Privatization and the separation of ownership and control: lessons from Chinese enterprise reform

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1. Introduction

Chinese enterprise reforms have not involved major privatizations. Instead, greater and greater autonomy has been given to state-owned firms.¹ The growth of township and village enterprises has been encouraged and prices have only gradually been liberalized. The success of the reforms by any measure has been enormous. The Chinese authorities have managed a transition towards a market economy without major disruptions to the economy. Moreover, the effect of the reforms - in particular enterprise reform - on output growth has been tremendous. From the very beginning of the reform process in the late 1970s until 1995, China’s GDP has grown at an annual rate of close to 10%. There has only been a minor contraction (by East European standards) in the late 1980s.

This paper is mostly concerned with the township and village enterprise sector, which is the most dynamic sector in the economy. It analyses how a thriving and efficient market economy could emerge in this sector without significant transfer of ownership of the means of production into private hands. The success of Chinese enterprise reforms in this sector is due in large part to the gradual and piecemeal introduction of market reforms emphasizing better managerial incentives along with greater decentralization, regional autonomy, and greater competition in the product markets. It is also worth emphasizing that an important aspect of the Chinese reform process has been its experimental nature. Initially, no detailed blueprint of reforms was specified. Regional governments as well as lower government tiers were free to explore different options. It is only when a clearly dominant strategy emerged that a systematic implementation of this strategy was attempted.²

The transition towards a market economy has been achieved without undermining the whole planning system. In contrast to the reform process in Russia and other East European economies, the emphasis has been on incentives and competition rather than ownership. The Chinese experience shows that it is not necessary to privatize a state-owned firm in order to improve its efficiency, and that it is possible to avoid the huge (short-run) disruptions in the economy caused by "shock therapy" reforms.

Underlying the entire analysis of this paper is the observation that, irrespective of whether firms are privately or collectively owned, the main sources of inefficiency in
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production are the lack of competition in product markets combined with the separation of ownership and control. There is an extreme form of separation of ownership and control in a state-owned firm, but control is also likely to be separated from ownership in private medium-sized and large firms. Because of this separation it is not clear a priori that private ownership is a more efficient arrangement than public ownership. Moreover, competition in product markets, which is known to improve efficiency significantly, can be introduced whether firms are private or state-owned. The overall strategy of Chinese enterprise reforms can be described as a strategy of encouraging competition in product markets and improving the governance structure of firms, while retaining collective ownership of the means of production. An entirely different strategy has been pursued in Russia and other East European countries, where little has been done to increase competition or to improve the supervision of managers, but all the emphasis has been on rapidly transferring ownership from the state into private hands.

Despite the important differences in underlying economic conditions and in the histories of transition in Eastern Europe and in China, this paper argues that important lessons for enterprise reform in Russia and other East European countries can be drawn from the Chinese experience. The very success of Chinese reforms and the mixed results achieved by privatization in Eastern Europe so far suggest that in Eastern Europe too much emphasis has been put on the problem of transfer of ownership and not enough attention has been devoted to managerial incentives and product market competition. Thus, just as McKinnon (1994) has argued that valuable lessons for transition in Eastern Europe can be drawn from Chinese macroeconomic policies, this paper argues that valuable lessons can be drawn from Chinese microeconomic reforms.

The paper is organized as follows. Section 2 briefly discusses the main costs and benefits of privatization when there is separation of ownership and control. Section 3 describes the most remarkable development in the Chinese economy, the growth of township and village enterprises (TVEs). It explains how the development of TVEs can be seen as an alternative to mass privatization. Section 4 speculates on the future of TVEs. Could all state-owned enterprises (SOEs) be turned into TVEs? Are TVEs a stable institutional arrangement which could form an alternative to private ownership? Finally, section 5 provides a few concluding comments.

2. Public versus private property when control and ownership are separated

In a modern economy, the technological returns to scale are such that it would be inefficient to attempt to eliminate the problem of separation of ownership and control directly by forcing managers to be the owners of the firm. Even if there are individuals wealthy enough to be owner/managers of large enterprises they would not necessarily have the expertise to run these firms. In other words, the distribution of managerial talent may not coincide with the distribution of wealth. The more technologically advanced the economy, the more specialization in management is required and the less likely it is that a wealthy individual could run any large firm which he owns without transferring substantial control to managers with specialized skills.

