China's industry

The greatest change in China's industry is the restructuring of state-owned enterprises (SOEs) and the development of a non-state sector. The China State Statistics Bureau (2004) presents data for seven different classes of enterprise ownership: individual ownership, private ownership, foreign ownership, joint ownership, shareholding corporations, collective ownership, and state ownership (see Table 3.4). Each of them is subject to different laws and regulations (Figure 3.3). However, information is not uniformly available to analysts for all indicators of these classifications; frequently, some of the ownership categories are aggregated as "other types of ownership" (Asian Development Bank, ADB, 2003). Moreover, there were breaks in the series due to changes in composition of the reporting firms and to periodic clean-ups of data series, for example in 2000. Our analysis will focus on state-owned enterprises, private enterprises and shareholding corporations. These types represent the main pattern in Chinese industry. This section will depict the restructuring of state-owned enterprises and the development of collective and private ownership. The governance structure of the shareholding corporations will be analysed in Chapter 6.

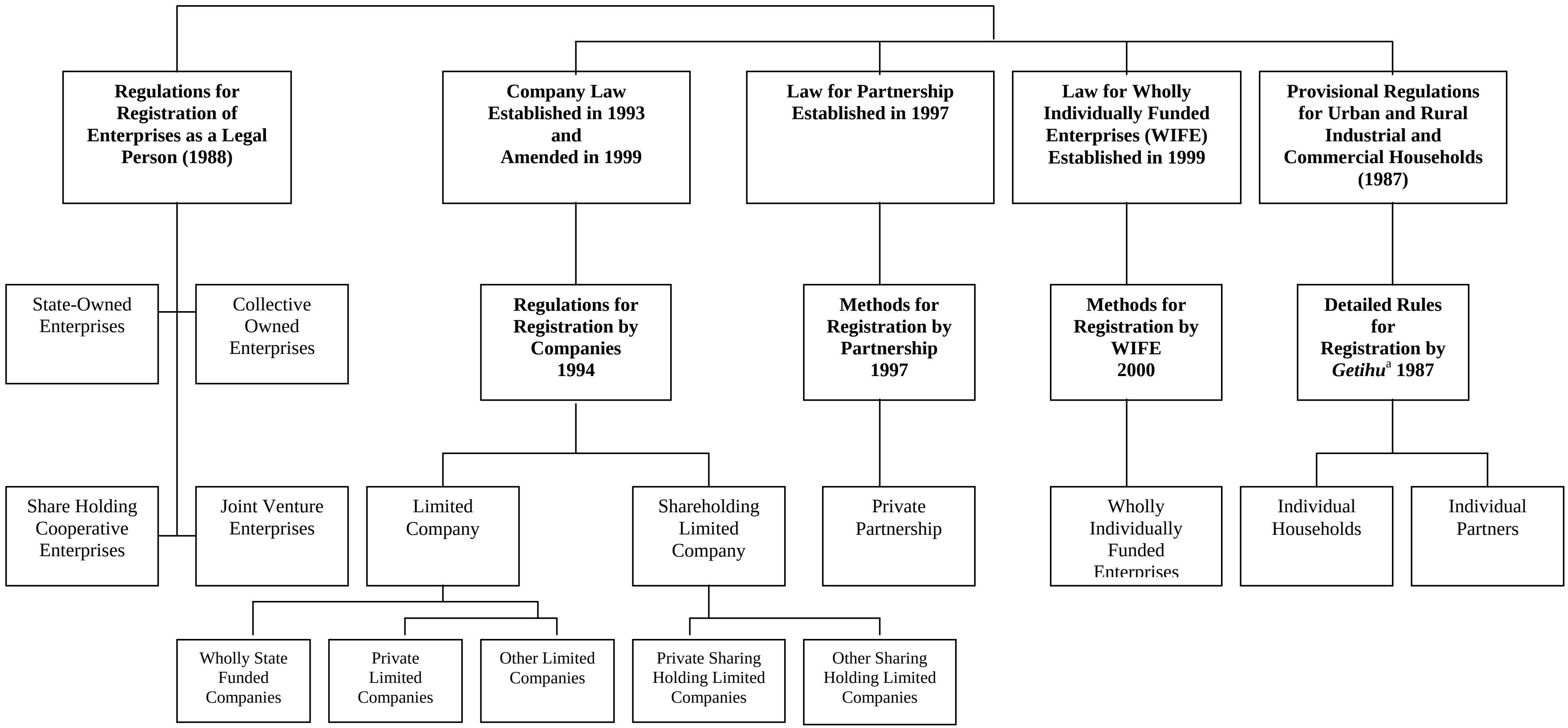
Table 3.4 Classification of Enterprises by Ownership

Wholly Domestically Funded	**Foreign-Funded***
State-owned enterprises	Joint ventures with domestic firms
Collectively owned enterprises	Cooperatives with domestic firms
Shareholding enterprises based on a collective system	Shareholding corporations
Limited liability companies	Wholly foreign funded
Joint ventures of domestically owned firms	
Shareholding corporations	
Private-owned enterprises	
Others	

* These include enterprises invested by foreign investors and investors from Hong Kong, Macau and Taiwan. Although the regulation makes this distinction between these two groups of investors, for the purpose of this study, these firms are analyzed as one category. For all practical purposes, these firms face similar policies and regulations and share many common characteristics.

