

**Enterprise Reform in China: Agency Problems and Political Control**

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Abstract

The past reform of state-owned enterprises in China has delegated many effective control rights to managers while maintaining ultimate control rights for the Party and government. The result is that either the agency costs are high because managers lack accountability or the political costs are high because the government causes political interference. Reform of state-owned enterprises in China should aim at reducing both political and agency costs, which can be done through depoliticization, effective corporate governance, and desocialization. In particular, China needs an ownership transformation with a combination of privatization, denationalization, and pluralization; a state assets management system to limit political influence from the government; and corporatization to establish effective corporate governance which may take a variety of forms.

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# **Enterprise Reform in China: Agency Problems and Political Control**

## 1. Introduction

Reforming China's state-owned enterprises (SOEs) has become the core in China's transition to markets. In 1994, SOEs in China employed 75.45 million employees in all sectors (p.90, *Statistical Yearbook of China*, 1995). In the industrial sector in the same year, China had about 102.2 thousand SOEs with 43.69 million employees and produced about 34% of the national industrial output (pp.375-376, *Statistical Yearbook of China*, 1995). The SOE sector still constitutes the backbone of the economy which includes most resource and basic industries. It is also the main revenue source, as well as a major financial burden for providing explicit and implicit subsidies, of the government. While promoting new private or non-state enterprises is very important, it is not a substitute for transformation of old state enterprises.

The experience of SOE reforms in the past 17 years has been mixed. As compared to their own past, SOEs' performance has improved in terms of increased productivity (Chen, et al 1988, Groves, et al 1994); on the other hand, as compared to firms of joint ventures, private enterprises, and township-village enterprises (TVEs), SOEs clearly lagged in economic efficiency (Jefferson and Rawski, 1994, and Woo, et al 1994). Recently, there is a growing dissatisfaction with SOE performance due to the shrinking government budget, aspiration for higher growth, and a more liberal, open, and competitive economic environment.

The past enterprise reform strategy aimed at improving enterprise incentives by means of "expanding enterprise autonomy" and "increasing retained profits" to enterprises. As a result, managerial incentives for profits have been increased and SOEs in China are no longer those described under the classical planning system. Yet, the main problem has been the narrow focus of providing contractual incentives for managers without fundamental transformation of government institutions, ownership structures, and corporate governance. The managerial incentives through contractual arrangements are important, but their effectiveness depends on several complementary factors. First, the total incentives of managers are affected by effective control rights and income not specified by contracts. Second, for

efficiency purposes, the choice of managers with the right type of ability is as important as providing right incentives. Third, political process originating from the ultimate Party and government control of SOEs continues to affect both the incentives and selection of managers. And fourth, the relationship between government and enterprise is further complicated by the social responsibility of the enterprises for their employees. Failure to address these complementary issues account for the difficulties encountered in the past reforms.

In this paper, I will analyze some fundamental issues concerning enterprise reforms in China by applying ideas from the newly developed theory of property rights and the firm. This theory emphasizes the importance that allocation of control rights of assets has in analyzing firms. For example, Grossman and Hart (1986) and Hart and Moore (1991) make a distinction between *specific* and *residual* rights of control when contracts are incomplete, and argue that allocation of residual rights of control (as opposed to specific rights via contracts) have critically important incentive effects. Aghion and Tirole (1994) further distinguish between *formal* and *real* authorities. They argue that one party who has formal control rights may *delegate* to another party partial real control because of latter's informational advantages. These concepts are useful in understanding the issues concerning firms in mature market economies such as separation of ownership and control and delegation. They are also useful in understanding firms in transition from planned to market economies (such as SOEs in China) if specific institutional background can be taken into account.

My analysis will be divided into two parts.<sup>2</sup> The first part (sections 2 and 3) provides a positive analysis of the reality of SOEs in China concerning the allocation of control rights. I characterize the situation as a type of equilibrium with the following two features. On the one hand, without a change of nominal state ownership, many contractual and residual rights of control have been reallocated (i.e., delegated) to managers so that managers exercise many *effective* control rights (mainly the rights to use assets and to distribute income). This transfer of control rights has provided incentives for managers to

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<sup>2</sup> The main emphasis of this paper is internal organization of SOEs. Another set of SOE problems concerns the lack of external discipline from product market competition and capital market restraint (i.e., the problem of soft budget constraint). As this paper will show, the latter has a root in the internal organization of SOEs.

increase current production, but at the same time it also has enabled them to plunder state assets. In this aspect, China is similar to Eastern Europe and Russia. On the other hand, the *ultimate* control rights such as selection and dismissal of top managers, approval of large investment projects, and veto of large assets disposal, still remain in the hands of the Party and the government; especially the central government.<sup>3</sup> Although the Party and government control serves to check managerial assets stripping to some degree, it continues to cause political interference on economic decisions and foster corruption. In term of the continued Party control, China differs from Eastern Europe and Russia.

Understanding this interaction between the effective control by managers over some decisions and the ultimate control by the Party and government over other decisions is the key to understanding the problems with the past reform and the issues to be addressed in the future. This interaction highlights the intertwining problem of high *agency costs* (the costs of managerial self-dealing) and *political costs* (the costs of government failure) arising from the current ownership and control arrangement. Most previous studies failed to address these two costs together in an explicit way. When the virtue of expanding enterprise autonomy is emphasized, reducing political costs from government interference becomes a major concern and the agency problem from managers is neglected. That is why separation of ownership and control is viewed as a problem in the West (because it increases agency costs), but regarded as a solution in China (because it reduces political costs). On the other hand, the agency problem, such as state assets stripping, received more attention recently, increasing a temptation to control managers. However, application of the agency theory to China has to incorporate considerations of political costs as well, because reducing the political costs is precisely the reason for expanding enterprise autonomy in the first place.

Economic efficiency and social welfare require reduction of both political costs and agency costs. The second part of the paper (sections 4 and 5) argues that in China political and agency costs can be reduced by reallocation of control rights and by restructuring institutions through three means: The first is

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<sup>3</sup> The terms "ultimate" and "effective" control rights here are similar in meaning to "formal" and "real" authority used by Aghion and Tirole (1994). I prefer the former because ultimate control could sometimes be informal, and be real as well.