If the separation of ownership and control cannot be overcome directly it can be mitigated by giving managers adequate incentives and by monitoring their activities. The importance of managerial incentives is now well recognized and an important argument in support of privatization is that managers get better incentive packages under private ownership. In addition to managerial incentives it is equally important to have a good system of supervisory incentives for the managers adequate responsibility to debates on reform the current system (Cadbury Report). responsibility of investors 

2.1 Managerial

There is overreliance in the past and present on private or centrally planned for the privatization inefficiency is that collective owners as for their super extreme form of shareholder ownership among all citizen large shareholders especially when supervised.

The government in most countries the office failed adequate monitoring nation the main ones. Governments in the former CPI in China (before to the planning era set their prices but of this centralization a milder form in informational private economies.

Governments were encouraged
system of supervision of managerial activities. Here the main difficulty is to set up proper incentives for the monitors (the representatives of the owners of the firm) to supervise managers adequately. If the firm is privately owned it is the Board of Directors' responsibility to supervise management. Anyone who has been following the recent debates on reform of corporate governance is well aware of the glaring deficiencies of the current system of supervision of managers in privately owned firms (see e.g. the Cadbury Report). If the firm is state-owned, the supervision of managers can be the responsibility of a ministry, local government or a specialized government agency. The deficiencies in the supervision of managers in state-owned firms are even more glaring than those in private firms, with, perhaps, the exception of TVEs, as we shall argue in section 3.

The importance of managerial supervision may be reduced when firms are subject to tough competition in the product market, since managers then have less room to mismanage - thus, the importance of creating a competitive environment. Interestingly, the Chinese experience seems to indicate that competition in product markets is already a very effective disciplining force, even when there is little or no competition in labour or capital markets.

2.1 Managerial incentives and monitoring in state-owned firms
There is overwhelming evidence, world-wide, of the inefficiency of nationalized firms in the past and present, whether in developed market economies, in developing countries or in centrally planned economies. Indeed, this evidence provides the strongest support for the privatization programmes implemented the world over. The main source of this inefficiency is the extreme form of separation of ownership and control implied by collective ownership and the absence of adequate incentive schemes for managers as well as for their supervisors, who are often politicians. Collective ownership is the most extreme form of shareholder democracy; share holdings in any firm are by law dispersed among all citizens in the country and usually there is no mechanism for the creation of large shareholders. It is the very dispersion of ownership that gives managers a free hand, especially when they do not face any competition and when they are not adequately supervised.

The government is the de facto representative of the owners of nationalized firms. In most countries these firms performed poorly also because the various administrations in office failed adequately to supervise management. As the failures of governments in monitoring nationalized firms have been widely documented I shall only briefly mention the main ones.4

Governments imposed excessive centralization on the nationalized sector, especially in the former CPEs. In the latter economies, in particular in the former Soviet Union and in China (before the reform period), firms were required to hand over all their revenues to the planning authorities. Firms could not initiate new investment programmes, let alone set their prices and wages without authorization of the planning authorities. As a result of this centralization, investment and resource allocation decisions were taken without appropriate information about costs, available technology and demand. Centralization took a milder form in the nationalized sectors in market economies and, as a result, the above informational problems were far less serious than in the case of SOEs in command economies.

Governments tended to shield nationalized firms from competition and to dull managerial incentives by removing the threat of bankruptcy. Firms running large losses were guaranteed subsidies to cover these losses. Firms had soft budget constraints. As
result, managers of SOEs had no strong incentives to minimize costs and to innovate. Often managers had little control over firing and hiring decisions anyway.

Managers of nationalized firms were often replaced when a new administration took office. Managerial positions in nationalized firms became political appointments and, more generally, the whole firm could become a political fief. Nationalized firms in most countries have been captured by the political parties in power, which generally did not guide the management of these firms in the best interest of the general public.

