Reform of Ownership and Control Mechanisms in Hungary and China

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REFORM OF OWNERSHIP AND CONTROL MECHANISMS IN HUNGARY AND CHINA

RECENT DEVELOPMENTS AND FUTURE DIRECTIONS

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INTRODUCTION AND SUMMARY

i. Economic reform of centrally planned economies has gained momentum in recent years. One major development is the attempt to reform the ownership and control mechanism of industrial enterprises. In Hungary, the new association law, passed in October 1988, would enable the transformation of state enterprises into joint stockholding companies and would allow the establishment of limited liability companies by individuals. In China, "ownership reform" is considered to be the central element of the economic reform program; a number of new measures such as management contracts and joint stockholder companies already have been introduced. In Yugoslavia, which has a history of worker self management, a further step toward reform in property rights is being explored in response to major economic crises in recent years.

This paper reviews developments in the reforms of Hungary and China, the front runners in the reform of ownership and control mechanisms in planned economies. The paper also identifies desirable directions and steps for future reform in these countries. The experiences of Hungary and China would be useful for other socialist countries contemplating similar reform programs. These reforms also may provide lessons for public industrial enterprises in developing countries. The reform processes demonstrate the need to view reform of ownership and control mechanisms as an integrated process removing systemic and administrative constraints on the development of market mechanisms in both product and financial markets.

In the first chapter, the economic background of recent moves toward reforming the ownership and control mechanism is described. The current ownership and control mechanism has the following three structural characteristics: First, no entity can have full property rights to the productive assets, i.e., the right to manage the assets and the right to appropriate return from the assets. Second, the government exercises monitoring and control over enterprises as the sole agent of the people as a whole, through its hierarchical administrative structure. Third, the government uses its strong regulatory and administrative authority to make enterprise-specific interventions for achieving its economic and social objectives. This structure of the ownership and control mechanism is considered the root of major systemic problems in planned economies: weak incentives for efficient management of assets and asset accumulation, underdeveloped financial markets, and limited and distorted competition.

The second chapter briefly reviews recent reforms in Hungary and China, focusing on those relating to the ownership and control of state industrial enterprises. The basic conclusion is that recent measures, particularly in Hungary, have created an opportunity for fundamental transformation of the ownership and control mechanism, although the steps taken have been limited. Enterprises have been given more management autonomy, but property rights to the residual value of enterprises remain unclear. The government's ownership function still is exercised through its hierarchical administrative structure. The government makes substantial regulatory and administrative interventions, especially supporting loss-making enterprises. Both the new management system introduced in Hungary and the management contracts introduced in China have failed to encourage enterprises to manage and accumulate assets efficiently.
v. **The third chapter** assesses the potential and limits of worker self management, the introduction of which is a common trend in ownership reform in planned economies. The discussion suggests that the introduction of worker self management is an attempt to enhance the incentives and accountability of enterprises (under the limitation of the monitoring and control capacity of the government) and affirm the workers' right to participate in management in socialist economies. However, self management is not likely to be an effective measure for addressing systemic problems as long as the property rights to the residual value of enterprises remain uncertain. Self management also has other limitations. This chapter points out that capital tickets, introduced in Hungary, and the restricted shareholding companies experimented with in China can solve only part of the problems of self management.

vi. **The fourth chapter** discusses four major dimensions in bringing about substantive reform. First, the need for further rationalization of regulations and other administrative interventions is discussed. Ownership reform alone will not induce a market-oriented response from enterprises as long as the government continues to tax efficient enterprises and to subsidize inefficient enterprises. In the worst cases, enterprises' stronger profit orientation, through ownership reform, can intensify their rent-seeking activities and generate a sense of unfairness in society—a danger currently more apparent in China. Price-based measures applying uniformly to all enterprises should be used to achieve economic policy objectives. Social policy should target individuals rather than enterprises. Second, the major constraints on separating the ownership and regulatory functions of the state are discussed. The introduction of competitive mechanisms in ownership and control is a necessary step to transfer the remaining ownership function to financial institutions. Third, measures to strengthen financial discipline and promote adjustment of the many loss-making enterprises are discussed. It is proposed to create an incentive system that allows investors and enterprises to appropriate the gains from adjustment. The reported success of mergers and acquisitions in China demonstrates the potential power of such incentives. The necessity of directing financial support specifically to individuals who suffer as a result of enterprise adjustment is emphasized. This measure would help avoid undermining the adjustment and financial discipline of enterprises. Fourth, the possible strategies to eliminate hierarchical control structures and to introduce competitive mechanisms in ownership and control are discussed. The chapter highlights the advantages of restructuring the ownership function of the state from the current hierarchical control system to a two-tier competitive shareholding system involving financial institutions, intercorporate shareholding, and some shareholding by workers. This change would further the network system that allows and encourages extensive participation by all economic agents and individuals in the monitoring and control of economic institutions in which they have a stake (investment or savings). The chapter also discusses major steps for introducing such a system.
CHAPTER I

NEED FOR REFORM IN OWNERSHIP AND CONTROL MECHANISMS
IN THE CENTRALLY PLANNED ECONOMIES

1.01 In spite of extensive economic reform in Hungary and China in recent years, industrial sectors in these countries are still plagued by the systemic problems caused by the absence of adequate ownership and control mechanisms for state enterprises. While economic reform has brought about significant successes in agriculture as well as in private industry and trade, the performance of the state industrial sector, which accounts for a large majority of industrial activity in these countries, has been below expectations. In Hungary, the growth of the industrial sector and the whole economy has been stagnant in the 1980s (1.3% annual growth rate for industry and 1.6% GDP growth for 1980-86), despite an investment ratio exceeding 25%. In China, although growth has been impressive in the 1980s, it has been intensive in resource use, and the growth rate of the state industrial sector has been much lower than that of the nonstate industrial sector. The absence of economic dynamism in these countries is clear in comparison with the market economies that shared the same post-war history, e.g., Hong Kong and Taiwan.

1.02 In traditional planned economies, before introducing economic reform, production and investment plans were centrally determined, with enterprises formally responsible only for implementing these plans. Resources necessary for these tasks were allocated centrally also. Enterprises were virtually administrative units within the government hierarchy, with their autonomy and accountability extremely limited.

1.03 The recognition of the critical importance of decentralized decision making, guided by economic incentives for efficient allocation of resources, has led to increasing enterprise autonomy and the introduction of various incentive systems. However, until recently, reforms have been implemented without fundamental change in ownership and control mechanisms of state industrial enterprises. First, no institution nor individuals can have full property rights on productive assets, i.e., the right to manage the assets as well as the right to appropriate returns from the assets, reflecting the socialist principle that the assets of enterprises belong to the people as a whole. The government is supposed to act as the "owner" on behalf of the people as a whole. Second, the government administration exercises monitoring and control over enterprises as the "owner" (the sole agent of the people as a whole), through its hierarchical administrative structure. As a result, the

1/ The output share of state industrial sector is 82% (1985) in Hungary and 69% (1986) in China.

2/ The gross output growth during the period from 1978 to 1986 was 56% for the state sector and 123% for the collective sector.

3/ Even in the heyday of central planning, enterprises could affect plans through bargaining with the government. Therefore, the relationship between the government and enterprises was not one-directional. However, the government had the final authority on production and investment plans.
control function associated with ownership is not institutionally separated from the regulatory and other administrative function. In particular, the sectoral ministry plays a key role in exercising ownership functions for all enterprises belonging to the sector as well as in implementing regulations pertaining to these enterprises. Third, the government utilizes its strong regulatory and other administrative authority to make enterprise-specific interventions to achieve its economic and social objectives. This structure of ownership and control in planned economies has been a major cause of the following systemic problems: weak incentives for efficient asset management and asset accumulation, underdeveloped financial markets, and a limited and distorted competition mechanism.

A. Weak Incentives for Efficient Management of Assets and for Asset Accumulation

It is widely recognized that a major cause of relatively low economic growth and the obsolete industrial structure in centrally planned economies--despite high investment rates--is the weak incentive for efficient asset management and asset accumulation in these economies. Enterprises are not allowed to own their assets, and until recently, their autonomy to use resources was sharply limited. A further disincentive is that heavy taxation and income regulations restrict them in appropriating profits. Their accountability for losses also is limited due to explicit and implicit subsidies from the state (i.e., soft budget constraints). Further, the government supervising agency for state ownership is not an economic institution allowed to appropriate profits--nor forced to take losses; that is, it does not have economic incentives to behave as an efficient investor. Consequently, no institution--including an enterprise and its supervising government agency--has a clear right to appropriate returns from the productive assets. Additional value created by better management of assets or by increased investment is diffused across the economy, or socialized. Losses also are diffused across the economy or socialized.

The weak incentive for asset accumulation is not in conflict with the tendency toward excessive investment, the salient characteristic of enterprises in planned economies. The strong propensity to invest is an artificial phenomenon since it arises from the combination of soft budget constraints,

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5/ There exist the other institutional constraints on the government as an investor: firstly, since the government is a unified entity with a hierarchical control structure, the inefficient monitoring and control of a particular enterprise by a particular supervising agency is not easily detected nor corrected. Secondly, as discussed later, there have been conflicts between the ownership and regulatory functions of the government. Thirdly, the political system in the planned economies has tended to protect the government from the monitoring and control by the people.
the availability of cheap funds tied to investment, and the restrictions on wage payments. Consequently, although investment is active, it is not efficient. Without these artificial incentives toward investment and constraints on consumption, the tendency probably would be for underinvestment in state enterprises.

1.06 The clearest evidence of the weak incentive for efficient asset management and accumulation is the existence of many chronically loss-making enterprises. All major planned economies are faced with the serious problems of such enterprises since the enterprises as well as the supervising government agencies have only weak incentives to turn around or close loss-making businesses.

B. Constraints on Developing Financial Markets

1.07 The centralization of ownership and control functions in the governments of planned economies has severely constrained the development of financial markets since non-government investors, such as enterprises and banks, do not have adequate safeguard mechanisms for investments on their own. First, they do not have the right to control management in proportion to the risk taken, nor can they secure loans or bonds with collateral. Second, until recently the issue of negotiable shares had been illegal in most planned economies, so that investments were non-liquid. Third, establishment of limited liability companies had also been illegal. Fourth, creditors did not have the right to initiate bankruptcy until recently.