"*depoliticization*" of enterprises to reduce the political influence from the government on business decisions, which means to limit ultimate control of enterprises by the Party and government. As a first step, it means separation of enterprises from the government and separation of government's function as an assets owner from its function as a regulator. The second is the establishment of an effective "*corporate governance*" to limit the agency costs of managers, which provides mechanisms for selecting good managers and for providing them appropriate incentives when they are in effective control. And the third is "*desocialization*" of enterprises to unbundle their social responsibilities for employees and turn enterprises into pure economic organizations, which help reduce both political and agency costs.

To achieve this goal, several operational issues deserve particular attention. First, China needs to formulate a strategy for ownership transformation. It is both politically and economically important to separate small SOEs from large SOEs. Ownership transformation of small SOEs is more likely to succeed first and it is more important in China than in Eastern Europe. China needs to treat small and large SOEs differently and pursue a strategy with a combination of privatization, denationalization, and pluralization. Second, because the state will continue to own and control a substantial number of large enterprises for some time, China needs to establish a state assets management system to minimize political influence. And third, China needs to experiment and institute different corporate governance suited for different types of enterprises; international experience has shown diversity of governance structures in different countries depending on the particular regulatory environment. I argue that solving these operational issues are essential for reducing political and agency costs and for ensuring long-run growth of enterprises.

The rest of the paper is organized as follows. Section 2 examines effective managerial control in SOEs. Section 3 discusses ultimate control by the Party and government. Section 4 argues for reducing both political and agency costs by means of depoliticization, effective corporate governance, and desocialization. Section 5 focuses on some operational issues. Conclusions follow in Section 6.

## 2. Effective Control by Enterprise Insiders

Enterprise insiders refer to managers and workers employed in SOEs. This section first details how managers and workers in the state sector gained effective control. Then it discusses the significant effects of reallocation of control rights on the growth of the non-state sector and on the state sector itself. For the former, it emphasizes the implicit subsidies and insurance provided by the state sector to the non-state sector; for the latter, it underscores the phenomenon of spontaneous privatization and state assets stripping.

### **Common Features of Control and Benefits for Managers and Workers**

Under the old planning system, most specific and all residual control was assigned to the branch ministry/bureaus of the government, and enterprise had some specific control and limited income. Reforms were intended to provide enterprise "insiders" (managers and workers) incentives by granting them more control rights and income. Experiments with expanding enterprise autonomy and providing enterprises with profit incentives started as early as 1978. The major effort was the promotion of the "contract responsibility system" in 1987. By 1989, almost all SOEs adopted a contract responsibility system (see Wu 1994 and Naughton 1995 for details).<sup>4</sup> In 1992, the contract responsibility system was enhanced by the "Regulations on Transforming the Management Mechanism of State-Owned Industrial Enterprises." The specific purpose of this regulation was to further expand enterprise autonomy, which granted, at least in writing, enterprise managers the "14 rights" of control in (i) production; (ii) pricing; (iii) sales; (iv) procurement; (v) foreign trade; (vi) investment; (vii) use of retained funds; (viii) disposal of assets; (ix) merger and acquisition; (x) labor; (xi) personnel management; (xii) wages and bonuses; (xiii) internal organizations; and (xiv) refusal to pay unauthorized charges by the government.

The effective control rights of enterprise managers vary, being in some cases less, and in other

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<sup>4</sup> Using the survey data for 1980-1989 for 769 SOEs in four provinces, Groves, et al (1994) found that, with an increased autonomy in output decisions and with higher marginal profit-retention rates, enterprises strengthened workers' incentives by using more bonus payments and hiring more contract workers, which in turn increased productivity.

more, than the formal ones. There are some common features concerning managerial control rights over assets. First, enterprises typically have effective rights to use state assets and to distribute and enjoy incomes so generated but have no formal rights to dispose assets. Second, the allocation of effective control rights and income is not entirely clear, which often leads to conflicting claims among managers, local government officials and the central government. And third, there exists little congruence between allocation of effective control rights and financial risks, that is to say, nobody is responsible for downside risks.

The extent of managerial control is not mechanically specified by the government, it is endogenously determined by managerial maneuver. For example, managerial autonomy is greatly enhanced through a series of organizational transformations which create autonomous divisions (known as "secondary legal entities"), which in turn form subsidiaries, joint ventures with foreign and/or domestic partners, and joint-stock companies. In this respect, China is similar to Hungary, where the process is called "partial transformation." The motivations for such a reorganization of managers in the two countries are also similar: The desire for independence from the government, for shifts of bad debts and over-employment burdens onto parent companies, and for undertaking new business opportunities without losing existing connections to and benefits from the state.

This process in China is often associated with new projects, especially new ventures in special economic zones and development zones. Consider the following scenario: a state-owned enterprise of Beijing first sets up a wholly-owned subsidiary in a special economic zone of Shenzhen; then the subsidiary enters into a joint venture with domestic and Hong Kong partners; later the joint venture sets up another subsidiary in Pudong development zone in Shanghai, and then the subsidiary forms another joint venture with a TVE in nearby Wuxi of Jiangsu. After several rounds of transformation, effective managerial control expands.<sup>5</sup>

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<sup>5</sup> Qian and Stiglitz (1996) report several cases of such organizational transformation. For example, a joint venture in Guangdong was formed by a Hong Kong partner and three Chinese partners (each with one-quarter of shares). Of the Chinese partners, one is a company affiliated with the central government, another with the provincial government, and yet another with the municipality government. The managers claim that they have greater autonomy due to the new ownership and organizational structure.

In contrast, workers' control of enterprises in China was never significant, because the trade unions and workers' congresses have been, and still are, under strict control by the Party. The Party and the government continue to view an independent trade union as one of the most serious threats to its leadership. Not surprisingly, the role of workers within the enterprise is mostly consultative.

The main benefits received by the top managers are not from salaries and bonuses but from perks, including assignment of better and larger apartments, private use of cars, availability of "corporate accounts" for business lunches and dinners, entertainment, domestic touring, travelling abroad, and the like (Qian and Stiglitz 1996). If all of these consumptions are perfectly legal, some others are not. As a result of rapid development of the non-state sector, managers, or their relatives and friends, often have their own businesses, which provide opportunities for diverting state assets to private benefits.