It is only fair to say that when the first nationalizations were introduced nobody had spelled out clear economic principles for the managers of nationalized firms to follow. Indeed, the first motivation behind nationalizations was often not economic but social or political. Nationalized firms were supposed to be showcases of labour relations and to provide cheap services and goods to the general public or to industry at large. Minimizing costs, maximizing profits or balancing the books were rarely held out as important objectives. Thus, one should not judge the performance of nationalized firms only by these criteria. If at the outset the main objective had been to minimize costs and to balance the books it is conceivable that the performance of nationalized firms could have been radically different. Indeed, in the countries and/or sectors of the economy where greater emphasis has been put by the government on cost performance, nationalized firms have had similar and sometimes better performance than their private counterparts (a well known and often cited example is the electricity generation industry in France).

2.2 Managerial incentives and monitoring in private firms

In the 1980s a consensus emerged in the economics profession that the most effective way of improving the cost and profit performance of nationalized firms is to privatize them. Disagreements were mostly about the pace and extent of privatizations. Vickers and Yarrow summarize the mainstream view on privatizations as follows: "It...Privatization is likely to improve social welfare only if it provides significantly keener managerial incentives than does the control system for public enterprise...Given the incentive problems associated with the control of publicly owned firms, it is likely that public monitoring systems are generally less effective than their private counterparts" (Vickers and Yarrow, 1988, p.44).

Once this consensus emerged little thought was devoted to the question of how to improve existing control systems in nationalized firms and most of the debate centred on how to achieve privatizations as quickly and efficiently as possible. Existing control systems in nationalized firms may be worse than those in private firms, as Vickers and Yarrow argue; but this does not mean that the controls provided by boards of directors or by corporate raiders are satisfactory.

Just as in state-owned firms, the representatives of owners in private firms are often not acting in the best interest of owners. There is a lot of evidence suggesting that Boards of Directors in many large firms are captured by management. Recently, many Boards in the US and the UK have awarded compensation packages to executives which many commentators have argued are out of proportion with the contribution made by these executives to the performance of the corporation. Also, the takeover and leveraged buy-out wave of the 1980s has shown how ineffective the disciplinary threat of takeovers is for most companies; takeovers have been an effective disciplinary device only in a few spectacular cases in the US and the UK.

It is hardly surprising then that major breakdowns in managerial governance regularly occur even in the most advanced capitalist economies. Some well known recent examples include the Savings and Loan debacle in the US, the spectacular failures of Polly Peck,

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In developing countries and in former CPEs the governance structures in private firms are likely to be considerably more fragile. Three important features of former CPEs exacerbate the corporate governance problem in the newly privatized firms. First, individuals have little wealth and wealth is widely dispersed. As a result, stock ownership is likely to be widely dispersed and/or to be concentrated in the hands of employees and workers. This usually means that "entrenched management" faces little or no disciplinary threat from shareholders and their representatives. In some cases, as in the Czech Republic and Russia, concentration of share-ownership has been achieved through financial intermediation (mutual and investment funds). However, the absence of proper accounting and auditing practices and of almost any serious financial regulation has allowed some of these funds to take advantage of gullible and ill-informed small investors; this has (almost inevitably) resulted in major financial scandals. Second, the expertise and knowledge required to run the large industrial conglomerates is in the hands of the managers of the former SOEs and the planning officials. The important informational monopoly of the ex-nomenklatura makes it even more difficult to monitor management. Third, the newly privatized firms in Russia face almost no competition in the product markets and practically no threat of bankruptcy.

Given the important inefficiencies that are likely to arise from the separation of ownership and control in newly privatized firms, the case for full scale rapid privatization is not compelling. A reform programme that increases competition in product markets, improves managerial incentives and strengthens management control systems directly, without first transferring ownership from the state into private hands may be more sensible. This has been the Chinese approach over the last decade. Judging from the success of Chinese enterprise reforms there may be some useful lessons to be learned from this reform process for transition in Russia and other Central and East European countries.