Sources: China State Statistics Bureau (2004) and ADB (2003)

Figure 3.3 Laws and Regulations for Wholly Domestically Funded Enterprises and Businesses



Note: a: *Getihu*, which is a diminutive of gongshanghu, denotes a single industrial and commercial proprietor. These individual businesses cannot employ more than eight people and are commonly referred to as individual employed or self-employed. Although *Getihu* businesses are owned by private individuals or households, they are not legally considered as enterprises, and are therefore excluded from the official definition of private enterprises.
Source: Asian Development Bank (2003, p.70)

3.3.3.1 Restructuring state-owned enterprises

State-owned enterprises (SOEs) are enterprises established by the government and owned by "all the people of China" and managed by government-appointed bureaucrats. The administrative superior could be the central government, the local government or the Ministry of Industry. State-owned enterprises (SOEs) are the pillar of the Chinese economy. Although the share of SOEs in the Chinese economy declined from 75% in the late 1970s to about 28% in 2000, SOEs recently still accounted for some 44% of the country's urban employment, and for as much as 70% of government revenues (The Economist, September 4th 2000). Large-scale SOEs still constitute the backbone of the economy in sectors such as wholesale commerce, transportation, communication, and banking.

Reforming SOEs has always been a priority in the reform process in China, which aimed at enhancing the efficiency of SOE. From 1979, the "profit responsibility system", the "tax substituting for profit remission" and the "managerial contract responsibility system", were respectively introduced to provide profit incentives for managers (see Chapter 6). It had limited success by some measurements, for example, in increasing the enterprise productivity (Groves et al., 1994). To further toughen up the "soft" budget constraint, a bankruptcy law was enacted in 1986, but it was rarely used against SOEs. The government enacted the *Enterprise Law* in 1988, which was the first law on SOEs. It made SOEs legally responsible for their own profits and losses. From 1992, China's SOEs reform has been the key point of economic system reform. The focus of SOE reform shifted to the ownership and governance issues. All large SOEs were corporatised. They were converted into wholly state-owned companies, wholly state-owned holding companies and joint stock companies. With the development of the capital market in China and the statement of the central government that the capital market should serve SOEs reforms, more and more SOEs have entered the capital market. They can issue short-term or long-term bonds in the market. They can finance through the repurchase of treasure bills. They also may issue their shares in the stock market and become a listed company. However, state-owned stocks that account for about half of the total equity of all listed companies cannot be circulated. In essence, the governance structure of listed companies with controlling shares held by the state is still characterised as a governance structure typical of state-owned enterprises.

In the governance structure of SOEs, the government is the representative of "the whole people" and plays a key role. The role of the government is not only reflected via its interference with firms' operation decisions, but is also expressed in the authority to appoint operators and managers, the authority to examine and approve major decisions made by the enterprises, and the authority to exercise external supervision over the operational activities (Chen and Huang, 2001). A survey conducted in 2000 by the Chinese Entrepreneurs' Survey System showed that since 1979, government appointments have always been the principal form of choosing and promoting operators of state-owned enterprises, accounting for about 76 to 80%. Another survey conducted by the Chinese State Economic Restructuring Office indicated that the general managers appointed by the board of directors accounted for 30%, and those appointed by the government or the competent departments for 70% (Chen and Huang, 2001). Due to the not circulating and high percentage of state-owned shares in the stock structure, transfer of control primarily takes place via a contractual transfer of state-owned stocks and not via trading in the secondary market[8].

Systems of corporate governance should discipline managers in such a way that the interests of the stakeholders are served. This can be realised via a two-tier system as known in Germany and the Netherlands where a supervisory board monitors the management board. The Anglo-Saxon solution is appointing non-executives as member of the board of directors. Moreover, internal disciplinary mechanisms can be complemented by the control of workers councils. Next to the internal mechanisms, external mechanism may also monitor management; the market for corporate control being the most important one. In practice the monitoring of management has shown to be costly and incomplete. All recent scandals in Western Europe, the Anglo-Saxon countries and Asia show that it is not a problem specific to a specific economic system, but a worldwide phenomenon.

Also the transition economy of China faces problems to control management. The separation of decision taking and decision control (Jensen and Meckling, 1976) is hard to realise. Often the same person serves as both the chairman of the board of directors and as the general manager. A survey conducted by Tenev and Zhang (2002) showed that two-thirds of all directors are executive directors and only 3,1% have some degree of independence. About half of the executive directors have a senior management position. The overlapping rate of board members and company managers (expressed as the ratio of managers on the board of directors to total number of board members) of listed firms was 54,8%. Wu (1994) pointed out that the basic character of China's SOEs governance could be summarised as "insider control" under administration intervention. About "insider control", Aoki (1994a) stated that in a transitional economy, which was shifting to a new structure, enterprise managers had obtained irreversible authority. Taking advantage of the vacuum in supervising and restricting power after the disintegration of a planned economy, managers have further intensified their control and "have mastered the control authority *de facto* or according to law, with their interests fully reflected in the corporate strategic policy decisions" (Aoki, 1994b, p.20).