The workers in state-owned enterprises benefit from enterprise reforms in several ways. First, nominal wages and bonuses (both pecuniary and in-kind) increased as the managers gained substantial discretion in the use of enterprise revenue. Second, construction of residential housing expanded as a legitimate welfare expenditure. And third, many SOEs established collective enterprises to provide jobs for their employees' children. In some enterprises, the biggest benefit for workers is the opportunity to purchase "internal shares" which are sold to them at discount prices. These shares often have guaranteed dividends and command a premium which is often double the interest rates of bank deposits. If the enterprise goes public, capital gains could be as high as five to ten times the face value.

At the national level, wages and bonuses per employee in the state sector have been increasing for most years since 1978, despite the fact that returns to capital in the state sector steadily declined from 25% in the early 1980s to less than 10% since 1992. Indeed, as Table 1 shows, profits and taxes per value of net fixed assets and working capital in state-owned industrial enterprises were quite stable between 1978 (24.2%) and 1985 (23.8%); it then fell to 20.7% in 1986, and further still to 17.2% in 1989 and below 10% in 1992 and afterwards. What is interesting is that the figure was steady in the initial years of introduction of the contract responsibility system (1986-88), but fell sharply in the later years, despite the fact that 1992 was a high growth year. The decline of returns to capital does not automatically mean

efficiency losses. It could mean a transfer of cash flow from state enterprises to non-state enterprises, and from enterprises to employees.<sup>6</sup> Such a redistribution can happen because of reduced revenue due to increased competition, or increased "costs" due to rent transfers to managers and workers, or substitution of capital for labor.

### **Contributions of SOE Reforms to the Growth of the Non-State Sector**

A significant, but neglected, effect of expanding enterprise autonomy in the state sector is its contribution to the rapid development of non-state enterprises such as joint ventures, TVEs, and private firms. The spectacular expansion of the non-state sector, which accounted for 66% of the total industrial output in 1994, was a major source of success for China's economic reforms. With the increased control rights and changed incentives of managers, the state sector has helped the fast entry of non-state enterprises in several ways.

State-owned enterprises are directly involved in setting up joint ventures and many collectives. Some of the collectives are in fact SOE subsidiaries but are registered as "collectives" (so-called "one factory, two systems"). The incentives of managers for doing so are obvious: to gain more control rights. Frequently, SOEs subcontract with TVEs or other collectives, not just to obtain better sourcing but also to divert cash flow to their workers and managers, as the state is not able to closely monitor such transactions. This practice helped immensely the TVEs and other non-state enterprises to enter the market and to expand at a rapid pace.

The state sector also provides implicit subsidies and insurance for the non-state enterprises which indirectly helps the latter. Specifically, employees in the state sector (managers, engineers, technicians, or un-skilled workers) take advantage of flexible rules under the expanded enterprise autonomy to join the non-state sector, but at the same time continue to enjoy partial or total benefits from the state sector, and/or have the option of returning to the state sector later ("leaving without quitting"). This practice reduces the

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<sup>6</sup> This is consistent with the econometric study by Groves, et al (1994), who found that the increased enterprise autonomy, in their sample of 769 SOEs for 1980-89, raised workers' incomes but tended not to increase profits or lower state subsidies.

cost of labor reallocation from less efficient to more efficient firms. If the marginal product of a worker leaving an SOE is small, this practice could represent a Pareto improvement at the margin: Employees leaving for the private sector are made better off; the enterprise can use the extra money for paying more bonuses to the remaining workers; and the government does not have to pay more subsidies to state enterprises than before and may even get some taxes from the new non-state sector.<sup>7</sup>

There are varieties of such practice. An employee in the state sector can take a leave for several years and still continue to enjoy welfare benefits from the enterprise, such as medical insurance and housing. An employee can choose to give up all the bonuses, salary, housing and other benefits from the enterprise, but keep the option open of returning to the enterprise in case his or her private business goes under, known in China as "stopping the salary and keeping the position" (*tingxin liuzhi*). In a family with two working adults, one of the couple may choose to work in the non-state sector to get high monetary returns (with high risks as well), while the other one remains in the state sector to receive stable low incomes and all the welfare benefits. These households, known in China as "one family, two systems" (*yijia liangzhi*), have done the best in the reform period by obtaining the best part from socialism and capitalism. Of course people may choose different forms over time.<sup>8</sup> In a certain sense, the state sector serves as a social safety net for those former SOE employees. With flexible policies on labor mobility, the state sector actually contributes to and promotes, rather than hinders, the development of the non-state sector.<sup>9</sup> This suggests that the total contribution of the state sector is perhaps underestimated if such cross subsidies to the non-state sector are ignored.

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<sup>7</sup> One possible distortion in this arrangement is the following: If the implicit cross-subsidies and insurance are too high, there may be either too much labor diversion to the non-state sector, or too much risk taking by it. For the analysis of effects of "supply diversion," see Murphy, Shleifer and Vishny (1992).

<sup>8</sup> Indeed, many people who went to the special economic zones or joined the foreign joint ventures or started their own business were from the state sector, and they kept their affiliations with the state sector and received the welfare benefits for a long time until they felt sure about their career in the non-state sector.

<sup>9</sup> Using data on 434 Chinese cities, Wei and Lian (1993) find positive correlations between the growth of non-state enterprises and the initial size of the state sector for cities initially dominated by SOEs.

## Spontaneous Privatization and State-Assets Stripping

Spontaneous privatization in China refers to the process of unauthorized transfers of assets from either the state or collectives to formal or *de facto* private ownership. Typically, managers and employees of the enterprise are the main beneficiaries. Local government officials also become beneficiaries because managers often bribe them to let the deal go through. It is interesting to note that spontaneous privatization is also a significant phenomenon in Eastern European and former Soviet Union countries, with perhaps the only exceptions being the Czech Republic and East Germany.

Spontaneous privatization often started with the contract responsibility system. The contractors first secured loans to expand the business. Then they acquired complete control rights over the expanded and successful business. Eventually, the contractors obtained ownership rights of the entire business. However, when the business goes under, the state absorbs any financial losses -- it is the owner in that event.<sup>10</sup>

In this type of spontaneous privatization, the government does not give away assets in the usual sense, rather, it gives away an opportunity in exchange of an informal non-cash promise: If the business grows, the contractee pays back the debt and becomes the owner of the new business; if the business goes under, the government takes back control. Several interesting features emerge. First, strictly speaking, this is not privatization since the old stock is not sold. Second, the scheme by its nature focuses on new business (rather than old), on flow (rather than stock), and on growth. Third, the share of the state sector is gradually reduced as that of the private sector is increased. And fourth, because of personal efforts involved, the process likely favors entrepreneurs who take big risks (i.e., the screening effect). The key to this process is the relatively little start-up capital required, which is used as collateral for securing large bank loans at a very low interest rate. Before long, the net assets value of the new subsidiaries will far exceed the original equity value. The managers think (and many other people agree) that since it is they who created the new business, they therefore should be entitled to the value added.