1.08 These constraints on the development of financial markets have limited efficiency gains from decentralized investment decisions. Thus, a strong tendency exists for enterprises to reinvest retained earnings in their own businesses. Liberalization measures to increase retention of profits and permit the retention of depreciation by enterprises has sometimes led to the implementation of fragmented and inefficient investment, for example, in both Hungary and China. Further, biases against risky investment arise since risk associated with industrial activity cannot be diversified efficiently. In fact, many enterprises do not have access to the financial resources for overcoming temporary liquidity shortages without support from the state admin-

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5/ Merger or acquisition, which transfers the control right from one enterprise to another, has been possible. However, it often has been implemented administratively by forcing profitable enterprises to absorb loss-making enterprises, except for recent experiments in China (see Chapter II).

7/ For Yugoslavia, the possibility of bias in the opposite direction (bias toward financial intermediation) is pointed out by Nuti D. M. ("Possible Financial Innovation under Market Socialism," in Financial Reform in Socialist Economies (edited by Sokil Catherine, EDI of the World Bank and European University Institute, 1988). The basic logic is that restricted property rights on physical capital assets encourage enterprises to invest in financial capital assets. However, in China and Hungary the tendency is to own and invest in physical assets.
Implementing large-scale investments is very difficult without the support of the government.

Constraints on the development of financial markets also have restricted the availability of information for the government to make investment decisions. The information problem is exacerbated by limited competition in product markets.

C. Limited and Distorted Competition Mechanisms

In planned economies the government exercises both regulatory and ownership functions with regard to state enterprises. On the one hand, the government acts as agent for the ultimate owners, the people as a whole, with supervising ministries or agencies monitoring the performance of enterprises and taking adequate corrective measures. On the other hand, the government acts as regulator of enterprise activities, often using measures such as taxation and subsidies, and pricing and investment regulations to achieve economic and social objectives. The supervising agency again plays a key role in implementing these regulations.

The double roles played by the state ministries and agencies often have caused serious conflicts of interest, limiting and distorting competitive mechanisms. The regulatory power of the state agencies is misused or compromised. In particular, sectoral ministries tend to use their strong regulatory power to protect those incumbent enterprises in which they have an ownership stake. As a result, the ministries have severely restricted competition from domestic entry and from imports, while taxes and subsidies often have been used to support loss makers. At the same time, the ownership and control functions of the state agencies are misused for the sake of regulatory objectives. Enterprises often are forced by the government, as the owner, to take actions at the expense of the value of enterprises, to fulfill centrally determined objectives, e.g., domestic supply, export, employment, price stability. Consequently, regulatory objectives often are achieved through highly non-uniform intervention across enterprises. Finally, the concentration of enterprise ownership and control authority in a supervising agency leaves little room for effective competition among the enterprises under its supervision.

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8/ It is suggested that many (40% to 50%) enterprises would go bankrupt in Hungary if subsidies from the government budget were eliminated, due to the absence of financial markets. (Tardos M., 1986, "The Conditions of Developing a Regulated Market," *Acta Oeconomica*, Vol. 36, pp. 67-89).
CHAPTER II

RECENT DEVELOPMENTS IN HUNGARY AND CHINA

Reform in Hungary

2.01 Hungary began a major economic reform program in 1968 when it abolished largely compulsory production targets and introduced price mechanisms for allocating products. Further comprehensive reform was resumed in 1979 and has gained momentum since 1985: a new management system (1985); a new income regulation (1985); complete elimination of the production profile restrictions (1985); bankruptcy law (1986); the separation of commercial banking functions from the central bank (1987); major tax reform, introducing a personal income tax and value-added tax (1987); and the new association law (1988). The following subsections briefly review the recent progress in the reform of ownership and control mechanisms since 1985.9/10/

A. The New Management System and the New Income Regulation

2.02 New Management System. The government of Hungary has been introducing the new management system since 1985. The main objective of the reform is to enhance enterprise autonomy by separating management functions from the ownership and regulatory functions of the state. Essentially all management authority relating to production, investment, organization, marketing, and personnel has been delegated to enter-

9/ The major reform measures introduced before 1985 were the consolidation of the three industrial sector ministries into a single ministry of industry, and the transfer of price setting authority from the sectoral ministries to the National Material and Price Board, in 1981; initiation of the deconcentration program of monopoly enterprises and trusts in 1981; and the relaxation of the production profile restriction (enterprises were allowed to undertake ancillary production activities for up to 30% of their output) in 1982-83.


11/ The production profile restriction was eliminated in 1985, giving enterprises under the new management system the full right to determine their product lines. Foreign trade rights were also liberalized for finished products and necessary inputs in 1986.
prises, except for public utilities and large, strategically important industrial enterprises.

2.03 State enterprises were classified into three groups: those that would remain under state management, those for which an enterprise council would take management responsibility, and those for which the general assembly of workers would take management responsibility. Enterprises under state management include public utility enterprises and selected large industrial enterprises, which account for about one-quarter of state enterprises. The general directors of these enterprises continue to be appointed directly by central government agencies and county councils.

2.04 Except for enterprises under state management, in those with more than about 500 employees, management decisions are exercised under the supervision of an enterprise council, consisting of employee representatives, unit heads, and staff appointed by the director.12/ The director is nominated by the enterprise council, which functions on the basis of one vote per member. The enterprise council delegates operational matters to the director. About half of state enterprises are managed by enterprise councils, as of 1987.

2.05 In enterprises with fewer than about 500 employees, an assembly of workers exercises management decisions. Around one-quarter of state enterprises are managed by enterprise assemblies, as of 1987.

2.06 The introduction of the new management system was completed in 1987, although further transfer of enterprises from state management to enterprise councils is expected.

2.07 New Income Regulation. The enterprise income regulation was also reformed in 1985, with a twofold objective: to encourage the profit orientation of firms by making taxation more uniform, and to correct the tendency of firms to "ploughback" available resources into their own operations by increasing taxation on the internal use of resources. The major changes were the following:

(a) The profit tax was reduced from 45% to 35% (raised again to 40% in 1986) while an accumulation tax and an assets tax were introduced and the wage tax was increased.

(b) Depreciation was entirely reserved to enterprises--previously, 40% of depreciation was paid into the state budget and remained inaccessible to firms.

12/ The supervisory ministry is not represented in the council but has veto power over the choice of director. There was serious debate on whether the supervising ministry should be represented in enterprise councils. The perceived necessity of separating management from the regulatory function led to the decision that the ministry should not be represented.
(c) Enterprise-specific subsidies and taxes were substantially reduced.

(d) Discretion in the use of internal funds was increased by abolishing the distinction among development funds, profit-sharing funds and voluntary profit reserve funds.

(e) The system of wage regulation became more flexible with the introduction of progressive wage taxation (up to 50%) based on the level of individual employee earnings. The dominant mechanism of wage regulation had been prohibitive taxation based on the increase in average earnings beyond the level determined by enterprise profitability and the wage bill savings achieved from a reduction in a firm's work force.

2.08 As a safeguard against enterprises taking undue advantage of flexible wage regulations in regard to wage increases, a supplementary penalty tax was introduced in 1985. This tax was applied to the excess of the wage increase over the growth of value-added by more than 2% (150% in 1985). This special tax was tightened in 1986 and 1987 to curtail rapid wage increases that were taking place.

2.09 A further tax reform became effective as of January 1988, introducing a value-added tax and personal income tax and eliminating many existing enterprise taxes, including the wage tax and the enterprise property tax. However, the penalty tax has remained.

2.10 The introduction of a new management system and new income regulations has strengthened substantially the management autonomy and accountability of Hungarian enterprises. State intervention, including selection of management, has been reduced considerably, and the fiscal environment has become more simple and uniform.

2.11 However, three major problems and limitations still exist. The largest problem is weak interest in assets. The growth of wages and bonuses became disproportionately large in 1986 so that the government was forced to tighten the penalty tax on wage increases exceeding the growth of value-added. Two major causes for this rapid growth in wage payouts not accompanied by a corresponding improved performance of the economy are soft budget constraints and uncertain property rights to the residual value of enterprises.

13/ Enterprises were classified into four categories: enterprises subject to earning level taxation (I), enterprises subject to earning increment taxation (II), enterprises subject to central wage regulation (III), and enterprises subject to strict central regulation (IV).
2.12 It is clear that increased management autonomy may lead to higher wages unaccompanied by productivity increases unless the soft budget constraint is tightened. In fact, tightening of the budget has been delayed (the introduction of the bankruptcy law and the establishment of the commercial banking system took place only toward the end of 1986 and in early 1987), and insufficient. Loss makers can increase wages considerably because they still have access to various financial sources.

2.13 In regard to the uncertain property rights to the residual value of an enterprise, reform has made the workers of enterprises seemingly residual claimants, since the only way for the government to have claims on the value of enterprises is through taxation uniform to all enterprises—and the government does not have authority to demand dividends from enterprises arbitrarily. However, enterprise assets still formally belong to the state. Wages are heavily regulated. Due to this ambiguity of property rights, as well as the government’s arbitrary expropriation of enterprise assets in the past, enterprises perceive great uncertainty in their ability to appropriate returns from investments.14/15/

2.14 A view exists that the delegation of management to enterprise councils or general assemblies was directly responsible for this problem since it did not allow effective representation of owners who could control the demands of workers for higher wages and bonuses.16/17/ However, the root cause is the uncertain property right, since workers also are concerned with the long-term viability of enterprises, especially if given the clear right to share in the residual value of enterprises.

14/ Kornai notes that "because of the ceaseless and unpredictable changes of the financial rules, taxes and subsidies, firms feel insecure and exposed to the arbitrary improvisations of the bureaucracy," after noting the observed tendency of operating to reduce large profits. ("The Hungarian Reform Process: Visions, Hopes, and Reality," Journal of Economic Literature, December 1986).


16/ Exceptions are enterprises with financial difficulties. Since workers in the enterprises with excessive debt do not benefit from reinvestment (the return accrues to the creditors), they do not have the motivation for reinvestment. Enterprises with financial difficulties are, however, generally under state management.

17/ There exists some bias against investment by self-managed enterprises even if workers have clear rights to the residual value of enterprises (refer to the discussion in section C of Chapter III).
A second related problem is that the new management system still constrains monitoring and control by external investors, and thus the development of financial markets. Investors do not have representation on the enterprise council and cannot directly influence major corporate decisions, including the selection of management and investments. Along with the limited financial resources in the economy—due to heavy taxation—this restriction hinders access to financial markets.