In the meantime, there is a lack of effective monitoring of management. Because of the highly centralised equity, the degree of participation in controlling corporate operational policy decisions by small and medium-sized shareholders is quite low, and these shareholders, lack the motivation and means to monitor management

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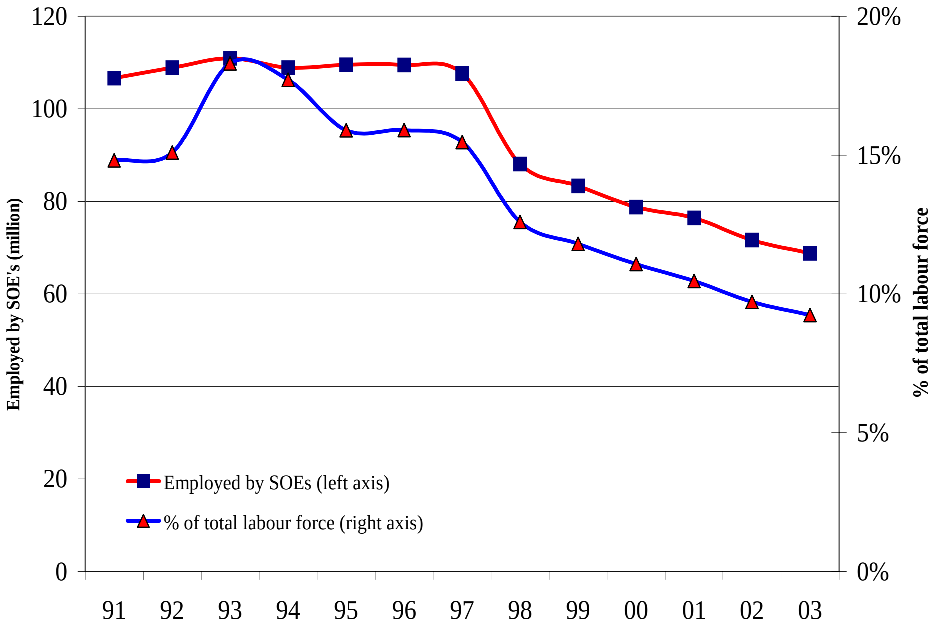
[8] The primary market is the market where governments and corporations initially sell securities. The secondary market is the market where already-existing securities are bought and sold.

(free rider problem). In recent years, both the number of shareholders present at shareholder meetings and the percentage their shares account for, are decreasing. In 2003, annual reports of listed companies showed that there are 47.000 shareholders on average in each listed company. However, only 12 shareholders or agents on average presented at shareholders meetings holding shares representing 55,96% of the total shares. Most minority shareholders do not exercise their voting rights (People's Daily, May 12th 2004). As a result the decisions made in shareholding meetings benefit the majority shareholders, such as for example the transfer of assets to the holding company for a low price. Without effective monitoring from the outside, misbehaviour of managers contributes to the failing of enterprises, such as extending the scale of production without clearly defined objectives. Neither the employees as shareholders nor the board of directors have the ability to monitor the managers and their business decisions.

In literature often a relation is made between the long-term interests of the manager in the company on the one hand and his remuneration and the number of shares he holds on the other. In the Chinese SOEs the relationship is not very promising. The remuneration system of managers in SOEs provides little incentive to develop a long-term strategy (Tylecote and Cai, 2004). It is not only the relatively low level of remuneration of enterprise operators and managers, but also the relative monotonousness of the remuneration structure for most managers of state-owned enterprises. A survey conducted in 2000 by the Chinese Entrepreneurs' Survey System showed that the percentage of managers whose annual wages were more than RMB 60.000 in private companies, foreign-funded enterprises and enterprises involving Hong Kong, Macao and Taiwan investments, was 50,8%, 38,4% and 27,3% respectively. But it was only 4,5% in state-owned enterprises (SOEs). Also the number of shares held by management is relatively low with accompanying consequences for the incentives. According to the first regulation of the listed companies— "*Interim Provisions on the Management of the Issuing and Trading of Stocks*", which was issued by Order No.112 of the state council on April 22, 1993, no individual is allowed to hold more than 0.5% of the common shares issued by a listed company (Article 46). In 2003, the legal maximum for individual shareholders was increased to 5,0% Our empirical study shows that the mean percentage of managerial ownership is just 0,03% (see Chapter 5). The normal remuneration of managers in SOEs and the number of shares hold by them, fail to provide an effective incentive. On the contrary: the governance structure leads to excessive "on – the – job –consumption and invisible earnings" (Chen and Huang, 2001). Some managers enjoy luxury cars and expensive hotels while their firms are going bankrupt.

However, reform of the SOEs is probably the most difficult task that faced and still faces the Chinese reformers. After twenty years of restructuring, the most successful SOE reforms are perhaps the privatisation of small-sized SOEs and the layoffs of redundant employees in the mid-1990s (Qian, 2002). Privatisation of small-sized SOEs started by local governments as experiments, first in a few provinces such as Shandong, Guangdong, and Sichuan as early as 1992 (Cao, Qian, and Weingast, 1999). Later, the central government endorsed it under the policy of "*grasping the large and releasing the small*." Millions of redundant SOE workers have been laid off since. After reaching a peak in 1993, the total state employment in China (including both civil servants and SOE employees) started to shrink. By 2003, it dropped about 37.88 million compared to 1991 (see figure 3.4.).

Figure 3.4 The Number of State Employment (1991 – 2003)



Source: calculated from Annual Report of Labour and Social Security (1992-2003).

However, the core of the SOE sector – the large-scaled enterprises (including those already listed on China's two stock markets) – remains a problem. Many reforms were implemented but did not work well or did not work at all. Though SOEs remain the main revenue source for the government (they account for more than one half of total government revenue), they also represent a big financial burden. The financial performance (i.e. profitability) of these enterprises continued to decline. On average, profits and taxes per unit of net capital stock[9] and working capital[10] in state industrial enterprises fell from 24,2% in 1978 to 12,4% in 1990 and further down to 6,5% in 1996 (China Statistical Yearbook, 1997). In 2000, there was constantly more than one-third of SOEs in the red (Qian, 2002). The poor

[9] Net capital stock means fixed assets.

[10] Working capital, synonymous with net working capital, means current assets minus current liabilities.

financial performance of SOEs is also responsible for China's banking sector problem.

