Reforming Corporate Governance and Finance in China

Yingyi Qian
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The Economic Development Institute of The World Bank
Foreword

This EDI Working Paper will be published as one of 12 chapters in a forthcoming book entitled: Corporate Governance in Transitional Economies: Insider Control and the Role of Banks edited by Masahiko Aoki and Hyung-Ki Kim. The book will have three parts:

Part 1: Generic and Comparative Issues: Theory and Policy Implications (chapters 1–3)
Part 2: Country Studies in Comparative Perspectives (chapters 4–8)
Part 3: Relevance and Lessons of the Japanese and German Experience (chapters 9–12)
A list of titles is provided on the inside back cover of this paper.

The book presents the results of a research project on corporate governance issues in transitional economies from a new perspective based on comparative institutional analysis. A concern with three issues—the emergent phenomena of insider control, the possible role of banks in corporate governance, and the desirability of the comparative analytic approach—sets the common ground for the research presented in this volume.

The coexistence of the alternative models of corporate control in the developed countries suggests that the possible "lessons" for the transitional economies may not be so obvious. It makes little sense to judge the merits of each corporate governance model and its applicability to the transitional economies without taking into account a country's stage of development and the history of its institutions and conventions. In designing corporate governance structures for the transitional economies, economists are required to identify the specific conditions under which each corporate control model (or combination of models) works, the availability of these conditions in the transitional economies, and the most efficient approach to achieve these conditions. By pooling rich individual country studies and cross-examining and comparing their implications, we may be able to avoid premature generalizations or theorizing based on the observation of a single economy. By comparing the workings of diverse systems, we may also be able to uncover latent factors that are conducive to, or constrain, the workability of particular governance structures. Comparative analysis may thus serve in the social sciences as a kind of proxy for laboratory experiments.

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Hyung-Ki Kim, Chief
Studies and Training Design Division
Economic Development Institute
Reforming Corporate Governance and Finance in China

Yingyi Qian

Reform of corporate governance and finance is the central issue in the next stage of enterprise reform in China. Although small-scale privatization is under way and spontaneous privatization is not uncommon, for political reasons mass privatization as seen in Eastern Europe and Russia is unlikely to occur in China, at least for the next several years. Nevertheless, a great deal could and should be done in reforming corporate governance and finance in China to improve the performance of its enterprises.

In addressing governance and finance reform, or enterprise reform in general, the first thing to note is the great variety of ownership and property rights arrangements in China. Until recently, Chinese statistics classified enterprise ownership into four general categories: state-owned, collectives, individuals (private firms with fewer than eight employees), and “others,” the last including private enterprises with more than eight employees, joint ventures, wholly owned foreign ventures, limited liability companies, joint-stock companies, and so forth. We actually find even more variety within each category (see table 7-1). First of all, the state sector is far from homogeneous. Unlike Eastern Europe and the former Soviet Union, where most state-owned enterprises were controlled by the central government, most state-owned enterprises in China are controlled by governments at the provincial, city, and county levels. According to the 1985 industry census of China, the shares of industrial output of the national total (at or above township level) produced by state-owned enterprises under the control of central, provincial/city, and county governments were 20 percent, 45 percent, and 9 percent respectively (see also Granick 1990).

Table 7-1. China: Types of Enterprise Ownership

<table>
<thead>
<tr>
<th>Area</th>
<th>Public enterprises</th>
<th>Non-state-owned enterprises</th>
<th>Private enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>State-owned</td>
<td>Collectives</td>
<td>Urban individual</td>
</tr>
<tr>
<td></td>
<td>enterprises</td>
<td>Individual</td>
<td>joint-ventures</td>
</tr>
<tr>
<td>Urban</td>
<td>Controlled by central, provincial, city, and county governments</td>
<td>District and neighborhood enterprises</td>
<td>Urban cooperatives</td>
</tr>
<tr>
<td>Rural</td>
<td>n/a</td>
<td>Township and village enterprises (TVEs)</td>
<td>Rural cooperatives</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Rural individual</td>
</tr>
</tbody>
</table>
Second, the fast-growing “nonstate sector” has a mix of private and public enterprises, the latter including “collectively owned” enterprises that are controlled by governments at the township or village levels, known as “township-village enterprises” (TVEs). The main difference, in property rights, between a state-owned enterprise and a collectively owned enterprise is this: because state ownership means ownership by all the people, the central government reserves the ultimate rights of reallocation of residual cash flow and assets in state-owned enterprises (SOEs), even if the control rights have been delegated and residual income has been assigned to local governments. But the central government (and any government except those of the townships and villages) has no such rights over the assets of collectively owned enterprises.