2.16 A third problem is that enterprises are still subject to extensive government interventions, limiting enterprise autonomy and accountability. Most important, as already mentioned, subsidies are available to loss-making enterprises, so that the soft budget constraint has not been sufficiently tightened. Furthermore, comprehensive price and income regulations continue. Although the institutional removal of the price regulating authority from the sectoral ministries, as well as the use of import prices as a reference point for price regulation, should have reduced the tendency for price regulation to be used to support loss-making enterprises, price regulation still constrains the profit orientation of enterprises. This is because a major reference point for price regulation is production cost. The income regulation, including the regulation of the total wage bill, tends to constrain incentives for enterprises to achieve higher efficiency as well as the wage differentiation between enterprises that is necessary for reallocation of labor.

B. The Bankruptcy Law

2.17 The Hungarian bankruptcy law was enacted in 1986 to strengthen the financial discipline of enterprises, to reduce exit barriers for inefficient enterprises, and to protect the interest of creditors. Although there had been an administrative rule allowing liquidation of state enterprises, creditors did not have the right to initiate the process of liquidation before enactment of the 1986 law.

2.18 The law was introduced with the government's announcement of its determination to curtail financial assistance to loss-making enterprises, although the law itself does not prevent the state from

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18/ Merger was preferred to liquidation.
helping loss-making enterprises outside the framework of the bankruptcy law.\textsuperscript{19/}

2.19 No major bankruptcies of state enterprises have occurred since the enactment of this law, primarily for the following reasons:

(a) Financial restructuring of major loss-making enterprises took place before the enactment of the bankruptcy law (e.g., steel sector).

(b) Financial support continues to loss-making enterprises outside the framework of the bankruptcy law, and in implementing the law, there has been a strong bias for rehabilitation of large industrial enterprises.

(c) Commercial banks, which started their operations after the split from the central bank in January 1987, generally are hesitant to initiate the liquidation process for large industrial enterprises.

2.20 Although state financial support for rehabilitation is linked with the development of a restructuring plan "securing" production profitability, financial support has not adequately promoted exit of enterprises from inefficient production lines. A restructuring plan usually presupposes the continued operation of the formerly loss-making enterprise in the same sector (e.g., shifting from deep mines to surface mines in the coal industry).

2.21 The enactment of the bankruptcy law and introduction of related measures (e.g., a scheme to help displaced workers) have not significantly strengthened financial discipline nor promoted enterprise adjustment.\textsuperscript{20/} The following three major constraints exist:

\textsuperscript{19/} The law stipulates the mechanism for state-supported rehabilitation. The necessity of state support for rehabilitation--including financing from the rehabilitation fund--is decided by the Rehabilitation Office of the Ministry of Finance after consultation with relevant ministries and organizations. Two sets of conditions for state-initiated economic rehabilitations are specified by the bankruptcy law: necessity of rehabilitation with respect to regional employment, defense and international obligation (exceptions can be decided by the Council of Ministers); adequate perspective to restore production profitability through the implementation of a rehabilitation plan.

\textsuperscript{20/} It is observed that the original idea of the bankruptcy law (the liquidation of low-efficiency workshops and factories) lost ground. (Sipos A. - Tardos M., 1986, "Economic Control and the Structural Interdependence of Organizations in Hungary at the Second Decade of Reform," \textit{Acta Oeconomica}, Vol. 37, pp. 241-265).
(a) **Limited autonomy of enterprises and paternalistic attitude of the government.** Loss-making enterprises have put strong pressure on the government for financial help by arguing that their losses are the responsibility of the state, since enterprise autonomy had been limited and enterprises heavily taxed. Consequently, it is common that the management of a loss-making enterprise is not replaced even if substantial state financial support must be provided. Although the government has established a rule that the provision of financial support outside the framework of the bankruptcy law may not be repeated for the same enterprise, it is not clear how credible such a rule is, given the history of the government’s repeated financial supports to the same enterprises. The supervising agencies appear more concerned with protecting the enterprises they have created than with improving the efficiency of state investment.

(b) **Infancy of the commercial banks and restricted property right for investors.** The commercial banks as well as the other economic institutions have not been active in dealing with loss-making enterprises either in liquidation or in restructuring. The commercial banks are not motivated to take initiatives for liquidation, probably because of their expectation that the government will guarantee the viability of the credits the banks inherited from the National Bank and also because of their small loan-loss reserves. Another reason that commercial banks and other economic institutions are not active in supporting investment for restructuring is because of the absence of safeguard mechanisms for such investments. These external investors cannot secure management control nor a return commensurate with the risks involved, due to the restricted property right to the residual value of enterprises.

(c) **Concern over regional employment and foreign exchange.** Although the labor market in Hungary generally is tight,21/ large-scale loss of employment in some regions is a serious concern of the government. The short-run impact on foreign exchange also is another concern that creates a bias in the government against bankruptcy.

C. **The New Association (Company Formation) Law**

2.22 Hungary enacted a new association law in October 1988 that allows (i) state enterprises to be converted into stockholding companies; (ii) individuals to own negotiable and transferable shares with voting rights; and (iii) individuals to form limited liability companies and stockholding companies (limited to a maximum of 500

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21/ Labor is in the same short supply as other production inputs in Hungary. The number of vacancies far exceeds that of job seekers.
employees). 22/ A previous amendment to the old association law (1987) allowed the creation of stockholding and limited liability companies by legal persons (i.e., enterprises and cooperatives).

2.23 The new association law provides a framework for establishing the property right to returns from investments and for the development of a competitive financial market, although the law's actual impact depends on how the state exercises its ownership under the new framework.

2.24 The decision to convert state enterprises into stockholding companies is left to enterprise councils. A number of constraints preclude actual transformation of state enterprises into shareholding companies, however: absence of clear rules for conversion and reluctance of both workers and ministries to convert. First, it is not clear to which institutions the proceeds of conversion belong, reflecting the current unclarity of ownership, and which institutions are allowed to hold shares in these enterprises. Second, workers lose not only the quasi-rent coming from their residual claimant status under current enterprise management--if the proceeds of conversion are determined to belong to the state--but also managerial independence from outside investors. Third, sectoral ministries lose the (monopoly) right to supervise enterprises as the agent of the people, especially the right to appoint or endorse managers. It is expected that in 1989 the government will submit a Law of Transformation to clarify its rule. 23/

2.25 A related development is the issue of capital share tickets, introduced in Hungary on an experimental basis in 1987. These tickets entitle holders to a specified minimum and maximum share of an enterprise’s profits, but the holders have no claim on assets in the event of an enterprise’s liquidation. These tickets are transferable to non-employees and are negotiable at the discretion of the enterprises. However, they do not carry voting rights.

REFORM IN CHINA

2.26 China launched a major economic reform program in 1978. In the state industrial sector, an economic responsibility system was introduced in 1981 to strengthen enterprise autonomy and accountability.

22/ The establishment of limited liability companies by natural persons was possible before the law but required the approval of the Council of Ministers (the approval had never been given).

23/ It is reported that two options are under consideration in preparing the Law of Transformation. One option is to allow the proceeds of conversion to belong to enterprises. Another is for the state to appropriate the proceeds. One possibility which is discussed among the policy circle in Hungary is that the first option would be applied to smaller enterprises and the second one to larger enterprises.
Enterprise decisions on pricing, production and sales, investment planning, internal organization and personnel management, and disposition of wages and loans have been gradually liberalized. State grants were replaced by loans, and the proportion of profits retained by enterprises increased to 45%. Recently a bankruptcy law was introduced on a trial basis.

2.27 The recent focus of the reform program is ownership reform, based on the view that unclear property rights are the main constraint on the progress of further economic reform. Management contracts have been introduced extensively to separate ownership from management functions. Mergers and acquisitions also are being promoted to inject competition into management. Shareholder companies also have been introduced experimentally, to clarify enterprise ownership and control.

A. The Management Contract System

2.28 Since 1981 the Government of China has been introducing an economic responsibility system in the industrial sector. The two major forms of the economic responsibility system are (i) the management contract system and (ii) the leasing system.

2.29 The management contract system has been introduced widely in medium to large industrial enterprises, while leasing is used in collectives and small enterprises. The major objective of these systems is to enhance management autonomy and accountability by separating the ownership and management functions of state enterprises. The enterprises are given full authority over operation of the existing assets and become responsible for the resulting profit and loss.

24/ The greater autonomy of enterprises was authorized legally by the 1984 Provisional Regulations concerning Further Extending the Decision-Making Power of State-Owned Enterprises and more recently by the 1988 Law on State-Owned Enterprises.

25/ There was, however, a policy debate in the Chinese policy authorities between the group advocating the necessity of coordinated reform program placing price reform as the central focus and the group putting the main focus on micro-reform (ownership reform). Jinglian Wu and Bruce L. Reynolds, 1988, "Choosing a Strategy for China's Economic Reform," American Economic Review, May.

2.30 The typical management contract system includes the following provisions.27/

- The enterprise is obliged to transfer an agreed upon amount of profit and tax to the state and to accomplish contractual technical innovation.

- Linking the total volume of wages to certain performance criteria (e.g., profit and asset accumulation) also is stipulated. In return, the administrative agency guarantees certain aspects of the market environment to the enterprise, as well as provides production support through tax breaks, interest payments, price supports, and allocation of raw materials and components.

- The contract is between the supervising agency (representing the owner) and the managing director (sometimes a management group) and runs typically three to four years.

2.31 The selection of management has become increasingly dependent on competitive bidding. The contract responsibility regulation stipulates that public bidding should be the method to select enterprise managers or a managerial group. Bidders can be individuals, groups, or enterprises. In fact, the regulation explicitly encourages enterprises to bid for the management of other enterprises.

2.32 Under the system, enterprises are required to adopt an accounting system that separates the net assets of an enterprise into an enterprise fund and a state fund.

(a) **Source of funds.** If a loan is repaid with after-tax profits, the fixed capital financed by that loan comes under the enterprise fund. The rest of the fixed capital comes under the state fund.28/ Depreciation is apportioned between the enterprise fund and the state fund according to the ratio embodied in the depreciated fixed capital.

(b) **Use of funds.** The enterprise fund, as the first-line reserve, must cover the losses of enterprises. It must also be used to make up any difference between the profit contracted for and the actual profit.