Qian (1999, 2000, 2002) explained the problem in China's corporate governance from a transitional economy perspective. Qian (2002) pointed out that China's corporations suffered from the conflict between the old governance structure (i.e., the Party committee) and the new structure (i.e., the shareholder meeting, the board of directors, and the supervisory committee) (see Chapter 6). The new corporate governance is hard to establish with the government acting as a "super owner" (Qian, 2002). The key problem is the government's control over the appointment of SOE managers. The government has exercised its control over the selection and dismissal of SOE managers through its human resource department at different levels. For example, the Central Government Organization Department (the level of the minister or deputy minister) has the authority to appoint the top managers of very large SOEs, as does the Provincial or Municipality Government Organization Department (the level of the bureau chief or deputy bureau chief) for most large and medium-sized SOEs. This authority applies to joint-stock companies as long as the state has the majority share, even if they are listed on the stock market or are located in the special economic zones. The appointment and dismissal process represents the most important channel of political influence on enterprises by the Party.

In Qian's opinion, China's corporate governance reform can be regarded as a process composing of three stages: corporatisation, rearrangement of corporate control rights, and privatisation. Taking political constraints into account, the first two measures are practicable, but privatisation is still not feasible. However, informal and implicit privatisation seems more acceptable to the government and the public. So some enterprises are collectively owned enterprises in the name, but in fact controlled by an individual. Qian (1999) pointed out that, no matter which corporate governance system China will adopt, it should satisfy three conditions. First, it should be feasible in politics and will not lead to government administrative intervention or resistance. Second, it should increase manager's responsibility and limit intervention from the administration. Third, it should be helpful in reducing the ratio of state-owned shares.

W. Zhang (1996, 1998 and 1999) explained the problem in China's corporate governance from an agency perspective. W. Zhang (1998) argued that the Chinese SOEs' reform only solved the short-term managerial incentive problem, but not the long-term ones and neither the management selection problem. An incumbent manager may have incentives to make short-term profits but because he/she does not know how long he/she stays with the company, an incentive to apply a long-term horizon is lacking. A problem is not unique to the Chinese economic system by the way (Groenewegen, 2004). However, at present there is no mechanism to ensure that only qualified people are selected for management positions. The fundamental reason being that "bureaucrats" rather than "capitalists" select managers of SOEs. Since bureaucrats have the authority to select managers but do not bear the consequences of their selection, they have no proper incentives to find and appoint competent people. Since good performance does not guarantee incumbent managers a long stay, the manager does not have long-term incentives. Also other factors, such as political factors and *Guanxi* with bureaucrats play a role. W. Zhang (1998) also argued that these built-in problems of state ownership couldn't be solved by state-dominated corporatisation. 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 competent people will be professional managers and that managers are well disciplined, the authority of selecting management must be transferred from bureaucrats to stakeholders. W. Zhang (1998) called for privatisation of both state enterprises and state banks.

Several empirical studies support Zhang's idea. Xu and Wang (1999) used the data from listed companies in Shanghai Stock Exchange and Shenzhen Stock Exchange to analyse the relationship between the performance of listed companies and variables such as the ownership concentration, and the presence of large institutional investors. They found that the higher the ratio of state-owned shares, the worse the performance; the higher the ratio of legal-person shares, the better the performance; there are no relations between individual shares and the performance of enterprises. Y. Lin (1995), Berkman et al. (2003) concluded that the firm value was improved for a sample of Chinese listed firms after the transfer from government controlling agencies to legal person shareholders. In a case study, W. Zhang (1999) found that the higher the ratio of state-owned shares, the lower the commitment of the board of directors. As to the above results, Xu and Wang (1999) explained that legal person shareholders have played a positive role in monitoring the management and improving firms' performance for they had a large enough interest in the firms and ensure managers to work in the interest of shareholder through direct control. (Berkman et al., 2003) suggested that corporate governance could be improved by including private block holders in the ultimate ownership structure, which more closely aligns cash-flow rights with control rights.

The above findings imply to stimulate legal-person shareholders and to strengthen the importance of monitoring. Just as W. Zhang (1999) pointed out the state could not be a qualified shareholder, neither does the state nor its representatives have the right incentives to monitor managers of SOEs. Thus, legal-person shareholders should play an important role in governance, but because the state would then loose control the feasibility of such a drastic reform should be questioned.

There are also some other explanations by Chinese economists of the failing system of corporate governance. C. Zhang (1998) argued that the misgovernance of SOEs in China resulted from its financing mechanism. He pointed out that the capital in Chinese firms could be grouped into two parts: State-owned capital and civilian-owned capital. To monitor insiders, it is suggested that the financing institutions should also be reconstructed into two parts: an administration institution for state-owned capital, and different financial intermediaries (such as mutual funds) and competitive financing markets for private capital. Y. Lin (1995) argued that the core of the reform of SOEs was to create a fair competitive environment and a hard budget constraint. Similar to Alchian (1950) and Stigler (1958), Y. Lin (1995) argued that in the long run, product market competition would force firms to minimise costs, and as part of this cost minimisation to adopt rules, including corporate governance mechanism, enabling them to raise external capital at the lowest cost. However, different from Achian and Stigler, Jensen and Meckling (1976) pointed out that the competition in product and factors market couldn't eliminate agency cost stemming from managers' inside control. Furthermore, because managers hold only few shares in their enterprises and will not be hold responsible for the potential bankruptcy, pressure of market competition does not make managers to reduce production and transaction cost. They will try to promote sales and cut prices, which leads to so-called "vicious competition" (Zhang, W., 1999).