A related, but broader, phenomenon is known as state assets stripping. State assets stripping,

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<sup>10</sup> Nee and Su (1993) report several cases of such a privatization in China.

according to the National Administrative Bureau of State-Owned Property, include any transfer, at below fair market prices, of state assets to non-state entities, like individuals, collectives and joint ventures. There is no precise figure on the magnitude of state assets stripping. In 1993, total state assets in enterprises and government institutions in China were approximately 3 trillion yuan. Some estimate that about 100-300 million yuan worth of state assets flow out of the state coffers each day, or around 30-100 billion yuan every year (*Guangming Daily*, October 5, 1993).<sup>11</sup> There is also no precise figure on illegal capital flow out of the country. But the problem could be serious. One indication comes from the large unaccounted error term in the capital account of international finance balance sheet of China. In 1985, the error was small and positive (US\$ 0.92 billion), that is, there could be unaccounted capital inflow. It became negative and large in magnitude recently: - US\$ 8.3 billion in 1992 and - US\$ 9.8 billion in 1993, which were about 10% of total export (p.506, p.551, *Statistical Yearbook of China, 1994*).

State assets flow out to the non-state sector in two main channels.<sup>12</sup> The first channel is during and after formal property rights transformation. It is estimated that in Guangdong Province, which has the most joint ventures, about 90% of Sino-foreign joint ventures were formed without assets appraisal from the Chinese partner. It is often the case that the interests of the Chinese side are not sufficiently protected. The flip side of this is that foreign investors are provided strong incentives to invest and form joint ventures with the Chinese state-owned enterprises.

During the formation of a joint stock company, undervaluing the present value of state assets is also a common practice. On average, the present value of the capital is only about 40%-50% above the historic costs in spite of inflation. Despite the fact that the state has a majority interest in almost all joint-stock companies, the state share is in fact discriminated against. For instance, in some cases the state shares don't pay dividends, while workers' shares pay excessively high dividends. In other cases when shareholders are given the option to purchase new shares at a below market price (as a substitute for

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<sup>11</sup> Because new investments in state assets are about 200-300 billion each year, the state assets are still expanding in absolute terms.

<sup>12</sup> Estimates below are provided by officials from the National Administrative Bureaus of State-Owned Property, otherwise noted.

dividends), the state is unable to come up with cash and is not allowed to sell those options. The net effect is dilution of state ownership. In one example from Shanghai, the state share was reduced from 61% to 40% after a few rounds of distribution of such new shares purchasing options (*Guangming Daily*, October 5, 1993).

The second channel of state assets stripping is from control rights transfers under the contract responsibility system of 1987 and the new operating mechanism of 1992. In order to fulfill the contract obligation of current profit remittance to the government and to please workers by maintaining high welfare, managers often sacrifice the future of the enterprise by engaging in asset-value-reducing activities, for example, by using up depreciation funds ("eating up the equipment") and by overborrowing to pay bonuses. This is known in China as "preserving benefits of the two ends (profit remittance to the government and welfare of workers) and sacrificing the middle (enterprise long-term development and assets value)." Managers also often grant profitable business to their friends in the non-state sector in order to obtain side payments, while billing overhead and leaving less profitable and more risky business to the state sector.

### 3. Ultimate Control by the Party and the Government

It would be wrong to conclude from the above analysis that managers have total effective controls over the assets of SOEs (known as "insider control"). In at least three aspects the Party and the central government still maintain effective control: appointment and dismissal of top managers; approval of large investment projects; and veto of large assets disposal. The focus here will be the role of the Party in appointment and dismissal of managers and the relationship between the central and local governments when the former delegates some control rights to the latter.<sup>13</sup>

### **The Role of the Party in Personnel Selection and Dismissal**

A fundamental principle of China's political and economic organizations is known as "the Party

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<sup>13</sup> For central government control over large investment projects, see Huang (1994).

controlling personnel." The Party exercises its ultimate control over personnel selection and dismissal through its Organization Departments at different levels. The Central Party Organization Department has the control authority of personnel above the level of deputy minister or governor, the level includes the heads of some very large SOEs. The Provincial Party Organization Departments control bureau level appointments which include the heads of most large- and medium-sized SOEs. For example, the legal representative of an enterprise (i.e., the top manager) must be appointed and certified by the Party Organization Department when the enterprise registers with the National Administrative Bureau of Industry and Commerce, joint stock companies must do this too (and even in Special Economic Zones such as Shenzhen).

Groves et. al. (1995) report an encouraging development of managerial labor markets in 1980s in China.<sup>14</sup> There were also experiments in that period in which some managerial positions in SOEs were auctioned off. There was even a plan to reform the appointment system in 1988 when the Party considered to shift some authority to the government's newly established Ministry of Personnel. Unfortunately, not only have the experiments not become a mainstream mechanism, but after the Tiananmen Square Incident, the Party reasserted its control over personnel to a higher degree. Overall, the authority of the Party Organization Department has not been seriously challenged by the previous economic reforms because it has always been regarded as the domain of "political reform."

To some extent, the authority of the Party to appoint and dismiss managers serves as a counterbalance measure against complete managerial discretion. Although an appointment does not carry an explicit compensation package, as is typical in a capitalist firm, each managerial position has automatic discretion over a huge amount of control rents, especially in the fast growing areas and newly emerging businesses such as real estate, security brokerage, futures trading, and financial intermediaries. Therefore, while promotion within the bureaucratic hierarchy becomes less attractive than before, disciplinary dismissal by the Party will cause severe damage to managers because of the removal of the rents associated

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<sup>14</sup> Groves, et al (1995) found, in their sample of 769 SOEs for 1980-89, that poorly performing SOEs were associated with shorter management contracts and larger security deposits, and were more likely to have new managers selected by auction.

with the position. Even though some people do not want to be promoted, they still have strong incentives to *maintain* their positions in order to obtain such rents. However, if managers succeed in capitalizing the rents, they may quit the job at some point to start their own business. By that time, control of personnel by the Party may be less effective. In retrospect, the willingness of the central government and the Party to decentralize (delegate) authority to managers without fear of a complete loss of control is perhaps due to the fact that the Party still controls appointments of managers and their dismissals.