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28/ If a loan is repaid with before-tax profits, the fixed capital is divided into the two funds according to the profit retention rate before the contract.
(c) **Ownership.** While an enterprise fund is owned by the people as a whole, just as is a state fund, it remains belonging to an enterprise even after the contract expires.

Although the contract system has clearly enhanced management autonomy and seems to have contributed to the rapid growth of the industrial sector, it has encountered the following three major problems:

(a) **Continued conflicts between regulatory and ownership functions of the state.** Economic policy instruments such as taxes, prices, and interest rates often are negotiated as part of the contract. The consequence is a highly non-uniform regulatory environment, taxing efficient enterprises and subsidizing inefficient ones. Therefore, the contract system can function as an insulating mechanism for enterprises against policy changes, so that the effectiveness of macroeconomic policy as well as price reform is substantially lessened.

(b) **Still limited management autonomy.** Enterprise management is still oriented toward the government rather than the market because the government retains strong regulatory power over the enterprises. The government exercises exclusive or dominant influence over the appointment of senior managers, investment decisions, and allocation of credit, raw materials and intermediates, and labor and price determination. Some liberalization has taken place in reform-oriented provinces, but the industry’s bureaucracy plays a central role in implementing these regulations.

(c) **Weak interest in assets.** The introduction of the contract system has not significantly stimulated workers' interest in better management of assets and in the accumulation of assets. The Shenzhen Province Government, for example, has recently introduced a new income regulation linking the compensation of management with the accumulation of assets, based on the concern that enterprises have not shown much interest in asset accumulation. However, the basic cause for this weak interest in assets is the short-term nature of the management contract and the weak link between enterprise performance and the availability of capital. First, an increase in asset value during a contract period works automatically against the interests of incumbent management in the next contract period, due to the correspondingly

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20/ All investments, except for those for small technical transformations, have to be approved by the supervising agencies. Moreover, larger investments (i.e., those exceeding Y 10 million) are still "planned" by the government, and enterprises are responsible only for their implementation.
higher base value of the assets (ratchet effect). Second, the better performance of enterprises is not directly linked to better access to capital. In short, the present contract system far from simulates the function of a capital market.

B. The Bankruptcy Law

2.34 A law providing bankruptcy procedures for enterprises was enacted in December 1986 and became effective for trial implementation in November 1988. The main objectives are to strengthen the financial discipline of enterprises, promote efficient use of resources, and protect the interests of creditors, as in the case of Hungary.30/

2.35 The introduction of the bankruptcy law has been controversial in China since opponents of the law argued that enterprises could not be held responsible for bankruptcy, considering their weak autonomy.31/ As part of the response to the controversy, the law limited the definition of bankrupt enterprises to those incurring losses through mismanagement. Additional laws and regulations, including one providing an unemployment compensation system, complemented the bankruptcy law.

2.36 The major features of the bankruptcy law in China are the following:

(a) Creditors are given the formal right to initiate bankruptcy proceedings.

(b) The supervising governmental department may file a petition initiating enterprise rehabilitation. If a rehabilitation plan is agreed to by all parties, including creditors, the enterprise undergoes two years of rehabilitation. The governmental department, not the creditors, is responsible for monitoring the rehabilitation.

(c) Administrative, or even criminal, penalties may be brought against the enterprise manager and/or the representative of the supervisory agency for mismanagement and/or fraud.

(d) The state is required to arrange reemployment of the workers of bankrupted enterprises and to ensure the provision of basic living needs for these workers until reemployment.


31/ Ibid.
In spite of the enactment of the bankruptcy law, it is unlikely that there will be extensive bankruptcies of state enterprises. Authorities in advanced "reform cities," such as Shenyang and Wuhan, emphasize mergers and takeovers rather than bankruptcy in dealing with loss-making enterprises.

Although similar, there are more serious constraints on the adequate implementation of the bankruptcy law in China than in Hungary. The most important constraint is in the government support to loss-making enterprises through various channels, such as tax and debt relief. The Regulation on the Contract Responsibility System itself presupposes the continued existence of loss-making enterprises by allowing them to enter into the management contract targeting only the reduction of loss.

The government seems to support loss-making enterprises for the following three reasons. First, as the controversy before the enactment of the bankruptcy law suggests, the still weak autonomy of management as well as the long history of government intervention are the major impediments to the government's transfer of major responsibilities to enterprises.

Second, the government is still directly responsible for employment. Unless the government is confident of providing adequate jobs for those made unemployed because of an enterprise's bankruptcy, it has to support the loss-making enterprises.

Third, the supervising governmental department has a strong administrative stake in the survival of enterprises under its supervision, while it is not held financially accountable for the losses incurred by enterprises.

The weak autonomy of the banks and preservation of hierarchical control by the supervising department are more serious in China than in Hungary. Credits are often allocated by government agencies and, consequently, are guaranteed explicitly or implicitly. However, the supervising agency is solely responsible for the initiation and

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32/ Before the implementation of the bankruptcy law, bankruptcies of two non-state enterprises took place, based on the provisional regulations of provinces.

33/ It is also natural for the workers to expect the government to take this responsibility, due to the past absence of management autonomy and to the past lack of freedom to choose jobs. (The law allowing contract labor for the newly employed was enacted only recently.)

34/ Possible administrative and criminal penalties against the supervising department as prescribed in the bankruptcy law may actually strengthen the incentive for the department to prevent bankruptcies of enterprises under their supervision.
monitoring of enterprise rehabilitation and determines the administra-
tive and criminal penalties to be imposed on management. This is
contradictory, since the monitoring and control authority of the
bankrupt enterprise should move from the owners (the supervising
department) to the creditors (banks).

2.43 Restricted property right for investors constrains voluntary
adjustment of loss-making enterprises. The restricted property right
can promote artificial liquidation. Enterprises in financial trouble
are restricted in getting external financing, since investors are
provided only the weakest safeguard mechanism for investment, as also in
Hungary. The exceptions in China are mergers and acquisitions (see the
discussion in the next section).

C. Mergers and Acquisitions

2.44 For the last two years some Chinese provincial and municipal
governments have promoted mergers and acquisition of enterprises under
their jurisdiction. The major objective is to solve the problem of
chronically loss-making enterprises by subjecting them to the control of
growth-oriented enterprises. The mechanics of acquisition vary accord-
ing to locality and individual case:

(a) In some cases, the acquiring enterprise is selected through
administrative intervention; in others it is chosen through
search or competitive bidding.

(b) The acquiring enterprise usually must fully honor the debt
as well as the pension obligation of the acquired enter-
prise.

(c) In some cases, the acquiring enterprise pays nothing toward
the acquisition of another firm, usually when the two enter-
prises belong to the same supervising agency or when
acquisition is carried out administratively. It is rare
that the acquiring enterprise is paid through reduction of
the debt obligation of the acquired enterprise, for example.

(d) Mergers take place almost exclusively among enterprises
belonging to the same local government. Mergers of enter-
prises belonging to different supervising agencies of the
same local government take place, although they may meet
resistance from the agencies that are losing their enter-
prises.

35/ It is suggested that the incentive for banks to file a petition for
bankruptcy is artificially large, since the only way for the banks
to acquire property rights on the assets of an enterprise is
through bankruptcy. (Peng Xiaohua, 1987, "Characteristics of
China’s First Bankruptcy Law," Harvard International Law Journal,
Volume 28, Number 2).
2.45 Reports are that mergers and acquisitions have had significantly positive effects on the turnaround of loss-making enterprises and the reduction of the state's budgetary burden for supporting these enterprises. This comes about through efficient use of production resources, new product development, and technology transfer.\textsuperscript{36}\footnote{Xing Youging, Lu Pu and He Zhongze, "A Discussion of the Merger and Property Right Transfer of Enterprises," mimeo, the System Reform Commission, 1988.} It is expected that similar initiatives toward mergers and acquisitions will take place widely in China in the future.

2.46 However, mergers and acquisitions in China are limited by the existence of regional and sectoral barriers. Evaluation of the firm to be acquired and of the necessary compensation for its creditors is the major problem resulting from unclarity of ownership. Currently it is almost impossible for an enterprise belonging to one provincial government to acquire another enterprise belonging to another provincial government. Even within the provincial government it is not clear which institution is entitled to use the payment for the acquired enterprise.\textsuperscript{37}\footnote{One recommendation is to give the supervising agency priority to use the payment made by the acquiring enterprise (He Zhongze, "On the Transfer of Enterprise Property Rights," Mimeo, System Reform Commission, 1988).} Moreover, the supervising governmental agency generally is resistant to losing its enterprise since this loss signifies the failure of past supervision as well as direct loss in administrative power.

2.47 Many mergers and acquisitions have been implemented through administrative measures, often not accompanied by payment. Without an adequate indicator of the efficiency of the deal, such deals can become arbitrary and open the way for government intervention on non-economic grounds. In particular, some mergers administratively promoted take place involuntarily, as the government forces profitable enterprises to absorb loss-making enterprises. These reduce rather than enhance financial discipline.

2.48 Some M&As in China aim to overcome the restriction on market transactions, especially involving land. Consequently, an enterprise can be taken over not because of its management inefficiency but because of the restrictions on transactions of the land-lease right. Such a possibility can harm managerial efforts.

2.49 Since no adequate administrative and legal framework for competition policy exists in China, there is a danger that increased merger activities may lead to monopolistic practices. (One of the causes for the highly concentrated market structure in Hungary is, in fact, mergers administratively implemented to absorb loss-making enterprises.)
D. **Shareholder Companies and Investment Management Companies**

2.50 China also has introduced *shareholder companies* in a number of "reform cities" during the last two years. The transformation of state enterprises into shareholder companies is still experimental and lacks legal support, although a new law on companies is under preparation.

2.51 Major features of the experiment are the following:

(a) **Distribution of shares.** When a state enterprise is transformed into a shareholder company, the state receives state shares, and the enterprise receives enterprise shares, equivalent to state and enterprise funds in face value, respectively. Additional enterprise shares can be issued to other enterprises as well as to individuals, such as employees and the general public. The state holds the majority share of state enterprises in most cases.

(b) **Rights associated with shares.** Enterprise and state shares are like common stocks in the West and carry voting rights. Enterprise shares are controlled by the legal representative of an enterprise. Shares issued to individuals are like preferred stocks. They do not carry voting rights but often have additional security: (i) payment of minimum interest and (ii) a buyback provision. The maximum dividend rate is regulated by the government.