3.3.3.2 The expansion of non-state-owned enterprises

The problems of corporate governance in SOEs mainly lie in insider control, lack of manager incentives, wrong election mechanisms and the relationship among large shareholders, small shareholders and debtors. Furthermore, lacking legal protection, the collusion between the management of listed companies and large shareholders or institutional investors harm small investors. Solving these problems is the most difficult task that faces the Chinese reformers. Fortunately for China, the vibrant non-state sector has grown so fast that the problem of the state sector became less critical. The 16th Party Congress of November 2002 launched the new policy of "readjustment of the layout of the state economy" narrowed down SOEs' scope dramatically. SOEs would withdraw from most industrial and service sectors. The new policy also called for the diversification of the ownership structure of those enterprises over which the state still wanted to maintain control, except for a few special sectors (such as military industry). All other enterprises would become joint stock companies with multiple owners. These new owners could be either domestic private investors or foreign investors, and the companies could be listed on the domestic or foreign stock markets.

Most of the current research in China on corporate governance focuses on SOEs' corporate governance and its implications for reforms, but seldom deals with non-state-owned enterprises' corporate governance. In fact, non-state-owned enterprises, which encompas collectively owned enterprises, private enterprises and foreign-funded firms, developed very quickly in the past few years. The ADB (2003) reported that the share of GDP produced in the non-state sector in 2002 exceeded two thirds of GDP, with the share produced by the truly private sector comprising more than half. Of course, the corporate governance mechanism in private enterprises is quite different from that in SOEs (see the last section in this chapter).

China differs from Eastern Europe and most other developing economies in an important respect: in the first fifteen years of reform between 1979 and 1993, the driving force of China's growth were neither private firms nor state firms (i.e., national government firms), but the collective enterprises (i.e., local government firms). In 1993 the collective enterprises contributed to 42% of the national industrial output (China State Statistics Bureau, 1994). After 1993, the collective enterprises were privatised or re-classified as private firms and private firms became the engine of growth in the late 1990s.

The collective enterprise (TVEs)

The collective enterprise is a special type ownership in China. Without the early contributions of the collective enterprise, the performance of China's reform would have looked very different in the early phase of economics reforms. In *Regulations for Classifying Registration and Licensing of Enterprises by Ownership* (State Administration for Industry and Commerce and China State Statistics Bureau, June 6th 2004), it is defined vaguely as the enterprise whose assets are owned by the collective. Unlike state-owned enterprises, which are nominally owned by "the whole people", the collective enterprise is nominally owned by a group of individuals who hold a joint and indivisible ownership over property (Putterman, 1996). The "sponsor", usually another company, a social organisation, or the local government, supplies the initial capital of a collective enterprise. Collective enterprises are well known as the Town and Village-owned enterprises (TVEs). The crucial feature of TVEs is the control by the local community in contrast to control by private actors or the national government (Chang and Wang, 1994; Li, D., 1996; and Che and Qian, 1998a). Weizmann and Xu (1996) described them as vaguely defined cooperative enterprises with the township government as their "leading government". China's rural industrialisation and local development benefited from the expansion of TVEs (Qian, 2002). TVEs, which numbered 1.5 million at their peak in 1993, contributed to rapid industrial growth in rural areas and absorbed millions of surplus farm workers. The TVE shares of output and employment in rural industry were 72% and 58% respectively in 1990s (China State Statistics Bureau, June 6th 2004).

The emergence of collective enterprises was initially in response to the relaxation of the state monopoly over the economy, especially over industrial production and investment. After 1980 the central government began to relax its monopoly over some industrial sectors with a shortage of supply. TVEs were ready to take advantage of large potential profits with the support from local governments (Byrd and Tidrick, 1987).

TVEs not only have contributed to growth, but also served the interests of national and local governments. Both economic and political rationales could be combined in the ownership form of TVEs (Qian, 2002). Rural community governments need to provide local public services and goods, such as maintaining order, building roads, providing water and irrigation systems and implementing family planning. These local public services and goods have both political and economic dimensions. For example, maintaining order provides political support to the national government, at the same time it is also conducive to local business development. Therefore, the interests of the national government will potentially be more aligned with those of the local governments than with those of a private enterprise owner. Indeed, when the local government controls TVEs, it will become more useful to the government than to private owners. As a result, the government may be more "friendly" toward TVEs than to private enterprises and therefore property rights of TVEs are more secure than those of private enterprises in the absence of a rule of law (Che and Qian, 1998b).

With the ownership and control rights over firms, the township and village government has a less costly way to extract revenues from these firms than from private firms because the latter control their own financial accounts. Jin and Qian (1998) concluded that the share of TVEs had a positive relation with the revenues of the national and especially the township and village governments: a 10% point increase in the share of TVEs is associated with a 2.4 percentage point increase in the revenue share of township and village government. The boom of TVEs provided financial support to the development of local economy. Qian (1999) showed that 59% of the after-tax profits of TVEs were reinvested and 40% was used for local public expenditure in 1992.