Third, there is a growing number of enterprises that fall into the category of “others”; the state or collectives still control more than 50 percent of their shares. At the moment, they are classified as the “nonstate sector” and are often regarded as “private enterprises” because they are neither SOEs nor collectives. But this could be misleading. The misclassification problem will become worse when more and more public enterprises are incorporated in the near future. This is not simply a statistical problem; rather, it is a problem concerning property rights and corporate governance.

In this chapter, I will restrict myself to SOEs and “other” types of enterprises, such as limited liability and joint-stock companies, in which the state controls more than 50 percent of interests. After all, in most cases, limited liability and joint-stock companies evolved from the former SOEs.

I will focus on four major issues concerning current reforms of corporate governance and finance in China. First, it will be shown that the gradual process of the reform emphasizing an “expansion of enterprise autonomy” and “increase in retained profits” has led to a significant reallocation of control rights (mainly the use of assets) and cash flows from government to enterprises, especially to managers. At the same time, the Communist Party still firmly controls personnel appointments and dismissals. These dual features make China’s case in part similar to that of Eastern Europe and Russia, and in part different.

Second, evidence will be presented to demonstrate that the past fifteen years of economic reform in China have also been associated with two major shifts in savings and finance: a shift of the savings source from the government to households, and a shift of the financing source of enterprises from the government budget to the financial system, especially the state banking system. The shifts are so dramatic that the savings and financing patterns in China are moving closer to those of other East Asian countries, including Japan.

Third, different views in the current debate over corporate governance reform in China will be considered. In particular, the benefits and costs of alternative governance structure in the political and economic environment of China will be analyzed, especially the role of financial intermediaries such as holding companies, investment companies, and pension funds, as well as commercial banks.

In order for the banks to play useful roles in corporate governance, the incentives for banks must first be addressed. Finally, issues related to reforming the existing banks and creation of new commercial banks in China will be discussed.

The chapter is organized as follows. The first section summarizes briefly the government policy of enterprise reform in the past fifteen years (1979–93). The second section reviews the enterprise reform experience, focusing on the dual features of managers’ control over use of assets and the Party’s control over managerial appointment and dismissal. The third section demonstrates how the patterns of savings and finance have been changing toward the banking system. Corporate governance reforms will be discussed in the fourth section, and the needed banking reforms in the fifth section. The final section offers conclusions.
The governance of SOEs in China before the economic reform was similar to that in Eastern Europe and the former Soviet Union, except that in China, the local governments played more prominent roles in planning. Under the classical planning system, enterprises had little autonomy, and their incentives from retained profits and bonuses were low; this was known as overcentralization in the relationship between government and enterprises. The profit incentives were even lower in China than in Eastern Europe and the former Soviet Union because of Mao’s preference for political and spiritual incentives over material incentives.

The main theme of the enterprise reform policies between 1979 and 1993 was decentralization from government to enterprises under “expanding enterprise autonomy” and “increasing retained profits” for the purpose of improving incentives. This strategy was prompted to a large extent by the overcentralization of the authority in the past; the successful experience of the contracting system in agriculture; the slowness in progress of fiscal, financial, and price reforms; and the political constraint on privatization.

Experiments with expanding enterprise autonomy and providing enterprises with profit incentives started as early as 1978, at the same time as the agricultural reforms. The major effort of enterprise reform by the government in this period was the introduction and promotion of the “contract responsibility system,” started in early 1987. By the end of 1987, about 80 percent of large and medium-size SOEs had adopted some form of the contracting system. By 1989 almost all SOEs had adopted a contract responsibility system that continues today. Under the contract responsibility system, enterprise autonomy was expanded, and retained profits were also increased. Contracts typically last for a period of three to five years, and are designed to provide incentives for enterprises by giving them shares of profits or the residual profits after fixed remittance. The government promoted the contract responsibility system because of political and economic constraints and the ease and intuitiveness of the concept. Some economists advocated it because they believed that a thorough contract responsibility system is a de facto privatization, and they regarded the contract responsibility system as a substitute for privatization.

The contract responsibility system was not interrupted by the Tiananmen Square incident. The system was enhanced by the Regulations on Transforming the Management Mechanism of State-Owned Industrial Enterprises issued in July 1992 by the central government. The specific purpose of this new regulation was to further expand enterprise autonomy, which officially granted enterprise managers the “14 rights” of control in: production, pricing, sales, procurement, foreign trade, investment, use of retained funds, disposal of assets, merger and acquisition, labor, personnel management, wages and bonuses, internal organization, and refusal to pay unauthorized charges by the government. In practice, enterprises gained full control in some areas, but only limited or no control in areas such as disposal of assets and the right of refusal to pay unauthorized charges.