(c) **Negotiability of shares.** Shares are negotiable, but enterprise shares are negotiable only between state enterprises. Individual shares are negotiable only among individuals. In some cities, such as Shanghai and Shenzhen, a secondary stock market has been established.

(d) **Control mechanism.** The shareholders' control mechanism is superseded by the supervising agency, in particular through the management contract system. Management is appointed directly by the supervising government agency. Although boards of directors exist, in the case of Shenzhen, for example, they do not have the right to appoint management. In the other cases, boards of directors merely serve as internal management committees or do not exist at all. The annual shareholders meeting often is not a substantive meeting, being merely a congress of workers.

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38/ The chairman of the board of directors is appointed by the Investment Management Company, which is responsible for collecting profits from state enterprises and for reinvestment.
2.52 A parallel reform in China is the establishment of investment management companies in several "reform cities." The objectives of establishing such companies are to separate the channel of profit remittance from that of tax collection and to manage investment in state enterprises efficiently from a financial perspective. The Shenzhen city government created its company in 1987, and it is expected to exercise ownership control through the board of directors.

2.53 However, major constraints hamper these companies. First, a company's control of local enterprises is superseded by the control exercised by a governmental department. This supervising agency still appoints managers of state enterprises and heavily influences major investment decisions. Second, there is no competition for ownership control since the investment management company is a monopoly in each province.

2.54 The experimental introduction of shareholder companies, as well as investment management companies, is not a substantial change so far. The powerful regulatory and the other administrative authority retained by the government makes shareholder control almost irrelevant. Moreover, since the government of China intends to keep majority shares of enterprises in a single agency, such as the Investment Management Company in Shenzhen, other investors, such as enterprises or financial institutions, cannot hold shares with any chance of controlling management.

2.55 Individual shareholding, even without voting rights, can facilitate the mobilization of personal savings for investment, risk diversification, and the enhancement of monitoring of state enterprises. The issue is whether individuals are willing to hold shares under the current restricted ownership and control mechanisms. The necessity of enterprises to provide additional security, such as through buy-backs, seems to indicate the unwillingness of the public to hold shares at this stage.

2.56 The enterprise share is an unusual aspect of the Chinese experiment in shareholding. Although they do not play a major role currently, enterprise shares are a hotly debated issue in China because of the potentially deep implication for the future ownership and governing structure of Chinese industry. We discuss these implications in the next chapter on the potential and limits of self management.39/
CHAPTER III

POTENTIAL AND LIMIT OF SELF MANAGEMENT

A. Tendency Toward Self Management

3.01 Residual Claimant Status and Management Autonomy of Enterprises. The common tendency of reform in planned economies has been to give increasingly more residual claimant status to enterprises. In Hungary, state equity investment is more like a medium-term loan, since enterprises are obliged to pay a fixed annuity irrespective of their profit performance. Similarly in China, enterprises often are obliged to guarantee fixed profit and tax remittances to the state in the contract responsibility system, while any excess profit or loss accrues to the enterprises.

3.02 Corresponding to this financial relationship, the control that state agencies have over enterprises' management decisions has become more like that of a creditor rather than shareholder. Under the new management system in Hungary enterprises are supposed to be free from specific interventions as long as they abide by laws. Under the contract responsibility system of China, enterprises are supposed to be largely independent from interventions from state agencies during the contract period. Restrictions on worker income in both countries can be interpreted as restrictions on dividends, as stipulated in covenants in debt contracts.

3.03 Efficiency Contracts between the State and Enterprises. A contract between a government and enterprises for the efficient use of state capital can be a debt-type contract if participation by other investors is excluded. Providing capital in the form of debt, rather than equity, has an advantage in terms of its incentive effect on enterprises.

3.04 First, fixed payment obligations force enterprises to bear the full consequences of their investment and production decisions and put strong pressures on enterprises to be efficient. This advantage is important when state agencies cannot adequately monitor and control enterprises because of various constraints (lack of incentive for

40/ State equity allocations up to 1985 were granted only for a fixed annuity. Since 1985, new recipients of state equity may be obliged to pay both a fixed annuity and a variable dividend. (Hungary: Development and Reform of Financial Markets, op. cit.)
Second, workers are given substantial right to participate in management according to the socialist ideology of "the workers as master of an enterprise." Workers' participation in management, in turn, requires their taking residual risk in order to reduce the incentives for opportunistic behavior by workers.

B. Limitations and Problems of Self-Management

3.05 Self management in planned economies, however, is not generally efficient. First, the property right to residual value is limited and uncertain in these economies, due to the principle of socialist ownership. Second, self-management generally is not efficient, even if the property right problem does not exist.

3.06 Limited and uncertain property right of residual value. Enterprises under self-management do not have full property rights to the residual value generated by the enterprise. In China, enterprise funds belong to the people as a whole, as stipulated in the regulation on the contract responsibility system. In Hungary, too, residual value ultimately accrues to the people, as shown by the stipulation in the bankruptcy law that any surplus value existing at the time of liquidation goes to the state. Although enterprises have significant discretion in utilizing residual value, according to Hungary's current regulations, still they are subject to restrictive income regulation. There is risk of expropriation of the residual value by the state because there is no firm legal ground protecting the assets of enterprises. This limited and uncertain property right clearly discourages enterprises from increasing their residual value.

3.07 Inefficiency of self-management. Even assuming that residual value belongs to enterprises, the limitations of managerial control and residual claimant status to workers generally cause inefficiency. The nature and degree of such inefficiency, however, has not been firmly established. Theoretical investigation of the behavior of

41/ The debt-type contract, while increasing incentives for shirking by the central monitor (supervising department), reduces incentives for shirking by members of an enterprise. (Alchian A. and Demsetz H., 1972, "Production, Information Cost, and Organizations," AER, December). It is efficient when the central monitor is not profit-oriented. When risk-neutrality of enterprises can be assumed and the bankruptcy risk can be ignored, the optimal financial contract involves fixed repayment, if decisions or level of efforts of enterprises are not fully observable by the suppliers of the funds. (David Sappington, 1983, "Limited Liability Contracts between Principal and Agent," Journal of Economic Theory, Vol 29, pp 1-21).
worker-managed firms makes several points about its potential inefficiency (Table 1 summarizes major points). Briefly, since remuneration of workers in self-managed enterprises consists of both wages and rent, but because an increased workforce dilutes rent, bias develops against employment expansion as well as against labor mobility. Restrictions on investors' participation in management control generates bias against risky investment and capital mobility. The restriction on the issue of transferable security limits the time frame for investment. Group ownership also dilutes the incentive for investment.

However, some inefficiencies attributed to self-management, such as the bias against employment expansion, are partly overcome by the design of adequate internal compensation mechanisms (e.g., differential remuneration for incumbent and new workers). Bias against risky investment and against capital mobility, however, seems to be structural. Therefore, theoretical considerations have not established gross inefficiencies of self-management, especially for smaller industrial ventures (see the Appendix for more detailed review of the theoretical analysis of self-management inefficiency).

There exists no decisive empirical evidence supporting gross inefficiencies of self-management either. Empirical evaluation is difficult due to the fact that observed behaviors of self-managed enterprises strongly reflect the policy environment, which has not been neutral in planned economies. However, a comparison of the generally disappointing experience of self-management in Yugoslavia and the successful experience of Spain (Mondragon cooperatives) suggests that a competitive environment (not distorted by government interventions) and clear property rights to residual value are likely to be critical rather than worker self-management per se (see the Appendix for a detailed discussion):

(a) Importance of competitive environment. Strong government interventions and weak financial discipline have distorted the competitive environment significantly in Yugoslavia. Such intervention did not occur in the Mondragon cooperatives.

<table>
<thead>
<tr>
<th>INEFFICIENCIES</th>
<th>SOURCES OF INECONOMIC</th>
<th>POTENTIAL REMEDIES TO REDUCE INECONOMIC</th>
<th>CAPITAL ACCOUNT (MONDRAGON COOPERATIVE)</th>
<th>CAPITAL TICKET (HUNGARY)</th>
<th>STATE SHARES (CHINA)</th>
<th>ENTERPRISE SHARES (CHINA)</th>
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<tr>
<td><strong>Labor Market</strong></td>
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<tr>
<td>Bias against employment expansion and against labor mobility.</td>
<td>Rents contingent on employment</td>
<td>Discrimination in remuneration between incumbent and new workers. Severance and retirement benefits</td>
<td>Positive effect, if rents are charged by exit benefit is provided</td>
<td>Positive effect, if rents are captured by capital ticket</td>
<td>Positive effect, only if rents are captured by state shares (capital charge)</td>
<td>No effect</td>
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<tr>
<td><strong>Financial Market</strong></td>
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<tr>
<td>Bias against risky investment and against capital mobility</td>
<td>Restrictions on external investors to participate in management control</td>
<td>No effect</td>
<td>No effect</td>
<td>Positive effect, only if the state agency replicates capital market</td>
<td>Positive effect, only if the state agency replicates capital market</td>
<td>No effect</td>
</tr>
<tr>
<td>Short time horizon of investment</td>
<td>Absence of transferable security capitalizing the value of investment</td>
<td>Severance and retirement benefits</td>
<td>No effect</td>
<td>Positive effect, since capital ticket is negotiable</td>
<td>Positive effect, since capital ticket is negotiable</td>
<td>Positive effect, only if the state agency shares are negotiable</td>
</tr>
<tr>
<td>Diluted incentive for investment and innovation</td>
<td>Group ownership</td>
<td>Issue of security to workers (e.g. borrowing from workers)</td>
<td>Some improvement, since capital can be withdrawn individually owned</td>
<td>Positive effect, since capital ticket is individually owned</td>
<td>Positive effect, only if the state agency replicates capital market</td>
<td>No effect, since enterprise shares is group share</td>
</tr>
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</table>
Importance of clear ownership. The ownership of capital is much more certain in the Mondragon cooperatives than in Yugoslavia. For Mondragon, capital is owned and controlled by each cooperative, not by society or the state, and individually-owned capital (capital accounts) can be withdrawn.43/

C. Assessment of Some Remedies for the Problems of Self-Management

3.10 Here we discuss the implications of capital tickets, introduced in Hungary in 1987, and of shareholder companies as experimented with in China, as remedies for the inefficiencies of self-management. Our conclusions are that these instruments can solve only part of the problems.