The corporate governance structure of the collectively owned enterprises differs from the SOEs and is more diversified. Companies with intensified control by local government or other state-owned institutions have a governance structure with the characteristics of SOEs. Like in SOEs, the local government can decide about the appointment and dismissal of the manager of TVEs. However, the collective enterprise is more independent and has more possibilities to react flexible. Normally the local government does not intervene in TVEs operations; managers in TVEs have a larger autonomy in their business than their colleagues in SOEs. Collective enterprises are largely market-oriented and operate outside the state plan (Nee, 1992). Entrepreneurial activities are initiated in market niches left unfilled by the state firms under the old planning system (Naughton, 1995). TVEs have a larger autonomy: for example, they can decide what and how much to produce and to sell at what price (Qian, 2002). Both inputs and outputs are not restricted by the state plan. Collective enterprises can employ experienced employees, adopt more flexible work practices and pay a higher salary. The price and volume of products vary according to the changes of the market. The management team cannot claim the profits, but it has discretion over how to reinvest the profits and whether to distribute them as bonuses within the explicit or implicit limits set by the company charter and government regulations (Dong and Hu, 1995). With the competitive advantage of management flexibility, collective enterprises benefite from economic reforms and thrived in the market.

Other collective enterprises with less control by local government whilst influenced largely by entrepreneurs are more like private enterprises. After turning over a fixed amount of premium, the managements retain all profits. Furthermore, in the late 1990s, many private companies registered in the name of collectively owned enterprises. These collective enterprises were called "red hat" firms, which were nominally collectively owned, but were really owned and managed by a small private group, or individual. After the second half of the 1990s most of the TVEs were privatised.

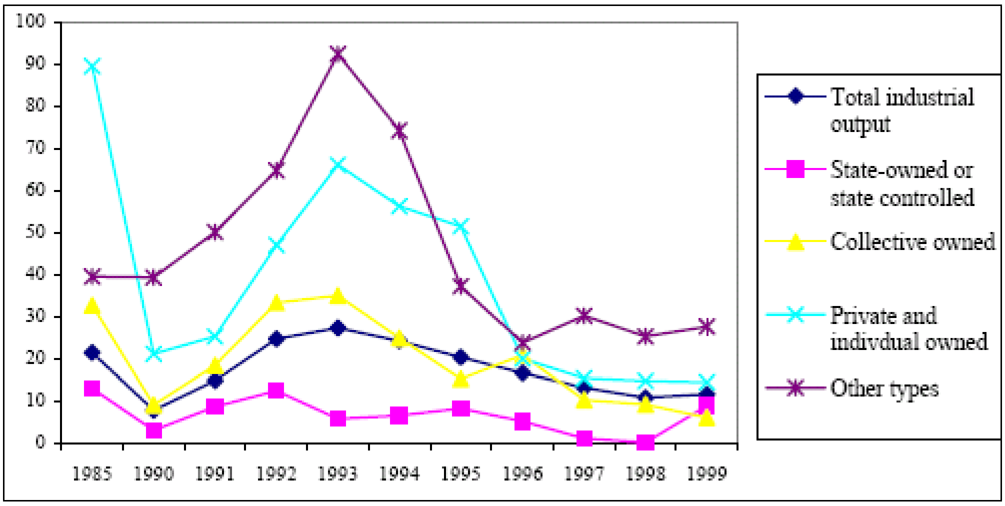
But why have the TVEs and not the private enterprises or privatised state firms been the driving force of China's growth in the early period of reform? In the informal institution layer, China's cultural tradition emphasises the priority of the "public over the private". The private property system still was thought of as "bad" and "harmful to the social welfare" for a long time. Collectivism and family-ism encourage people to work in a group, which fits with China's informal institutional structure. The discrimination of private property had not only been a legal rule but also a norm for a long time. Even today there will still be a large number of Chinese, especially the older generation, who relate privately owned enterprises with "cheating" and "poor quality". In the formal institution layer, one of the most salient institutional features in China before 1993 is the absence of rule of law to protect private property rights. Combined with a strong anti-private property ideology that is inherited from the central planning era, private property rights, both cash flow and control over assets, are not secure (Qian, 2002). Before 1993, the state attacked private enterprises during several general political turmoils after the reform, which included the "anti-spiritual pollution campaign" of 1983, the "anti-bourgeois liberalization campaign" of 1987, and most recently, after the Tiananmen Square events of 1989. It is not surprising that private firms were underdeveloped because of the absence of legal protection of private property rights (Qian, 2002). So the collective enterprises, such as TVEs, can be more secure than private enterprises in such an institutional environment because of the protection by local governments.

Promoting Private Enterprises

Evidence from Eastern European transition demonstrates that economic growth came from the *de novo* private enterprises, which were mostly small- and medium-size enterprises (SMEs). The striking example is Poland (Giffin and Ellington, 1995; Qian and Wu, 2000), which had not implemented any mass privatisation of large-scale state-owned enterprises. Poland succeeded in its transition because of the newly created private enterprises. While debating on how to reform (including privatise) large-scale state-owned enterprises, China privatised a large number of small- and medium-size enterprises and the progress in social security system reform in recent years has made it less difficult for local governments to sell their enterprises to private owners. According to the "*Tentative Stipulations on Private Enterprises*" issued by the State Administration for Industry and Commerce in 1988, the private enterprises were defined as "for-profit organisations that are owned by individuals and employ more than eight people."

The privately owned enterprises first re-appeared in China's economy in the early 1980s in the rural area. They have grown now into most branches of industry and formed the fastest growing, most efficient, and most vibrant part of the economy (Smyth, Wang and Kiang, 2001). After 1993 private enterprises developed quickly in China. The ADB (2003) found that to a very large extent, the driving force behind China's spectacular economic gains has been the emergence of non-state-owned sectors, especially the dynamic private sector. In 2002, the share of GDP in China produced in the non-state-owned sector exceeded two-third, the output value produced by private enterprises constituted more than one third of the total GDP (ADB, 2003). Figure 3.5 shows the growth rate of output in private enterprises is higher that in SOEs and Collective-owned enterprises.