### **The Central Government, Local Governments, and Enterprises**

Under regional decentralization, local governments are delegated control over most enterprises by the central government. But state ownership entails that these control rights are conditional. The central government reserves the ultimate rights of reallocation of residual incomes and the assets in state-owned enterprises, even if the control rights have been delegated to and residual income has been assigned to local governments. The unitary state ownership right was reasserted in the important Party document issued in November 1993: "For State-owned property in enterprises, the system will be for unitary ownership by the State, supervision by governments at various levels and independent management by the enterprises" (p.1, Supplement, *China Daily*, November 17, 1993).<sup>15</sup>

Because the central government has the ultimate control, the relationship between local governments and enterprises becomes subtle. Often, there is a conflict of interest between the central and local governments, and local governments collude with enterprises against the central government. This is more evident in the fast growing areas. Collusion between local government and SOEs can be partly explained by the insecure property rights of local governments. First, the local government worries about possible future reallocation of assets by the central government, and it often encourages the enterprise to pursue short-term goals of profit maximization, rather than increasing the net worth of the assets. The local government may also want to secretly privatize state owned enterprises under its control, or tacitly

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<sup>15</sup> In 1993, there were some lobby efforts by the local governments (e.g. Guangdong) to demand for regional ownership rights over some assets of those SOEs currently under the supervision of local governments. This effort was unsuccessful (private interview with Guangdong government officials in October 1993).

consent to or even encourage spontaneous privatization. Second, the local government also worries about the ratchet effect on revenue, so it tends to help the enterprise hide profits. The deal is the following: the local government allows revenues to go untaxed, and the enterprise picks up the bill for some government expenditures, like dining and travelling expenses.

There also exist conflicts between local government and enterprises. Managers complain about government interference and the imposition of unauthorized fees, which occurs more likely in poor areas or in those regions dominated by old-style SOEs (e.g., Northeast China). In those areas, immediate gains from new market development are small, and the local government's temptation for intervention and levying heavy fees is high. This leads to a vicious cycle: an underdevelopment of new markets leads to more government intervention, which in turn leads to slower growth.

#### 4. Reducing Political and Agency Costs

There is growing dissatisfaction and serious concern about SOE reforms from the government, managers, workers, and the public at large. In addition to the complaints about unfair distribution resulting from spontaneous privatization and corruption, unsatisfied SOE performance has been blamed for the problems of the government budget, inflation, and employment.<sup>16</sup> Without fundamental transformation of government institutions, ownership structures, and corporate governance, enterprise reform in China seems to be trapped in the following dilemma. On the one hand, expanding enterprise autonomy induces high agency costs when managers experience a *lack of accountability*; on the other hand, ultimate control over SOEs by the Party and the government entails high political costs when the government makes *political interference*.

Several factors make the agency problem worse in China than in the West. First, managers are not given shares or stock options which link the net worth of the enterprise to their efforts. Ironically, the

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<sup>16</sup> There emerges a consensus among economists and government officials in China that the advantage of the double-track reforms seem to reach its limit if the problem of the state-sector is not addressed. The benefits received by the non-state sector from maintaining the state sector are most important at the beginning years of reform when the economy was dominated by SOEs and entry was difficult. When benefits diminish the costs of maintaining a large and inefficient state sector becomes more important.

contract responsibility system, which intends to improve managers' incentives, is a reason for short-termism and for state-assets stripping, because managers were often highly rewarded by their current performance. Second, although product market competition is getting tough due to the entry of the non-state sector, there is a lack of capital market competition and there is only a limited managerial labor market competition. The lack of capital market competition is due to the fact that the state interests in SOEs are not easily transferable, and the government bureaucracy has the monopoly to maintain the ultimate control (i.e., sale of state assets) over the SOEs. The limited managerial labor market competition is due to the Party control of managerial personnel. Third, there is no clearly accountable representative of the owner -- the state here -- who has both the information and incentives to monitor the performance of managers. There are often several government agencies who have authority over an SOE, but none of them is able to monitor managers effectively. The monitoring roles of branch ministries/bureaus are diminishing with the enterprise autonomy expanding. While the Party monitors managers, it concerns more with their political rather than economic and financial performance. Banks are alternatives for the role of monitoring, but their ability and authority are limited.

Most Party and many government institutions such as Party Organization Departments and industrial ministries/bureaus remained intact after 17 years of reform. Unlike countries in Eastern Europe and Russia, the Party control over personnel decisions provides some checks on managerial discretion and plundering of state assets. But it is problematic. First, because appointment of managers and government officials are treated in the same way, its selection criteria are not always based on economic performance and often, political considerations are important factors. The process is politically complicated and secretive, which seriously undermines the selection of the right type of managers and adversely affect managerial incentives. Second, its evaluation methods are largely primitive, based mainly on information through bureaucratic channels, rather than on information provided by the market (such as stock market, rating companies, investment banks, or consulting companies). Third, people from the Party Organization Departments have no ability and incentives to make the right appointment in regard to managerial positions, since they are mainly politically motivated. The appointment and dismissal process represents an

important channel of political influence on enterprises. In fact, a major problem concerning newly established joint-stock companies is the conflict between the board of directors and the Party Committee, often over personnel decisions.

To increase economic efficiency and social welfare, enterprise reforms require reducing both political and agency costs. I argue that in China, political and agency costs can be reduced by reallocating control rights and by restructuring institutions through the following three means.

The first is *depoliticization* of enterprises to reduce the *political costs* by *controlling the government*. In the context of Russia, Boycko, Shleifer and Vishny (1995) argue that depoliticization is the most important objective in the initial stage of enterprise reform and privatization is exactly for that purpose. Although China differs from Russia in many aspects, depoliticization is equally important. In China, depoliticization first means separation of enterprise from the government. Not only should the management of an enterprise be insulated from government intervention, but if the government continues to own assets, then its function as an assets owner should be separated from that as a regulator. Moreover, the Party control over managers should be limited, if not eliminated.