3.11 Capital Tickets in Hungary. First, this measure might reduce pressures for higher wages and encourage voluntary reinvestment, since workers can secure individual rights on the returns from reinvestment by purchasing capital tickets. Second, since capital tickets are transferable, they might also reduce the problem of a short time frame for investment. However, since the number of capital tickets issued is still limited, returns from capital tickets constitute only a small portion of the compensation of workers. Consequently, their impact on the saving and investment behavior of enterprises seems to be limited at this stage.

3.12 To the extent that capital tickets capture rents on existing assets, they would have a favorable effect by reducing the bias caused by the rents against employment expansion and labor mobility. However, capital tickets so far have not substantially captured existing capital rents, since their use has not been linked to the clarification of ownership of existing capital assets. Capital tickets obviously do not improve the risk-taking capacity of enterprises nor their access to financial markets.

3.13 State Shares and Enterprise Shares in China. The introduction of unrestricted shareholding companies will, in principle, solve all problems attributed to self-management. However, in China most such (experimental) companies have been constrained by the following: the dominant proportion of state-owned shares; restricted participation by external investors, and restricted individual (including worker)

43/ However, since a capital account is not transferable, the Mondragon cooperative does have the problem of a short time horizon, although this does not seem to be a critical problem, probably due to this lifetime employment system. Such schemes may not be replicable in economies with high labor mobility, since the capital base of a cooperative can be endangered by high labor turnover. (Keith Bradley and Alan Gelb, 1982, "the Mondragon Cooperatives: Guidelines for a Cooperative Economy?" in Participatory and Self-Managed Firms, edited by Jones Derek C. and Svejnar Jan, Lexington Books.)
shareholding. Consequently, most shares are either state shares or enterprise shares (shares owned by the issuing enterprise itself).

3.14 To the extent that dividend payments on state-owned shares capture capital rents, the bias caused by the rents against employment expansion and labor mobility will decline. However, it would be extremely difficult for the state to determine an adequate dividend rate without the help of the competitive capital market.

3.15 The ownership of enterprise shares still is not clear, given the absence of a legal framework, so that the risk of expropriation remains. Moreover, the return on enterprise shares per individual worker is contingent on employment, so that enterprise shares act as entry and exit barriers to labor mobility. Although, a state-owned investment company can, in principle, help enterprises overcome their bias against investment, past experience and recent developments demonstrate the limitation of government agencies to behave as efficient investors. If enterprise shares are negotiable with other enterprises or with the state at reasonable prices, they help reduce the short-term time frame for investment. They will not improve the other aspects of inefficiency of investment due to self-management.

3.16 Enterprise shares create an additional problem. Currently, enterprise shares are represented by a manager. This may cause conflict of interest, since the manager potentially can use the voting power corresponding to the enterprise's shares to protect his position if and when ownership becomes diversified.

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CHAPTER IV

MAJOR ISSUES FOR FURTHER REFORM IN OWNERSHIP
AND CONTROL MECHANISMS

A. Rationalizing Regulatory and Other Administrative Interventions

4.01 Ownership reform (clarification of the property right to the residual value of enterprises) alone cannot induce a market-oriented response from enterprises as long as governments continue to tax inefficient enterprises and subsidize inefficient enterprises through administrative interventions. Enterprises will continue to behave to secure the most favorable government interventions rather than enhance their efficiency and productivity. In fact, the stronger profit orientation of enterprises through ownership reform can intensify rent-seeking activities of enterprises and a sense of unfairness in society. Moreover, if the separation of the ownership function and the regulatory function of the state is not undertaken, ownership reform can lead to strengthening or preserving of bureaucratic interventions in enterprise management, since it can tip the balance of bargaining power in government’s favor. For example, the management contract system in China seems to have strengthened the position of the supervising department, since the management position has become subject to competitive bidding conducted by the department.

4.02 Hungary has made substantial progress in rationalizing the regulatory as well as the other discretionary powers of the government for intervening in management by introducing the new management system. But enterprises still eagerly seek enterprise-specific interventions from the government, since the government can provide subsidies to enterprises through various channels: state equity allocations, rehabilitation funds, and approval for price increases.

4.03 The situation is more serious in China, where the government still has strong authority in allocating essential factors of production, including investment funds, essential raw materials and intermediate goods, and labor, as well as in determining prices and taxes specific to enterprises. Negotiations over management contracts tend to degenerate into negotiations over the allocation of rents and the exceptions from uniform economic regulatory and administrative environments. Under these circumstances, reform in ownership and strengthening the profit orientation of enterprises would not substantially encourage market-oriented behavior.

4.04 Therefore, high priority should be placed on further rationalizing of regulation and the other government interventions in both countries. In particular in China, more decision making authority has to be reserved to enterprises and financial institutions by further expanding the scope of the market in determining output and allocation of resources. More price-based indirect measures that apply uniformly to all enterprises should be used to achieve economic policy objectives,
such as export expansion, instead of depending on direct measures, such as management contracts. Finally, social policy objectives should be achieved, not by taxing or subsidizing enterprises but by developing appropriate instruments targeted to individuals, such as income taxation and unemployment compensation.

B. Separating the Ownership and Regulatory Functions of the State

4.05 The institutional separation of the ownership and regulatory functions of the state is also critically important in both China and Hungary to avoid limiting and distorting the competitive environment. The agency representing state ownership should function as an economic institution and its performance evaluated solely on investment performance. This agency should not have authority beyond that of any investor. The regulatory agency should not have an ownership interest in particular enterprises.

4.06 In China, reform in this direction has been experimented with in Shenzhen, for example, which established an investment management company and separated profit remittance from income taxation. However, there is considerable doubt whether this institutional reform has really changed the relationship between enterprises and government, since the sectoral government department still retains the power of appointing management and heavily influences major investment decisions.

4.07 In Hungary, reform has been toward delegating substantial ownership functions to enterprises. This strategy seems effective in separating the ownership and regulatory functions of the state. However, the separation is not complete, since the supervising ministry has the right to veto the appointment of management, and important segment of industries remain under state management.

4.08 The common reasons for the retention of ownership function by the sectoral ministry in both countries is the possibility of "irresponsible" behavior by enterprises and the "necessity" of ownership control in achieving economic policy objectives. As discussed in the previous chapters, the major causes of irresponsible behavior of enterprises are the uncertainty of property right and the governmental intervention encouraging such behavior (i.e., soft budget constraint). Therefore, the clarification of property right and tightening the soft budget constraint are part of the necessary steps to remove the remaining ownership function from the sectoral ministry. Ownership control of industrial enterprises generally is not necessary for the sectoral ministry to achieve its economic policy objectives.44/

44/ Even remaining central plans can be implemented by the government, in principle by explicit contracting of production of the goods, not by invoking the right of ownership. Through production contracts enterprises will be compensated by the payment of lump sums, thus avoiding undermining management autonomy and accountability.
4.09 The additional reason for the retention of the ownership function by the sectoral department in China is the overconcentration of financial power in the investment management company, if all ownership functions of state are transferred to the investment management company. This dilemma can be overcome only by allowing effective competition in ownership and control mechanism (see the discussion in D for more detail).

C. Strengthening Financial Discipline and Creating Incentives for Adjustment

4.10 Neither Hungary nor China has tightened soft budget constraints substantially, and the adjustment of inefficient loss-making enterprises has been slow. The following measures could be taken: First, a stronger incentive for autonomous adjustment of loss-making enterprises has to be created. Clearly such incentives are very weak in both countries, with the prevalent situation being the concentration of management control in the government and de facto full absorption of risks of adjustment or non-adjustment by the government. Government should allow investors (economic entities and/or groups of individuals, including workers) to appropriate full return from their investments in adjustment of loss-making enterprises and to control their management.

4.11 Mergers and acquisitions, which have become increasingly popular in China, are one such measure, despite several constraints (uncertainty of ownership and administrative interventions). A more comprehensive and drastic measure is to transfer ownership and control of a loss-making enterprise to investors (in the case of an enterprise with negative net worth, the bank may convert part of its loan to equity and sell that equity to investors) who could reorganize it as a shareholding company. This measure will, in one way, create incentives for investors to effect the adjustment required. It will also eliminate incentive distortions from the debt hanging over management and workers of a loss-making enterprise.

4.12 Second, in both countries, but especially in China, the long history of state intervention makes it difficult for enterprises to be assigned major responsibility for losses. Consequently, some financial support from the state may have to continue as compensation for the past absence of autonomy, even though substantial enterprise autonomy has developed. Both in Hungary and China, financial support has been provided to satisfy financial and investment needs of enterprises for their survival—thus undermining both adjustment and financial discipline. Instead, state financial support should be targeted to temporary

45/ The reorganization of chronically loss-making enterprises as stockholder companies with investments from customer companies, financial institutions, foreign investors and the state was proposed by a group of Hungarian economists in a 1987 report ("Change and Reform, 1986"), commissioned by the Council for Social Policy.
adjustment assistance for employees who lose their jobs or suffer significant income losses due to adjustment.

4.13 Third, the governments of Hungary and China have been unwilling generally to acknowledge enterprise failures and to take corrective actions. Supervising ministries' main concern often has been to protect incumbent enterprises of their creation, for which they secure special government support. Once again, regulatory reform is important in reducing incentives for government interference on behalf of loss-making enterprises. In particular, the separation and transfer of state ownership of industrial enterprises to economic institutions with profit and loss responsibility is a key step.

4.14 Fourth, despite their strengthened position because of bankruptcy laws, banks in both countries have been generally passive about reform. The autonomy and financial accountability of financial institutions must be strengthened further. In China, the credit decisions must be delegated to the banks, and state guarantees for loans and bond issues must be curtailed.

D. Introducing Competitive Mechanisms for Ownership and Control

4.15 The implementation of Hungary's new association law as well as that of the company law under preparation in China can become a major step in reforming the ownership and control mechanisms in these countries. It will facilitate the clarification of ownership and the introduction of competition in ownership and control. However, there are important measures to be taken for this legal change to lead to substantive change, since there is a strong tendency in planned economies for the government to preserve the hierarchical control structure of state enterprises.

4.16 As discussed earlier, reforms introduced in Hungary and China have not altered this structure fundamentally—the introduction of a new management system and a new management contract system, respectively, have taken place within the framework of this hierarchical control. Although recent bankruptcy laws in both countries have strengthened the positions of creditors, creditors still cannot take control of failing enterprises. Similarly, share owners in China do not have the right to control management.