3. Improving the performance of collectively owned firms: the case of TVEs

Very broadly, the aim of Chinese reforms has been to introduce greater decentralization and competition. State-owned firms were allowed to retain a fraction of their earnings and, thus, to obtain greater control over production, employment and investment decisions. The effect of these reforms on worker productivity in SOEs has been dramatic. But undoubtedly, the most important development of Chinese enterprise reforms has been the emergence and growth of TVEs. Rural industry in China is divided into two categories: township and village enterprises and below village level enterprises. Both categories of firms have grown dramatically. The discussion in this section focuses on the former category; one should, thus, bear in mind that the figures given below somewhat underestimate the importance of the growth of this sector.

By encouraging the growth of TVEs, Chinese reformers have introduced a new institutional arrangement which turns out to be a very effective mechanism for corporate governance. Since towns and villages have had considerable autonomy in deciding what their firms should produce and sell, the emergence of the TVE sector has given rise to greater and greater competition in product markets. This competition, in turn, has been an important disciplining force for managers of TVEs, especially since TVEs have typically not been entitled to the same subsidies as SOEs.
3.1 Decentralization and corporate governance in collectively owned firms

There is a wide variety of TVEs. Since TVEs are typically a residual category there are many different forms and often the distinction between a TVE and an SOE is not clear-cut. Nevertheless, the bulk of TVEs have many features in common which we briefly discuss in this section. Many TVEs have been set up by local governments, who control the appointment of managers, set the compensation packages of managers and take part in the most important decisions concerning the firm. Alternatively, when the creation of the firm has been initiated by an entrepreneur/manager, the local authority is the main supervisory authority and in practice township and village governments often do monitor these firms closely. The local governments are also the recipients of the residual returns of the TVEs. A large fraction of these returns is used to finance local government expenditures, including social welfare expenditures. The managers of TVEs are free to set wages and prices and to make production, employment and investment decisions. Thus, there is not much difference between a manager in a TVE and a manager in a private firm. The key difference is corporate governance.

The most remarkable aspect of TVEs is the de facto transformation of the notion of public ownership implied by their organization. While the ownership of SOEs is in principle dispersed over the whole country, the ownership of TVEs is basically restricted to the local community. It is easy to see that the local community is likely to have much greater control over the management of TVEs; not only does it have a larger stake in the TVE than in a distant SOE, but also the managers of the TVE tend to be locals with roots in the community. It is, thus, to be expected that management of TVEs will be under closer scrutiny and that the TVE is more likely to be run in the interest of the community.

The growth in TVEs is the most significant development in the Chinese economy over the past decade. The average real growth rate in output by the TVE sector from 1986 to 1991 has been around 14% per year. The share of TVEs in rural output was on average 33% in 1986 and had grown to 40% in 1991. In short, the TVE sector is growing faster than GDP and is gradually taking up a larger and larger share of output. Interestingly, the growth in output has not been accompanied by a similar growth in employment. The growth in employment has only been on average 1.65% per annum. Thus, TVEs have not yet been large absorbers of "surplus labour" in agriculture they were made out to be in Sachs and Woo (1994). One slightly puzzling aspect of these employment growth figures is that across regions the ratio of employment growth to output growth has been highest in the richer regions and lowest in the poorer regions (Tianjin, Beijing and Shanghai have had the highest ratios, while Yunnan and Guizhou have had the lowest). One would have expected that employment growth is highest in the poor regions where wage costs are lowest. On the other hand, the positive feedback effect of "local externalities" probably outweighs the wage differential between rich and poor areas. If market forces are left unchecked, labour is more likely to move from poor to rich regions than capital to move from rich to poor regions.

In terms of profitability, the after-tax performance of TVEs has consistently been higher than that of SOEs. In 1986 retained profits were 11.8% in SOEs and 24% in TVEs and in 1991 SOEs had 7.8% of retained profits while TVEs had 21.5%. This may explain why TVEs have grown faster than GDP over this period. Note, however, that the tax burden on SOEs appears to be almost twice the tax burden on TVEs, so that the difference in pre-tax performance of SOEs and TVEs is less pronounced. The reported pre-tax profits have been higher in TVEs than in SOEs, but that may be due in part to greater incentives for tax evasion in SOEs. The higher tax burden on SOEs is an indication of the emergence of the potential for higher tax evasion.