Separation of government and enterprise has long been recognized by economists and government officials in China as a key to enterprise reform. In the past, it was often associated with the reform of "separation of ownership and management," which was the underpinning of contract responsibility system. But to the extent residual and ultimate rights of control are important to incentives and economic efficiency in general, reducing political costs through separation of ownership and management has to be conditional and limited. Unless the issues of state ownership, government organization, and the role of the Party are addressed directly, separation of government and enterprise cannot materialize.

The second means is establishment of effective *corporate governance* of enterprise to limit the *agency costs* by *controlling managers* when they are in effective control. While managerial knowledge and initiatives are extremely valuable to corporations, managers should be held accountable to owners. In particular, assets stripping by managers should be stopped and non-political mechanisms of selecting and replacing managers should be installed.

Corporate governance is a set of institutional arrangements governing the relationship among several groups of stakeholders (investors (shareholder and creditor), managers, and workers). The structure of corporate governance concerns (i) how control rights are allocated and exercised; (ii) how boards of directors and top managers are selected and monitored; and (iii) how incentives are designed and enforced. A good corporate governance structure explores complementarity of these institutional arrangements to limit total agency costs. Economists agree that corporatization is a useful step in enterprise reform even without privatization. Corporatization helps to hold directors responsible for the assets of the company and prevent further asset theft; provide a mechanism for information exchange; set a stage for selling shares; and separate the state from enterprise (Lipton and Sachs, 1990, and Shleifer and Boycko, 1993). That is why corporatization was carried out before privatization in Eastern Europe and Russia.

The third means is *desocialization* of enterprise to *unbundle their social responsibilities* by providing *external welfare security for the employees* outside their work place. SOEs have been burdened with "social responsibilities" in five major categories: (i) redundant workers; (ii) retirement pensions; (iii) medical care; (iv) housing; and (v) other social services such as nursery and elementary schools. The social burdens of an enterprise are often singled out by both the government and enterprise themselves as the most important factor preventing SOEs from restructuring, because, as long as SOEs continue their dual roles as productive entities and social safety nets, they cannot be purely profit-oriented, and the costs for enterprises to restructure are also high. Indeed, SOEs often use their social responsibilities as an excuse for not restructuring and for asking for more subsidies (the soft budget constraint problem); on the other hand, the government also uses these as reasons to intervene with the operation of an enterprise. Debundling the social burdens of SOEs makes an enterprise a pure economic unit, which helps to reduce both political and agency costs.

These three methods are inter-related. Depoliticization associates with desocialization as excess employment and social burdens of enterprises are often imposed by politicians. An effective corporate governance is urgently needed when the government stops monitoring managers. Furthermore,

reorganization of the social burdens of SOEs (such as pension) has implications on corporate governance as well.

### 5. Some Operational Issues of Enterprise Reforms

The past enterprise reform failed because political control of enterprise remains, corporate governance is ineffective, and social responsibilities of enterprise continue. Since 1994, the Chinese government has 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" (p.1, Supplement, *China Daily*, November 17, 1993). Many problems arise at the operational and implementation levels. In particular, the reform measures have to be politically feasible. Although the measures proposed below look less radical (or ideal) than those pursued in Central and Eastern European countries, they are more radical than before. If implemented, these reforms will be significant in reducing political and agency costs.

### **Formulating a Strategy for Ownership Transformation**

To the extent ownership entails residual and ultimate rights of control of assets, ownership transformation is an important way for depoliticization and also has significant implications for dealing with the agency problem. A complete privatization, by definition, would eliminate state assets plundering. But privatization cannot automatically solve the agency problem in general, for example, managers could still plunder private assets.

In ownership transformation, it is both politically and economically important to separate small SOEs from large SOEs and treat them differently. Significantly different from Eastern Europe and Russia, the average size of state enterprises in China is much smaller, and small SOEs in China constitute a major part of the state sector.<sup>17</sup> Although small enterprises account for a smaller share in outputs, assets, and

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<sup>17</sup> For example, in 1988, employment per enterprise in manufacturing was 806 in the Soviet Union and 460 in Hungary, as compared to 145 in China. In wearing apparel, the corresponding figures were 6,600 in Czechoslovakia, 307 in Hungary, and 80 in China (Table 4.2 in Qian and Xu 1993).

taxes/profits in the state sector, they account for a larger share in employment, debts, and losses.<sup>18</sup>

Ownership transformation starting with small SOEs is a good strategy. First, it is politically feasible because it is within the policy limit of the government (Supplement, *China Daily*, November 17, 1993); second, it is easier to be implemented as such a program is less likely to introduce social unrest or to create government budgetary problems; and third, if successful, it will also be economically significant because it will address a large portion of the two serious problems of SOEs -- state employment and subsidies, and thus will substantially reduce the burden of the state sector.

In ownership reform China needs a combination of *privatization*, *denationalization*, and *pluralization*.

**Privatization.** Privatization is an effective way of depoliticization because the ultimate control rights of assets are reallocated away from the government. But the effect of privatization could be different between formal privatization and spontaneous privatization described above. Formal privatization is preferable to a spontaneous one not only because it is more transparent and thus fair, but also because property rights after privatization will be far more secure. Because spontaneous privatization is illegal, property rights over the assets from such a process are not protected and contracts are not enforced by the government. This increases the probability of reallocation of control rights.

Contrary to the outside perception, formal privatization of small SOEs in China has proceeded at a rapid pace since 1994, mainly pushed by the local governments at county and city levels. In the only publicized case, Zhucheng county of Shandong province privatized or partially privatized virtually all of SOEs under its supervision (*Economic Daily*, March 29-April 3, 1996, and *Wall Street Journal*, June 10, 1996). Other pioneering, but little known, cases include Shunde of Guangdong province, Yibin of Sichuan province, and Bin County of Heilongjiang province. In the past few years, Zhucheng was visited by 5,000 groups with 80,000-90,000 people from all over the country to learn the "Zhucheng model" of transformation of small SOEs (*Economic Daily*, March 29, 1996). Under local governments' initiatives

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<sup>18</sup> In 1995, the largest 1,000 of more than 100,000 SOEs account for 40% of total assets, 51% of net assets, 52% of sales taxes, and 66% of profits in the state sector (*People's Daily*, August 14, 1995).