4.17 The hierarchical control structure by the government will still preserve most of the systemic problems pointed out in the Chapter I, even if ownership is clarified. Most important, the development of financial markets will remain constrained. The monopolization of ownership and control by the government shareholding agency implies the continued absence of a safeguard mechanism for investments by the other investors, unless the guarantee is provided by government. Moreover, the government agency itself will continue to find it difficult to invest resources efficiently, given the absence of the mechanism for competitive evaluation of enterprises. The New Management System in Hungary provides enterprises with substantial, although uncertain,
property rights to the residual value of enterprises, so that incentives for self disciplining are created.

4.18 Breaking up hierarchical control and introducing competitive mechanisms in ownership and control do not imply "privatization." Even under the most restricted circumstances it is conceivable to create a two-tier shareholding system where the ultimate owner of the assets of all industrial enterprises is still a single state agency (e.g., the Ministry of Finance) but the asset of each industrial enterprise is owned directly only by the other industrial enterprises through intercorporate shareholding and by financial institutions such as banks and investment companies in a competitive manner (Figure 1). The negotiability of shares among enterprises and financial institutions allows competition in ownership and control over an enterprise, although the actual owner of the enterprise can be concentrated in a single enterprise or a single financial institution. (This type of reform has recently been launched in Algeria, where eight holding companies have been created for competition in equity markets). The possibility of intercorporate shareholding among enterprises greatly enhances the competition and capacity of capital markets.

46/ Intercorporate shareholding plays an important role even in market economies. It is estimated that 15% of the total market value of the shares is accounted for by intercorporate holdings in the USA (1981) and 26% in Japan (1981). In Japan where there has been extensive development of corporate groupings through intercorporate shareholding, intercorporate shareholding provides a means for risk diversification as well as for mutual monitoring (Aoki M., "The Japanese Firm in Transition," The Political Economy of Japan, Stanford, 1987). It is necessary to develop a regulatory framework that prevents excessive concentration of ownership through intercorporate shareholding or other means.
Figure 1: TWO-TIER SHAREHOLDING SYSTEM THROUGH FINANCIAL INSTITUTIONS AND INTERCORPORATE SHAREHOLDING

A Government Agency

\[\begin{array}{ccc}
\text{Financial Institution (A)} & \Downarrow & \text{Financial Institution (B)} \\
\Downarrow & & \Downarrow \\
\text{Enterprise (X)} & \Leftarrow & \text{Enterprise (B)} \\
\end{array}\]

(1) --> : monitoring and control

Figure 2: HIERARCHICAL CONTROL STRUCTURE BY THE GOVERNMENT ADMINISTRATION

\[\begin{array}{ccc}
\text{Sectoral Ministry (A)} & \Downarrow & \text{Sectoral Ministry (B)} \\
\Downarrow & & \Downarrow \\
\text{Enterprise (a1)} & \Leftarrow & \text{Enterprise (b1)} \\
\Downarrow & & \Downarrow \\
\text{Enterprise (aN)} & \Leftarrow & \text{Enterprise (bN)} \\
\end{array}\]

(1) --> : monitoring and control
4.19 The question is how the efficiency of the first tier of the system (i.e., financial institutions) is secured, given that these financial institutions are subject to similar hierarchical control by the government as are industrial enterprises under the current system (Figure 2). We point out the following substantial differences from the current hierarchical control system: First, financial institutions are economic institutions with profit and loss responsibilities unlike sectoral ministries. Although financial institutions will not be fully accountable for profit and loss, due to the reluctance of the government to let financial institutions go bankrupt, loss-making financial institutions would be restricted in taking in funds from the government, enterprises and individuals. If loss becomes substantial, management would be replaced by the government. Second, financial institutions are subject to competition among themselves, since each financial institution is free to invest in any enterprise. Competition generates continuous incentives for financial institutions to improve the efficiency of their investments. It also enhances the quality of information available to the government. Third, financial institutions in the two-tier shareholding system benefit from information supplied by the other participants (enterprises) in the capital market. This is not the case for a sectoral ministry.

4.20 The efficiency of the two-tier system will be significantly enhanced if workers (including managers) are allowed to own shares. Worker share holding will encourage self disciplining by enterprises. In fact, financial institutions may demand that workers hold substantial shares as a condition for investment, especially given the strong right of workers to participate in management in socialist economies.

4.21 The competitive mechanism of ownership and control can be enhanced further by expanding the degree of participation by enterprises and individuals in the monitoring and disciplining of enterprise, and by allowing the participation of nonstate financial institutions, such as pension funds and insurance companies in the capital market, as illustrated in Figure 3. First, state-owned pension funds and insurance companies can be allowed to participate in capital markets just as financial institutions can. Second, enterprises can be allowed to own shares of financial institutions, thereby subjecting financial institutions to monitoring by non-government entities, although the possibility of control of a financial institution by an enterprise would be excluded to avoid possible conflict of interests. Third, individuals can be allowed, as well as encouraged, to take risks in their investments of savings. This will make individuals another source of monitoring and discipline for enterprises, financial institutions, pension funds and insurance companies, short of controlling these entities. Individuals (nonworkers) can be allowed to hold non-voting shares of these institutions. The government can limit insurance coverage on deposits by individuals to financial institutions and for their pension contributions, so that individuals can be encouraged to move their savings according to the performance of these institutions.
4.22 In the following we discuss the seven major steps for eliminating hierarchical control and introducing competitive mechanisms in ownership and control.

4.23 (i) Reformulating the supervising authority of the government. The authority of the government as enterprise owner must be reformulated and limited to that of a shareholder. Currently in both China and Hungary, the government's authority as owner is independent of the financial status of enterprises as well as of their capital structure. If an enterprise goes bankrupt, controlling authority should be transferred from the government agency that owns shares (e.g., investment company) to the creditors. If the ownership structure of an enterprise is diversified, the controlling authority of a particular government agency should be limited to a level commensurate with the shares held by that agency. The regulatory framework for state enterprises, including laws on state enterprises and bankruptcy laws, has to be consistent with the diversification of ownership and control.

4.24 (ii) Transformation of budgetary institutions into economic institutions. Shares of industrial enterprises should be, in principle, held only by economic institutions with profit and loss responsibility and by individuals. Institutions will include state enterprises, banks, insurance companies, and pension funds. Currently, state agencies in charge of insurance and pensions often are not economic entities, since their profits and losses are absorbed or covered by the state general budget. Their transformation from budgetary institutions into economic institutions is necessary before they can become investors. It is also important to break up monopoly institutions to introduce competition.

4.25 (iii) Allowing shareholding by banks and establishing investment companies. Although the concentration of ownership in a few banks is not desirable for promoting competition in product markets, nor for safeguarding the stability of financial markets and promoting the development of the capital market, banks should be allowed to hold a substantial amount of their portfolios in the form of equity (considering the financial weakness of the other economic institutions). The establishment of investment management companies specialized in equity investment also can be useful for supplementing financial resources and for avoiding excessive dependence on banks. However, the government administrative agencies should not, in principle, own shares of industrial enterprises.

47/ Existing bank loans to loss-making enterprises already have substantial risk components. Banks should be allowed the option of converting part of their loans into equity and to have a corresponding voice in management as well as the right to an appropriate return from investing in successful adjustment.
Figure 3: NETWORK SYSTEM

A Government Agency (A) 

| Financial Institutions 
| Non-voting share 
| Deposit not fully insured 

A Government Agency (B) 

| Pension Funds 
| Non-voting share 
| Non-voting share, pension contributions not fully insured 

A Government Agency (C) 

| Insurance Companies 
| Share 
| Non-voting share, insurance return not fully returned 

(1) → = Monitoring and control
4.26 (iv) **Competitive allocation of shares.** Shares should be, in principle, allocated through competitive bidding so that shareholding reflects the risk-taking capacity of investors. Artificial restrictions limiting the portfolio of equity investments of these institutions should not be imposed so that the ownership structure of an enterprise can be determined endogenously as a result of continuous market forces.

4.27 (v) **Establishment of portfolio and competition guidelines.** However, it is necessary for the government to establish clear portfolio guidelines, as well as guidelines for competition, in order to prevent excessive concentration of ownership. This might lead to excessive risk taking by financial institutions and monopolistic behavior in product and in financial markets.

4.28 (vi) **Allowing substantial shareholding by workers.** Restricting shareholding to enterprise workers, which is one option under discussion in China, is not an efficient arrangement (see the discussion in the previous chapter). But if substantial shareholding by workers takes place in an environment of competition for ownership and control, it is likely to be the best arrangement under the circumstances. Such arrangement may develop competitively for loss-making enterprises of relatively small size. Moreover, as long as workers' participation in management continues to be mandated through e.g., enterprise councils, efficiency generally requires them to assume a substantial share of the residual risk of the enterprises. Consequently, a priori restriction on workers' shareholding is also going to be counterproductive.

4.29 (vii) **Allowing shareholding by individuals and foreign investors.** It would be valuable to permit individuals or private organizations to own shares, as currently proposed in Hungary and China, even though in a restricted manner (restriction of voting rights and restriction of the total proportion of shares held by individuals). The participation of individuals or private organizations increases not only the supply of risk capital but also information for evaluating the performance of enterprises. The participation of foreign investors would be valuable for the same reasons.

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48/ In cases where workers have a substantial stake in the future development of enterprises (e.g., skills highly specific to enterprises), and the profitability of enterprises is highly dependent on these workers, workers' control of management—with corresponding residual claimant status—can be the most efficient arrangement. Even in the Western industrialized countries with a highly developed capital market, company buy-outs by managers and employees take place as an efficient arrangement to promote adjustment and reorganization of ailing enterprises.
APPENDIX

REVIEW OF THE EFFICIENCY OF SELF MANAGEMENT

In this appendix we briefly review theoretical and empirical evidence concerning the efficiency of enterprise self-management.

A. Definition of Self-Management

Self-managed enterprises are those in which incumbent workers have managerial control as well as residual claimant status. Self-managed enterprises can be formed voluntarily and may be producer cooperatives or professional partnerships in market economies. Self-managed enterprises in planned economies are generally involuntary, due to legal prohibitions against the control of management by external investors and their participation in residual claims. Self-managed enterprises in planned economies also are subject to additional constraints, such as the restriction on the annual distribution of income to workers, since workers cannot claim full ownership of an enterprise's capital assets.