3.2 Competition

Another important success of TVEs has been the encouragement to policies of the sector to intern competition. Indeed, TVEs have been able to compete freely in the local market. Typically, the most successful TVEs have been those that have been closely tied to the local government. The government often provides a number of support mechanisms, such as the provision of cheap or free land, tax breaks, and access to local markets. These TVEs have been able to compete with each other and with other firms, including foreign firms. This competition has led to the emergence of efficient and successful TVEs, which have been able to grow and expand their operations. As a result, the overall productivity and efficiency of the Chinese economy have improved significantly.

To summarize, the introduction of competition in the market has led to an increase in productivity and efficiency in the Chinese economy. The success of TVEs has been due to the ability of firms to compete freely in the local market, and to the provision of support mechanisms by the government. The overall result has been an increase in productivity and efficiency, as well as the emergence of successful and efficient TVEs.
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s of the central government have, at a very early stage, exposed the TVE sector to international competition.

Competition in product markets can be an important disciplining force if, as a result of it, the most inefficient firms are closed down and the most efficient firms expand. The natural selection process of firms works best when firms’ sources of investment funds, inputs and employment are decentralized and when firms are free to make their own production, investment and pricing decisions. This has mostly been the case with TVEs.

Indeed, TVEs are not subject to the employment laws of SOEs; in particular, they can lay off workers, as they did massively in 1989 and 1990. Also, TVEs have usually not been constrained by the lack of available land, contrary to their counterparts in cities. As for investment funds, TVEs have been very successful in raising funds from the local community. Because of their local roots they have been able to engage in informal financial transactions. To a large extent, this local source of funding has counterbalanced the more restricted access to bank credit and state subsidies. Also, because the local community often has a substantial financial stake, a loss-making firm cannot survive as easily as other SOEs. There are and have been many unsuccessful TVEs and many have been closed down. The threat of liquidation of loss-making TVEs is one of the most important disciplining forces for TVE management.

TVE competition has also forced SOEs in a number of sectors to shape up. They had to improve product quality, cut prices and costs and to streamline internal production, often by subcontracting some activities to TVEs.

To summarize, two important factors explaining the success of TVEs are the introduction of a vastly improved governance structure and the high levels of competition in product markets (both inside China and in world markets). Arguably, the ownership and control structure of TVEs might actually dominate the governance structures of private firms. The local authorities may be better monitors than a board of directors or a bank. Indeed, local government represents the interests of the whole community and, thus, may be less likely to be captured by the management of TVEs. Local governments may also have stronger incentives to induce TVEs to internalize some of the negative externalities they may impose on the local community. Finally, it has been argued that the local nature of TVEs can foster greater cooperation between workers, managers and local government. Whether TVEs actually do control managerial performance better than private firms cannot be established definitively, but the huge success of TVEs is sufficient evidence to take this alternative form of governance structure seriously.

As Sachs and Woo (1993) and Weitzman and Xu (1993) have argued, there are factors specific to China which may have facilitated the emergence of this organizational form. The same form may not be exactly suitable in other countries like Russia. However, the Chinese experience suggests that alternative policy options to full scale privatization ought to be considered more carefully. For example, the introduction of greater competition prior to privatization (which could be achieved by breaking up existing conglomerates), greater involvement by local government in the supervision of firms, and greater decentralization in the allocation of credit combined with greater competition between banks are policy options which should be taken more seriously. The
Chinese experience also demonstrates that substantial efficiency improvements can be obtained through partial reforms and through decentralized reform. The main drawback of "shock therapy" is that it induces enormous disruptions in the economy at least in the short run: it has been more effective in destroying the coordination mechanism of central planning than in creating new market coordination. In addition, it has introduced enormous undiversifiable risks which have induced even the most dynamic agents in the economy to wait and see how this uncertainty is resolved. The additional advantage of the Chinese reform process is that it is much easier to correct policy errors and to push good reforms; also, it is easier for economic agents to adapt to the gradual transformation of the economy.

4. What is the future of TVEs?

The success of TVEs and the recent worsening in the performance of SOEs and urban collectively owned enterprises (COEs) suggests that the TVE sector ought to be expanded and that reform of COEs and SOEs may involve the creation of a governance structure similar to that of TVEs. This section asks whether TVEs can be expected to be a stable institutional arrangement which could form a long term alternative to private ownership of firms and whether the transformation of inefficient urban state-owned firms into something like a TVE is a feasible and desirable policy option.