and with an endorsement from the central government, it is estimated that up to 70% of small SOEs in China are currently undergoing some form of transformation as of mid-1996.<sup>19</sup> However, in China, free distribution of state assets is not allowed, employees or outside investors have to buy shares of SOEs.<sup>20</sup>

**Denationalization.** For those large enterprises which are not to be privatized, it is still possible to transfer some of them to a lower level governments of provinces and cities, that is, to denationalize. Under current law, state ownership means that the central government has ultimate control over the concerned assets, although it often delegates the control rights and assigns residual incomes to lower levels of government. Because the central government reserves the right to reallocate assets and residual incomes, local governments do not feel that the property rights of SOEs under their control are secure. Therefore many local governments prefer an alternative system of "public assets owned by multi-level governments" rather than the current system of "state assets managed by multi-level governments." The difference is that with local government ownership, the local government has ultimate control of local public assets and shares of local public assets can be defined and traded. One advantage of this system is the possibility of increased competition in capital and managerial labor markets *within* the public sector, in addition to competition *between* the public and private sector. This serves as a mechanism to limit political costs from public ownership and to increase local governments' incentives for efficient asset management.

**Pluralization.** For those enterprises the state intends to keep control of, ownership dilution is both possible and desirable. The concerned government may continue to hold controlling shares in an enterprise, but other institutional and individual investors could also hold shares. This is better than 100% state sole ownership (except for some special industries such as defense), because, opening enterprise to outside private investors with large blocks of interest will serve as a counterbalance to the state's political influence and as a monitoring device to managers. China's past experiment with joint stock companies shows that even when the state remains a majority shareholder, private investors on the Board of Directors often have

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<sup>19</sup> Private communication with economists and government officials in China.

<sup>20</sup> China has the advantage of a very high level of private financial savings. In 1993, household bank deposits and total financial assets were about 1 trillion yuan and 2 trillion yuan respectively, as compared with 3 trillion yuan total state assets (*China Statistical Yearbook*, 1994).

a strong voice for profit concerns and influence on business decisions. More importantly, pluralization of ownership would allow for an easy transition in the future if the government decides to further privatize these enterprises.

### **The State Assets Management System**

As the state will continue to own substantial shares of assets in the economy, a lot of discussion has been focused on establishing a state assets management system (Jiang, 1996). In the suggested two-tier system, the top tier is the State Assets Management Committee (SAMC), which is the representative agency for state property. The main task of the SAMC is the appointment and evaluation of board members and chief executive officers of financial intermediaries and large enterprises. The existing National Administrative Bureau of State-Owned Property will be incorporated into the SAMC as its administrative arm, responsible for auditing, collecting information and statistics, and measuring and recording asset values and transactions.

The second tier, which is between the SAMC and the incorporated enterprises, contains intermediaries which specialize in managing state assets. These intermediaries may include holding companies, investment companies, asset management companies, and industrial groupings; as well as insurance companies and pension funds. Some of the intermediaries will be organized based on existing organizations such as trust and investment companies and large enterprise groups.

How is depoliticization achieved through this transformation? There are suggestions to separate government administrative and regulatory functions (call it "government A") from the assets management functions (call it "government B") to minimize political influence of the government over enterprises. The conventional "government A" is run by politicians and bureaucrats and has many political objectives. "Government B" is designed to maximize the net value of state assets, and the employees in "government B" will be evaluated and rewarded according to their financial and economic performance. There are also suggestions to cut off the current administrative channel between government and enterprise through subordination by eliminating most branch ministries and bureaus. After ownership function is incorporated

into "government B," the functions of industrial policies will be moved to much smaller branch divisions inside the State Economic and Trade Commission (a la MITI of Japan), and other functions will be taken over by to-be-established independent business associations.

Similar schemes have been debated in some Central and Eastern European countries (such as Poland) in the past few years and there is no consensus on its effectiveness. At least three problems have to be resolved in order for this scheme to work in China. First, the specified objective of government B and evaluation criteria for its employees may become problematic in some circumstances. For example, if there exists divergence between social return and monetary return of investment in infrastructure and key industries, then maximizing state assets value cannot be socially desirable. Second, as many bureaucrats in the ministries/bureaus are eager to transform their agencies to assets management companies or holding companies, there exists a danger of monopolistic pricing and these holding companies taking back decision-making authority from the enterprises.<sup>21</sup> One particularly worries that a universal holding company, once created, is hard to get rid of, which may prevent future reforms and privatization (Aoki and Qian, 1995). One suggestion is to transform a ministry (e.g., petroleum chemistry) into several (say three) asset management companies, requiring them to compete with each other in the same industry. Third, the most critical and fundamental issue of this process concerns the future role of the Party. How to minimize, if not completely eliminate, the role of the Party Organization Department is the biggest challenge. The newly formed Shanghai State Assets Management Committee put the Municipal Party Secretary in charge of the Committee. This case demonstrates clearly the following dilemma: While the practice counters the effort to limit the role of the Party, without the Party secretary being in charge of its operation the SAMC could only be nominal, unless the Party gives up its control of personnel.

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<sup>21</sup> Carlin, Van Reenen and Wolfe (1995) report such cases in Central and Eastern European countries.

## **Corporatization and Corporate Governance**

Corporatization is an essential step toward an effective corporate governance. Corporatization in China starts with defining property rights of legal entities, that is, corporate property rights. After corporatization, an enterprise, as a legal entity, has property rights over its assets. According to the Chinese company law passed in December 1993, three major forms of companies are identified: joint stock companies, limited liability companies, and state wholly-owned companies. Boards of directors are established to represent the interests of all shareholders and make major and strategic decisions, including appointment and dismissal of top managers.

The idea of corporatization started to gain more and more approval in China from the government, enterprises and economists, only in 1993. By corporatization, the government hopes to have only limited liability for losses and to hold managers accountable for their actions. Managers see corporatization as a way to legitimize some of their effective rights of control over assets, shielding them from government intervention. They also see corporatization as a useful means to raise new capital in the future. But the biggest worry of managers in China, as elsewhere, is the possibility of loss of control and rents. Specifically, they don't like concentrated investors and large controlling blocks, so they want outside investors to be sufficiently diffused. The experience of Central and Eastern European countries has shown exactly how insider control becomes a serious problem after privatization (see Aoki 1995 and Transition Report 1995).