B. How Are Self-Managed Enterprises Expected to Behave?

A large volume of theoretical literature has analyzed the behavior and efficiency of self management. The traditional literature (Illyrian Model) assigned a highly mechanistic objective to the self-managed firm (maximization of the surplus per worker) and concluded that it would cause serious inefficiencies, such as "perverse employment response to positive demand shock."1/ More recent literature emphasizes the role of legal constraints on property rights and also indicates inefficiencies in self management.2/ At the other extreme, there is literature suggesting that self management of enterprises is efficient—or not as inefficient as the Illyrian Model suggests—given the availability of various transfer mechanisms to overcome the "appropriability" problem caused by legal or institutional


Following is a summary of major conclusions of the literature.

**Labor Markets.** Two related propositions exist, implying contractionary bias and low mobility of labor:

- Self-managed enterprises are biased against employment expansion. They also have a bias against labor-intensive investment.
- Exit of redundant workers also will be discouraged.

The first proposition arises from the existence of rent or quasi-rent for incumbent workers, their power in hiring decisions, and the assumed "egalitarian" principle in rent distribution. Under these conditions, unanticipated increases in demand do not lead to increased employment because incumbent workers would have to share the rent generated by the increased demand with those newly employed. A corollary is that investment requiring additional hiring is not preferred. If, however, workers are remunerated differentially in rent distribution, this proposition does not hold. The differentiation possibility develops through seniority-based payment, apprenticeship programs and contract labor.

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4/ The proposal of profit-sharing for macroeconomic stabilization (Weitzman, M. L., 1984, *The Share Economy*, Harvard) is sometimes interpreted as a favorable case for self management. However, a critical difference exists between the profit-sharing firm analyzed in Weitzman's work and a self-managed firm, which makes such an interpretation invalid: in the profit-sharing firm, hiring decisions are made by management, whose objective is profit maximization.

5/ "In addition (to the fact that fringe benefits can be paid at least partly on the basis of status or seniority) 10 to 11 percent of the workforce in the Yugoslav Social (or cooperative sector) consists of apprentices, novices, and workers on temporary contract" (Carson, *op. cit*, p. 582).
The second proposition similarly involves rent for incumbent workers, which they would lose by leaving their enterprises. Rent works as an exit barrier. However, if workers can realize rent through retirement benefits and pension funds, rent no longer constitutes an exit barrier.

**Financial Markets.** Three related propositions point to a tendency by self-managed enterprises to underinvest.

- Self-managed enterprises have a bias against risky investment and against capital mobility. This arises directly from the restrictions on external investors' rights in controlling management and their participation as residual claimants. Self-managed enterprises cannot efficiently diversify risk, since weak safeguard mechanisms for external investors discourage these investors. Cash-rich enterprises are biased in using their funds either for wage increases or for reinvestment in their own business if wage increases are restricted. To a certain degree, however, risk can be diversified through the introduction of profit-sharing financial instruments, such as bonds, the yield of which depends on profits. Creditors can impose various conditions on enterprises, short of controlling management, to safeguard their funds.

- Self-managed enterprises have short-term horizons for investments. This situation occurs because of the absence of measures for workers to appropriate the value of investment other than through their salaries. They cannot claim ownership of capital assets. Under such circumstances, incumbent workers receive zero value from an enterprise's cash flow after retirement, and incentives for investment generally are diminished. However, self management *per se* does not prohibit enterprises issuing the workers securities, such as capital tickets in Hungary, the value of which is linked to enterprises' long-term earning power. Alternatively, retiring workers can get compensation reflecting the value of their past contribution to the enterprise's capital investment, through short-term retirement benefits, for example. In these cases, the problem of horizons will be mitigated.

- Self-managed enterprises have diminished incentives for investment and innovation. This situation results from the nature of collective ownership. Neither an individual nor a group can fully appropriate return from investment and innovation since they are obligated to share any returns with the rest of the workers. Since an individual worker's sacrifice of wages to reinvestment does not bring him any right to a future return from investments, he may strongly prefer a wage increase to reinvestment. However, self management *per se* does not necessarily mean collective
ownership. Enterprises can issue security to an individual worker for his contribution to investment. Even without such an explicit compensation scheme, enterprises may be able to compensate workers through a combination of seniority-based wages and long-term employment guarantees.

The above points suggest that although restrictions on external investors in management and as residual claimants to investment are likely to have some negative effects on enterprise efficiency, various mechanisms can partially offset these inefficiencies. An evaluation of the efficiency of self management must, therefore, from look at empirical evidence, such as from the experience of Yugoslavia and the Mondragon cooperatives in Spain.

C. Experience of Self-Managed Enterprises - Comparative View

Yugoslavia

Regulatory Environment. Self management by workers has been the central element of the economic system of Yugoslavia since its departure from a central planning system around 1950. However, enterprises do not have full management autonomy. Especially since economic reform in 1974, the Yugoslavian government has regulated various aspects of enterprise decisions, such as distribution of net income, pricing, investment and employment, through social compact and self-management agreements. These negotiation mechanisms between enterprises and the government have allowed substantial discretionary intervention by local governments in enterprise management.6/ The government also has supported loss-making enterprises heavily.

Ownership of capital assets remains ambiguous. State ownership was abolished in 1953, but enterprises have only the right to use capital assets, not to divest them. They have to maintain the value of capital assets, and they are subject to regulations on distribution of income for workers, since capital assets are regarded as communal property.

Although enterprises may invest in other enterprises to participate in profits and decision making, such investments must be temporary and must not give the investors any management control. Banks

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also are not allowed to control the management of borrowing enterprises.7/

Workers cannot be fired. Compensation can be differentiated among workers, according to status, seniority, etc. Although the law stipulates that workers are to be remunerated based on current and past labor, this has not led to the development of a scheme directly rewarding workers' capital contribution.8/

Performance. Although the experience of Yugoslavia is difficult to evaluate because of heavy government intervention in enterprise management, self management has not produced satisfactory economic results.

In particular, labor market performance has been inadequate.2/ The government, dissatisfied with the slow growth in employment, has included an employment target in self-management agreements, but high unemployment persists. Labor mobility also has been low, with labor turnover relatively stagnant.10/ Recent econometric investigation suggests that labor immobility is a significant contributing factor to the income differentials across industries, together with weak product market competition.11/ However, it is important to note that other socialist countries, such as Hungary, have relatively mobile labor markets, with a labor shortage.

7/ Yugoslavian banks are not independent institutions. They are not allowed to accumulate profit, and their lending decisions are directly influenced by their founder enterprises and the government.


10/ Monthly labor turnover was 1% in Yugoslavia from 1974 to 1976, compared with 5.8% to 7.0% in the U.S.A. from 1950 to 1975. (Estrin and Bartlett, op. cit.).

However, the level of investment by enterprises has been high in Yugoslavia, as in other socialist countries. The rate of investment to GDP has been in the range of 25% to 30%, with a heavy concentration of investments in large capital-intensive projects. Although this investment performance is not consistent with theoretical predictions, investment behavior strongly reflects the heavy subsidization of capital investments by the government. The high investment rate has not brought correspondingly high growth, since the contribution from total factor productivity growth has been small. Savings from enterprise income have tended to fall in the absence of government regulation of an enterprise's income distribution decisions, which suggests that reinvestment by Yugoslavian firms may be involuntary to a certain degree. Meanwhile, the budget constraint on enterprises has been soft. The government has pegged the cost of capital at an artificially low level. It also has fostered the development of capital-intensive sectors through various sector-specific measures.

Spain

Although enterprise self-management is not extensive in market economies, producer cooperatives exist in the small-scale business sector of many countries. Their small, and temporary, presence is prima facie evidence that self-management is not an efficient form of organization, especially for large industrial undertakings, and that restrictions to force self-management on firms have high economic costs.

However, examples of successful cooperatives exist, among them the Mondragon cooperatives in Spain. In fact, the Mondragon cooperatives have been highly successful in achieving industrial growth. Some factors that seem to have made these cooperatives successful, compared with the self-management system in Yugoslavia, are: the competitive environment, clarity of ownership, and special factors limiting labor mobility.

Competitive Environment. Cooperatives in Mondragon are exposed to relatively competitive product and factor markets, unhindered by government intervention. Since the cooperatives are not supported by the regulatory authority of the government, nor by government restrictions on trade, investment, etc. they cannot insulate themselves from competition. Consequently, their resource allocations are guided by market signals. Wages are determined by comparing average earnings


14/ Tyson, 1980, op. cit.
in competitive private enterprises. Loans provided by the credit cooperative carry commercial interest rates.

Clarity of Ownership. No ambiguity exists between workers and the government in regard to the ownership of capital. A significant amount of enterprise capital is owned individually and can be individually withdrawn. Surpluses and losses generated by a cooperative are distributed in the following manner: 10% to the social fund, at least 20% to collective reserves, and the rest to individual capital accounts. A worker (cooperateur) can withdraw his account when he leaves his cooperative, although it cannot be paid out as long as he works in the cooperative. New members pay a substantial entry fee, part of which is allocated to collective reserves and the greater part of which is assigned to the worker's capital account.

Individualized capital accounts help cooperatives reduce some of the potential problems of self-managed enterprises, as discussed earlier. First, capital accounts will reduce the bias against employment expansion, since entrants pay an entry fee which adds to the collective resources. However, it is not clear whether the fee more or less roughly compensates for the possible dilution of rents of the incumbent workers. The right of a cooperateur to withdraw his account when leaving the cooperative reduces exit barriers. Second, since capital accounts can be withdrawn individually, an individual cooperateur has more security in appropriating return from reinvestment. However, a capital account provides no direct link between the decision of each cooperateur to sacrifice a wage increase for reinvestment and a share in the return from such investment. Moreover, unlike common stock, capital accounts cannot capitalize the future value of profits, so that the problem of short time horizons still exists. Furthermore, since it is not tradeable, a capital account cannot be used to diversify risk, unlike common stock.

Special Factors Limiting Labor Mobility. A strong link exists between cooperatives and the community, which is a key factor in the viability of the Mondragon cooperatives, which depend on individualized capital accounts. This limits labor mobility between the community and the rest of the economy. Mostly, those who want to accept such community ties are admitted into cooperatives, so the vulnerability of cooperatives to labor turnover does not occur.

(D-280)


16/ Ibid.

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