The second approach to enterprise reform was the experimental use of other organizational forms, such as joint ventures, limited liability companies, and joint-stock companies. By mid-1993, of 3,800 limited liability companies, unlisted joint-stock companies, and listed joint-stock companies, 62 percent were limited liability companies, 34 percent were unlisted joint-stock companies, and 4 percent were listed joint-stock companies. In addition to securing greater enterprise autonomy, another reason for setting up joint ventures was to attract foreign capital. It was also hoped that setting up experimental joint stock companies would raise funds to circumvent credit quota regulations imposed on banks. In all cases of limited liability companies and in the majority of cases of joint-stock companies, new funds were raised by private placement, often through closed subscription by employees and institutional investors. In many cases, with guaranteed dividends and no voting rights, the shares were more like bonds or preferred stocks.
As a consequence of the focus on fundraising, as well as the lack of reform in government functions, the issues of ownership and governance reforms were overshadowed in the process of organizational transformation. In almost all joint-stock companies, the state continues to own controlling interests. Although joint-stock companies enjoy greater autonomy than ordinary SOEs—in investment decisions and disposal of assets, for instance—it is still the government, rather than the board of directors, that appoints top managers, as is the case in ordinary SOEs.

Enterprise grouping was another attempt at enterprise reform, which usually did not involve raising new funds. This industrial reorganization was a response to the segmentation of industrial structures inherited from the planning system, especially after regional decentralization. In most cases, industrial grouping explored vertical and horizontal linkages without formal control rights shifts. These linkages were established to explore economy of scale and to obtain supply assurance without the involvement of financial and control issues.

Changing Patterns of Governance

It is generally agreed that ownership and enterprise reforms in the industrial sector are not as successful as the reforms in the agricultural sector. There are two basic reasons why industrial reforms are much more difficult than agricultural reforms in China. First, unlike the technology in family farming in China, technology in industry determines that enterprises have both complex internal organizational structural and external interrelationship (in that sense, Soviet agriculture has different technology than the Chinese). Second, unlike the simple institutional environment of agricultural organization, enterprise reforms depend on other complementary reforms in the tax and fiscal system, financial and banking system, investment system, social safety net, government bureaucracy, and so forth. Without those complementary reforms, enterprise reform alone cannot be successful. Hence, even though reforms in agriculture and industry face similar incentive, ownership, and governance problems, simple (for example, family-based) incentive schemes would work in agriculture, but would be unlikely to work in industry.

The central dilemma of enterprise reform in China has been this: either the enterprise complains of lack of autonomy, or the government as an owner loses control and suffers from lack of accountability. The economic reform has granted managers increasing control rights over the use of assets, which leads to a mixed outcome. On the one hand, giving control to managers has a potential efficiency gain because managers, unlike bureaucrats or politicians, have the skill and information to run the enterprises. On the other hand, because managers do not own the assets of enterprises, misgovernance of SOEs caused by the agency problem remains and has even worsened in some cases.

Control and Benefits for Managers and Workers

Even without formal privatization in China, significant control rights and incomes have been transferred to managers through “expanding enterprise autonomy.” The evolutionary process toward managerial control is similar to that of Hungary both before and after its political change in 1989 (Voszka 1993). The trend in China is reinforced because most managers are promoted from within the enterprises during the reform.

Like managers in publicly held corporations in the West, today’s managers of SOEs in China exercise great discretion over the use of assets and maintain considerable on-the-job consumption and other rents. The formal rights of managers include the “14 rights” stipulated in the 1992 regulations. The de facto rights vary; in some cases they are less and in other cases more than the formal ones. There are some common features concerning managerial control rights over assets. First, enterprise managers typically
have rights to use state assets and to enjoy incomes so generated, but they have no formal rights to dispose of assets. Second, the allocation of control rights and cash flow are not entirely clear, which often leads to conflicting claims. And third, there is no formal legal recognition and protection of the effective property rights.

Although a top manager’s salary and bonuses are only about three times the compensation of an average worker, their benefits depend much more on on-the-job consumption or perks, including assignment of better and larger apartments, private use of cars, availability of “corporate accounts” for business lunches and dinners, entertainment, domestic touring, traveling abroad, and the like. To appreciate the relative magnitude of perks compared with salary and bonuses, one needs to consider the following: one average business dinner in a decent restaurant could cost about an average worker’s monthly salary. While all of the above consumptions are perfectly legal, some others are not. As a result of fast development of the nonstate sector, managers, or their relatives and friends, often have their own businesses, which provide opportunities for diverting state assets to private benefits.