Because stock and bond markets will take a long time to develop in China, disciplinary mechanisms such as corporate control market through takeover and merger will not play a big role in the near future. To better control insiders, two recommendations have been put forward. First, there is a need to strengthen internal mechanisms of checks and balances among shareholders, board of directors, and managers. Specifically, one suggests to separate the role of chairman of the board and chief executive officers and set up an additional supervisory committee as part of the internal governance structure (Jia 1996). Second, many economists recommend relying on the development of relational banking that can selectively intervene in the manager-controlled enterprises at the time of financial distress (Aoki 1995).

Relational banking, as opposed to arm's-length banking, emphasizes control-oriented finance and thus can play a role in corporate governance (Berglof 1995). However, the banks' role in corporate governance in China is limited by the current Commercial Bank Law which prohibits banks from holding equity. This regulation was introduced for preventing state banks from diverting funds for investment speculations as they did in 1992-93. However, the government should consider the positive role of banks in corporate governance in revising the regulation.

A variety of corporate governance emerged in China recently, and the most prominent ones have taken the following three generic forms.

**"Partnerships" with Foreign Investors.** The success of many Sino-foreign joint ventures in China created some enthusiasm about the governance structure involving foreign investors. The large inflow of foreign direct investment (FDI) provided China with an opportunity to utilize foreign physical and human resources for enterprise reforms. The practice of taking a part of a state-owned enterprise and forming a joint venture with foreigners is not unusual and has received the nickname of "grafting" (*jiajie*). The most striking example is Quanzhou of Fujian province, where an overseas Chinese bought controlling shares of all SOEs in the city (Hu, 1994). But there is a serious limit for such a model due to the concern of "national interests," especially at the time of a growing nationalism sentiment. Although being significant, joint venture with foreigners is unlikely to become a popular future model of corporate governance for the majority of enterprises.

**"Stock Cooperatives."** For small SOEs, a possible governance structure is through a partial or complete sale of enterprises to managers and employees which enables them to obtain control. It is interesting to observe that the majority of privatized or partially privatized small SOEs through this method have voluntarily chosen a new corporate form known as "stock cooperatives."<sup>22</sup> Although varying greatly, most stock cooperatives can be understood as a mixed corporate form of stock companies and cooperatives with the following features. First, some or majority shares are subscribed and owned by employees as individuals; for those shares, distributions are determined by the number of shares, while control is

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<sup>22</sup> Stock cooperatives first emerged in the process of partial privatization of township-village enterprises.

determined by "one-person-one-vote." Second, some shares are earmarked as a trust fund for employee pensions and are owned by employees as a whole, benefits from those shares are distributed according to seniority. However, stock cooperatives are not simply traditional "producer cooperatives" because, first, the number of shares varies across employees depending on paid subscription, and second, there usually exist some (or large) shares of outside equity which carry one vote per share. Both enterprises and governments regard stock cooperatives as an appropriate corporate form for small enterprises at present time in China (*Economic Daily*, March 29-April 3, 1996).

**Governance with Institutional Shareholders.** Experience from both developed and transition economies has shown that the governance problem with large corporations is far from trivial. For large SOEs, a governance structure involving several large institutional shareholders as core investors is emerging in China. To start with, these institutional shareholders are mostly state financial intermediaries such as state holding companies and assets management companies. The holding company model is being experimented, for example, Ministry of Electric Power is being replaced by a holding company which holds shares in power generating stations and electricity networks. Large enterprise groups and the associated cross holdings among enterprises a la the Japanese *keiretsu* model is also in the process of formation. In some experiments such as the Second Automobile Group, the parent company of the enterprise group is being transformed into a state-owned assets management company when it stops the production supervision it now performs. Apparently, these methods of large enterprise transformation may create monopolies and anti-trust will become China's important task ahead.

## 6. Conclusions

The central theme of my paper is this: Reducing political and agency costs is the main concern in enterprise reform in China, which is affected by allocation of control rights via institutional and property rights transformation. I first apply this idea to analyze the reality of enterprise reform, and argue that the past reform has delegated many effective control rights to enterprise while ultimate control rights remain at the hand of the Party and the government. The result is that either the agency costs are high because

managers lack accountability, or the political costs are high because the government causes political interference, or both.

Both political and agency costs should be reduced, and I argue that it can be done through depoliticization, effective corporate governance, and desocialization. All three are essential, and the lack of any one of them would derail a good enterprise reform. Some key operational issues have to be addressed. Ownership transformation calls for a combination of privatization, denationalization, and pluralization; establishment of a good state assets management system has to limit political influence of the government on business decisions; and corporatization serves as an essential step toward effective corporate governance, which may take a variety of forms.

Enterprise reform in China encompasses a large scale institutional transformation including reforms in property rights, corporate forms of enterprises and the government bureaucracy. It will also require a fundamental reform in the financial system and an establishment of a social security system from scratch. The difficulty and complexity of the task cannot be underestimated. But there are some favorable conditions now. Reforms in the areas of foreign exchanges, taxes, and fiscal systems have made new breakthroughs, and price liberalization is close to complete. A large inflow of foreign investment is providing new capital, and increased competition from the non-state sector is putting more pressure on the state sector. The expectation of sustained rapid growth of the Chinese economy provides good conditions for labor re-deployment. Finally, the changing ideology has gradually relaxed the ideological and political constraints. Indeed, the Chinese style privatization is already underway at a rapid pace. One may expect that enterprise reform in China will make significant progress soon.

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Table 1

China: Returns to Capital and Labor in the State Sector, 1978-94

	Profits and taxes per value of net fixed assets and working capital in industry	Increase of real wages and bonuses per worker over the previous year
1978	24.2	6.2
1979	24.8	7.4
1980	24.8	6.0
1981	23.8	-1.3
1982	23.4	0.9
1983	23.2	1.4
1984	24.2	16.4
1985	23.8	4.8
1986	20.7	8.9
1987	20.3	0.5
1988	20.6	-0.7
1989	17.2	-4.6
1990	12.4	9.7
1991	11.8	3.2
1992	9.7	7.0
1993	9.7	5.7
1994	9.8	8.7

Source: p. 430, *Statistical Yearbook of China, 1993*;  
p.402, *Statistical Yearbook of China, 1994*; and  
p.406, p113, *Statistical Yearbook of China, 1995*.