4.1 The stability of TVEs

The organizational form of TVEs has been well suited for newly created businesses in townships and villages, whose initial size, labour force and financial flows were confined within the local community. The more successful TVEs, however, are likely to grow large enough that their activities can no longer be circumscribed within the local township or village. It would be inefficient to prevent the more efficient TVEs from growing outside their own communities. But TVEs overlapping several local communities may see the public control systems for managers break down; as the experience of the more successful TVEs shows, the managers of these firms become too powerful to be effectively monitored by local government officials. This is one important reason why the organizational form of current TVEs is likely to be modified.

Furthermore, the most profitable TVEs will want to invest in other localities, or attract workers from other localities. But TVEs investing outside their community will require protections to guarantee an adequate pay-out from their investments in other localities' TVEs. Investor protections can take two alternative forms: either investors get voting and control rights, or investors get the protections offered by debt contracts. Either way, the introduction of such investor protections require the establishment of some form of joint stock company. Similarly, when outside workers are hired the question arises of whether the new workers can share in some of the non-wage returns and benefits of TVEs to which workers from the locality have access. There are strong incentives not to treat these immigrant workers as equal partners in the TVE. In fact, given that TVEs have a structure which resembles that of a cooperative one can expect that this form of discrimination will become more and more common.

As more TVEs grow large the pressures to remove the constraints limiting their expansion will build up. Also, households will want to invest their savings in these profitable ventures. It would clearly be inefficient not to exploit this growing source of funds for investment. But to be able to attract private placements, TVEs must devise sufficiently attractive pay-out policies and also give individual investors adequate protection. In the final analysis, individual incentives are everything. Already, there are signs of misappropriation of profits, whatever the reason.

In all, it is likely to lead to the rise of the TVE, but it remains to be seen whether there will be any feasible policy to curb the growth of TVEs.

4.2 Reform and TVEs

By their very nature, TVEs are essentially privileges. Moreover, the TVEs have become an important part of the urban economy. Therefore, the question must be whether the policy changes can be made without jeopardizing the TVEs.

The types of TVEs that are likely to be introduced in the near future are those that are more or less autonomous in terms of the control of major inputs and outputs. The TVEs are then likely to be more competitive and efficient in the market. With greater managerial mobility, the TVEs are less likely to be subject to bankruptcy.}

5. Conclusion

Growth in the urban economy has led to substantial changes in the way urban enterprises are owned and operated. Traditionally, urban enterprises were publicly owned and operated by the government. With the introduction of TVEs, there has been a change in ownership and management.
movements can be the main drawback. At least in the mechanism of central t has introduced public agents in the formal advantage of SOEs and urban ht to be expanded enterprise structure ed to be a stable private ownership owned firms into
ted businesses in the were confined to likely to grow to the local township Es from growing municipalities may see the of the more powerful to be the reason whyunities, or attract unity will require other localities' or get voting and s. Either way, the one form of joint arises of whether efforts of TVEs to has not to treat hat TVEs have a at this form of its limiting their savings in these rowing source of VE s must devise vestors adequate

protection. In the long run some form of control rights must, therefore, be handed over to individual investors. There is another reason why TVEs must devise adequate pay-out policies. If they let retained earnings accumulate there will be stronger and stronger incentives for managers and local government officials to misappropriate those earnings. Already, there are alarming signs of growing corruption. If the rewards from misappropriating funds grow larger corruption is likely to spread, despite the harsh punishments imposed on those who are caught.

All in all, the growth of TVEs and the expansion in savings and capital markets is likely to lead eventually to the transformation of TVEs into joint stock companies and perhaps later to privatization. This process of gradual institutional transformation, however, should not be accelerated beyond what is immediately necessary. Most TVEs can at the moment function efficiently without requiring major transformation. It is only as the economy develops further and the need for diversification of investments is greater that the transformation of TVEs into joint stock companies should be encouraged.