Figure 3.5 Growth Rates of Real Industrial Output in China 1985, 1990-1999



1. "Other types" include foreign-funded firms and non-state-controlled shareholding corporations.
2. Since 2001, the China Statistical Yearbook does not report total industrial output by ownership, this figure presents growth rates only up to 1999.
3. The gross output data are adjusted using GDP deflators.

Source: Asian Development Bank (2003, p.3)

The fast development of private enterprises in China is closely related to the change of institutions both the informal and formal ones. At the level of informal institutions, the reform has aroused the sense of the “individual” in the people and encouraged people to “maximise their own interest”. “*Making money is glorious*” became a popular slogan in China. With the introduction of markets people started to realise that their income level was dependent on their talent and effort. The relationship among persons, *Guanxi*, became more dependent on the transaction of the wealth. However, some basic features of the Chinese traditional culture are also present here: the word “non-state owned enterprises” is preferred over “private enterprise” to avoid a negative connotation. Also the pattern of ownership appears to be dominated by partnership and family.

At the level of the formal institutions, the ideological and political discrimination against private enterprises has been eliminated. The Constitutional Amendment (1999) had already established private ownership as an important component of the economy. China's National People's Congress passed the "*Law for Wholly Individually Funded Enterprises*" in 1999, which provided, for the first time, legal protection for private entrepreneurial firms. Business owners are now able to be member of the Chinese Communist Party and registration of companies now meets no legal obstacles anymore.

Private enterprises in China firstly originated from TVEs. In the 1980s and early 1990s, TVEs had an advantage because of their ambiguous ownership. But in recent years, as the climate for private enterprise improved, many of these pseudo-collectives increasingly sought to take off their “red hat.” Ambiguous ownership was no longer attractive to managers of firms and both the managers and the government demanded clear property rights and control mechanisms. At the same time because of the lack of clearly defined property rights and good corporate governance, the weakness of TVEs became more and more obvious in the early 1990s. As TVEs grew large, they became more and more bureaucratic in management, resembling SOEs. In the managerial labour market, TVEs started to loose good managers to foreign and joint venture firms when the latter give the managers a higher salary and even shares of their firms. In the product market, fast entry of domestic private and foreign firms changed the previous seller's market into a buyer's market, eroding the profit margins TVEs enjoyed in the 1980s as early starters. Therefore more and more TVEs have been transformed into "stock cooperatives", which are collectively owned by the employees of the enterprises. Most of them have been privatised after 1995.

Furthermore private enterprises developed from the privatisation of small- and medium-sized SOEs. The 1995 government policy of "releasing the small" was further relaxed to "releasing the small and the medium" in the Decision of September 1999 on SOE reforms (China Daily, September 27th 1999). Its impact on the development of private enterprises was quite significant. This is because in China, unlike Eastern Europe, most SOEs are small and medium sized. In 1993, small- and medium-sized state firms employed about 67% of state workers and produced about 43% of state industrial output. Even without any privatisation of large state-owned enterprises, merely by releasing the small- and medium-sized SOEs, the share of state industry was reduced by almost half.

ADB (2003) found that most Chinese private enterprises were initiated by their former managers. As Kornai (1990) argued, rather than focusing on mass privatisation of existing state-owned enterprises, transition economies would be better off by promoting de novo private enterprises created by entrepreneurs. The Chinese do not lack entrepreneurship. These entrepreneurial firms always started small, and, because entrepreneurs have substantial personal stakes in the firms, they would be better positioned to avoid many of the pitfalls in governance that be set large firms at the initial stage of transition (Qian, 2000).

The organisational forms of private companies (*Siying Qiye*) can take many forms: sole proprietorships, partnerships, limited liability companies, and shareholding cooperatives. There are different requirements for registered capital and numbers of shareholders associated with these forms of private ownership. Over the past few years, limited liability companies among private companies have been growing the fastest.

In 2003, a survey by the ADB (2003) found that, only 23,8% of the private enterprises were companies with limited liabilities at the start-up stage, while this figure was as high as 48,2% in 2003. The survey from the Industrial Economics Research Institute of the Chinese Academy of Social Sciences (2000) reported that in 1992, the ratios of wholly owned enterprises, partnership enterprises and limited-liability companies among private companies was 55,3%, 32,0% and 12,7%, respectively. At the end of 1990s, the ratio of wholly-owned enterprises among private companies dropped to 36,8%, and that of partnership enterprises fell to 11,5%, while that of limited-liability companies rose to 51,8%. According to the statistics from the State Administration for Industry and Commerce (2002), about 68,5% of the private enterprises were limited liability companies in 2001 while 12,7% in 1992 and 46,1% in 1997.

According to a survey of the governance structures of private companies by Guo (2000), the basic characteristic of the equity of such companies was that private stocks account for 92%; that the percentage of personal stocks of proprietors was as high as 66%; that the percentage of stocks of brothers (two to three men bearing the same family name) is 14%; that the percentage of stocks of brothers (two to three men by different family names: cousin) was 3%; that the sum of the stocks of proprietors and their relatives and friends was as high as 83%; that technicians, managers and other types of staff held 3% of stocks, and collective stocks made up about 3%; other legal persons' stocks accounted for about 2%; and that township governments held about 2% of stocks. All this indicated that private companies showed the typical characteristics of family-dominated enterprises