4.2 Reform of SOEs: can and should they be turned into TVEs?

By their very nature and size, the activities of most SOEs span several localities. Moreover, the larger SOEs do not really have a natural local community attached to them. Therefore, a straightforward transformation of SOEs into TVEs is not really feasible. However, some of the desirable features of corporate governance in TVEs could be introduced in SOEs.

The types of inefficiencies in SOEs that are often mentioned are excess interference by the planning authorities in the day-to-day management together with a lack of autonomy of these firms, excess job security and a bloated labour force, inefficient pricing of inputs and outputs, obsolete production technologies and excessive protection from competition through restrictive regulations and automatic subsidies. All of these inefficiencies can be reduced by giving SOEs the kind of management autonomy that most TVEs currently enjoy. This involves, in particular, greater control over pricing, employment, output and investment decisions.

With greater autonomy, however, more financial responsibility and more effective managerial monitoring need to be introduced. This means, for example, that some form of bankruptcy of loss-making SOEs must be allowed. As for corporate governance, one possibility could be that the largest firms could be under the control of several regional or local governments, each having a stake in the firm. Such a scheme would raise interesting issues which have not yet been thoroughly explored by Chinese reformers. For example, ownership shares, procedures for collective decision making and rules for the allocation of residual returns as well as the financing of new investments would have to be specified. In other words, some legal form like a joint stock company would have to be defined. Potentially, trades of shares among regional and local authorities might be allowed so that the most motivated local governments can increase their stakes and, thus, have greater incentives to control management. These are difficult organizational issues which, however, need to be addressed urgently.

5. Conclusion

Growth in the TVE sector and in the size of TVEs has been uneven. There are already substantial regional inequalities. To the extent that local governments have an important stake in TVEs, this growing inequality between local communities and regions could undermine the unity of the country. The richer communities and regions are pushing for
more and more reforms and central government policies which may go against the
interests of the poorer regions and localities. The fact that TVEs are de facto locally
owned tends to exacerbate inequalities among communities and regions. Regional
inequalities are now sufficiently extreme that the favourable tax treatment of TVEs is no
longer called for. Higher profit and turnover taxes on TVEs together with suitable
regional redistribution policies may now be necessary, even if, as a consequence, they
have some adverse effects on the growth of TVEs in the more dynamic regions. An
increase in federal taxation on TVEs is all the more necessary since there are no well-
functioning capital markets in place which could facilitate the redistribution of
investments to the poorer regions. The recent reform proposals of the banking system are
a first step towards the establishment of a well functioning financial system which could
also help in reducing regional inequalities by encouraging investment in the poorer
regions.

Endnotes

1. See Groves, Hong, McMillan and Naughton (1994) for a description and analysis
   of this process.
2. See Qian and Xu (1993) on this aspect of economic reform.
3. To name just one example, when Edsel Ford died in 1943 his son Henry became
   the President of the company, but because he had little managerial expertise (in
   his own words: “clearly, I just don’t know enough to run this damn place”) he
   hired the rising star at GM, Ernie Breech, to run the company. This solved
   Henry’s managerial problem but also created the problem of monitoring a manager
   who knew more than he did.
4. See Boycko, Shleifer and Vishny (1993) for an extensive catalogue of government
   failures in state-owned firms.
5. See for example, Shleifer and Vishny (1988), Jensen (1988) or Jarrell, Brickley
7. See Herzel and Shepro (1990) for a description of some of the most notorious
   takeover battles.
8. See Bolton and Roland (1992), Tirole (1992) and Phelps et al. (1993) for a
discussion of the weaknesses of corporate governance in Central and Eastern
European economies and the drawbacks of relying on stockmarkets to monitor
managerial activities.
9. See McMillan and Naughton (1992) for a review of reforms and efficiency
   improvements in SOEs.
10. TVEs are the main source of employment in the non-agricultural sectors, where
    wages are substantially higher than in agriculture. Also, much of rural social
    welfare is financed through profits from TVEs. Localities with more developed
    TVEs tend to have more extensive welfare coverage; see Hussain (1993) and
12. Indeed, the lack of worker protections in TVEs has sometimes left workers
    defenceless against unscrupulous employers.

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