The governance structure pattern in private companies is characterised as the "blood-relative based distribution and balance of power among family members" (Chen and Huang, 2001). Family members constitute a considerable ratio in the management implying the authority to obtain residual claims and the controlling power. Though many large private companies have been set up as limited-liability companies and have introduced the standard modern corporate system, such as the shareholders' meeting, the board of directors, the board of supervisors and the general manager's office, the characteristics of family control remain evident. On the one hand, this finds expression in the fact that the sources of the board of directors, operators and managers have the characteristics of closure and are family-oriented. According to the third national survey of private companies conducted in 1998, 50,5% of the spouses of the married proprietors of private companies were engaged in managerial work in the proprietors' companies, 9,8% of the spouses were in charge of purchase and marketing, 20,3% of the grown-up children of the proprietors of private companies were engaged in managerial work in the proprietors' companies, and 13,8% of the children were in charge of purchase and marketing. On the other hand, it finds expression in the fact that corporate decisions are mainly taken by individuals; despite the existence of the board of directors, the shareholders' meeting and the general manager's office, under the family-oriented governance structure, decisions made by individual entrepreneurs still played a dominant role in making decisions. The ADB (2003) concluded that the proprietors of private companies kept important power in their own hands. Their survey (see Table 3.5) obviously showed that private enterprises were currently still run by the shareholders themselves. The separation of ownership and management has not been realised yet.

Table 3.5 Corporate Internal Governance Structure

Highest decision-making body	**(%)**
Shareholders meeting	13,2
Board of directors	33,1
President of the company or the chairman of the board	36,0
Major shareholders	14,3
Other	3,5
Major decision maker	
Major shareholders	86,9
Minor shareholders	2,7
Professional manager with no share	6,8
Other	3,5

Source: Asian Development Bank (2003)

The private companies pay relatively high wages to members of the managerial stratum and practice long-term incentive-based remuneration systems (Chen and Huang, 2001). But the governance structure basically does not rely on the external market mechanism to encourage and constrain managers. For these companies, the pressure does not come from the external monitor system, but from intense competition in the product market, the capital market and the labour market threatening the existence of the enterprise. Bankruptcy, merger, acquisition, reorganization and other components of the market mechanism put pressure on entrepreneurs and the managerial stratum.

The International Finance Corporation (IFC, 2000) provided a comprehensive list of the factors that either actually or potentially constrain the growth of private firms in the PRC. In the formal institution layer, the IFC assigned the Chinese government to build market-supporting institutions, which involved safeguarding the security of private property rights, relaxing entry restrictions faced by private enterprises, erecting a transparent regulatory environment, and implementing a rule-based tax administration. To accomplish this, the most important action required is to enforce the rule of law, which in many instances means implementing laws that already exist. In other cases, laws and regulations should be simplified to reduce the scope for bureaucratic discretion in their application. McMillan and Woodruff (2001) argued that in an economy making the transition from a command to a market system, the most important institutional support required from governments was to create (i) a legal system that ensures the enforceability of contracts, and (ii) formal financial sources that are accessible to small private firms.

In the layer of corporate governance, the IFC (2000) emphasised how firms should adapt their management and governance practices in order to adopt an organisational form appropriate to an enterprise system that will be based on much more formal rules. The survey of ADB (2003) indicated that the separation of ownership and management was still low though family-oriented private firms were shifting more or less rapidly to limited liability corporations. The IFC (2000) identified corporate finance and professional management as areas urgently needing improvement for firms that had grown beyond the size that their informal structure can support. It emphasised standardized accounting practices as an essential prerequisite for disclosing the true financial situations of firms. Without accounting transparency firms will be unable to finance themselves easily through the financial and capital markets.

It should not come as a surprise that the number and the size of private firms increase slowly: the discrimination of private firms is "bred in the bone" in the Chinese culture.

3.4 Concluding Remarks

The planned economy made China face chronic and fundamental economic difficulties. As a traditional agricultural country, China could hardly feed its people. The policy and strategy of the command economy led to an unbalanced and extremely inefficient development of its economy. With acute shortages of many consumer goods and housing, the Chinese people had a low living standard. Furthermore, the endless "class struggle" caused a large number of personal tragedies and violence to society. All these propelled China to a new road. The reforms reflected the deep negative feelings of politicians and the people about the failures of the thirty years of planned economy. These feelings were reinforced by the striking contrast between China's economic performance and the outstanding economic performance in other countries in the region.

The government started the economic reform in the agricultural sector in 1978, following the approach of piecemeal social engineering. At the beginning, the reformers did not formulate generate a clear target nor a detailed plan of where the economic reforms should be heading to or how the goals should be implemented step by step. Though the Chinese reform is often criticised for its unsystematic (even chaotic) approach, China showed a remarkable economic success in the first 15 years. Especially China's agricultural output grew at unprecedented rate after the "household responsibility system" was introduced.

One of the most significant events in the 25-year history of reform was the adoption in November 1993 of a program to guide China to a "socialist market economy". Since then, China's reform became a more systematic process. The government was dedicated to build market-supporting institutions and to address the problem of state-owned enterprises in a fundamental way. A system of law and regulation was set up to constrain the actors' behaviour, including the government. A series of well-planned radical changes in macroeconomic policy were launched. Aligning with international practices, more and more formal institutions, such as the tax and fiscal system, the monetary and financial system and the social security system, were introduced into China's economic system. At the same time, China has been on its way to a radical transformation of property rights and corporate governance, including privatising agriculture, restructuring state-owned enterprises and promoting the non-state sector. The government successfully privatised a large number of small- and medium-sized SOEs implementing layoffs of redundant employees. The non-state sector has grown so fast that it produced two-third of GDP in 2002 (ADB, 2003).

China has many opportunities to continue its fast growth in the coming years. However, whether the growth potential can be realized largely depends on whether the institutions are able to keep pace with economic development and on how government will further relax its control over the economy.