Managerial autonomy is greatly enhanced through a common practice in China—a series of organizational transformations effected by breaking up existing enterprises to form “secondary legal entities” (that is, subsidiaries), joint ventures with foreign and/or domestic partners, limited liability companies, and joint-stock companies. This practice in China is again very similar to that in Hungary, where it is known as “transformation” or “partial transformation.” The motivations of managers in the two countries for such a reorganization are also similar: desire for independence from the government, for shifts of bad debts and overemployment burdens onto parent companies, and for undertaking new business opportunities without losing existing connections to and benefits from the state.

But this process in China is more often associated with new business projects, especially new ventures set up in special economic zones and development zones. The following scenario is hypothetical, but highly suggestive: a state-owned enterprise (say, of Beijing) first sets up a wholly owned subsidiary in a special economic zone (say, in Guangdong); then the subsidiary enters into a joint venture with several domestic and foreign partners; later the joint venture sets up another subsidiary in another development zone (say, in Shanghai); and finally the last subsidiary forms another joint venture with a TVE (say, of Jiangsu). After several rounds of transformation, the managers obtain a great degree of autonomy. The key to this process is the relatively little start-up capital required, which is used as collateral for securing large bank loans at a very low interest rate.

Qian and Stiglitz (forthcoming) report several cases of such organizational transformation. For example, a joint venture in Guangdong was formed by a Hong Kong partner and three Chinese partners (each with a one-quarter share). Of the Chinese partners, one is a company affiliated with the central government, another with the provincial government, and yet another with the municipal government. The Hong Kong partner contributed some initial capital and technology and is managed by a Chinese manager from an SOE. In another almost identical case in the same area, the Hong Kong investor is in fact a Hong Kong company wholly owned by one branch of the Chinese government. In the latter case, the “Sino-foreign” joint venture is actually 100 percent state-owned, but both companies would fall into the category of the nonstate sector. The managers claim that they have greater autonomy because of the new ownership and organizational structure.

With the expanded enterprise autonomy, the agency problem of managers in China is much more serious than it is in the West because of property rights and other institutional reasons. First, managers generally are not given shares or stock options that link the net worth of the enterprise with their efforts. Second, although product market competition is getting tough because of the entry of the nonstate sector, there is a lack of capital and managerial labor market competition. Third, and most serious, there is no clearly accountable representative of the state with supporting institutions that has both the information
and profit incentives to monitor the performance of managers. The monitoring roles of both banks and branch ministries/bureaus are diminishing quickly in the reform of expanding enterprise autonomy, and no replacement has been formed.

All these factors contribute to the phenomenon of coalition between managers and workers in state-owned enterprises, as opposed to conflicting interests between the two in a typical capitalist firm, where the managers represent the owners’ interest. The collusion between managers and workers is better sustained because most managers were promoted from within the enterprise. As returns to capital in the state sector steadily declined from 25 percent in the early 1980s to less than 10 percent in 1992, wages and bonuses per worker in the state sector increased (table 7-2). The workers in SOEs benefited from expanding enterprise autonomy in several ways: increased wages and bonuses (both pecuniary and in-kind); expanded residential housing; job opportunities for employees’ children in collective enterprises sponsored by SOEs; and so forth. But in many enterprises, the greatest benefit for workers is the opportunity to purchase “internal shares,” which are sold to them at discount prices (or options to buy the shares in the future). These shares often have guaranteed dividends and command a premium that could double the interest rates of bank deposits. If the enterprise goes public, capital gains can be as high as five to ten times the face value, a windfall gain.

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

bSpontaneous or Informal Privatization

This practice in China, which has become more common recently, refers to the process of unauthorized transfers of assets from either the state or collectives to formal or de facto private ownership. The phenomenon is similar to that in the Eastern European countries and Russia, but to a lesser extent (see, for example, Stark 1993; Voszka 1993; Shleifer and Boycko 1993). Typically, managers and employees of the enterprise are the main beneficiaries, but local government officials also become beneficiaries, because managers often bribe them to let the deal go through.

Spontaneous privatization often occurred following the introduction of the contract responsibility system and during a series of organizational transformations as described above. Nee and Su (1993) report several interesting cases of informal privatization in China. One case concerns informal privatization of a part of an SOE. The Xiamen Food Company, an SOE, converted a department into a subsidiary, the Food Trading Company. According to the profit-sharing contract, the parent SOE claimed 90 percent of earned profits. The subsidiary was then contracted out to three employees of the original department. The subsidiary expanded quickly, and the three employees wished to purchase the assets of the subsidiary. They lobbied to have their contract lapsed on the ground that their business changed and the original terms no longer applied. Eventually the parent company agreed to sell the assets used to start up the subsidiary. These original assets were worth considerably less than the business that the three former employees developed themselves.

In this case, informal privatization started with the contract responsibility system. The contractors then were able to secure loans to expand the business. Subsequently they acquired complete control rights over the expanded and successful business, and eventually the contractors obtained ownership rights of the entire business. But what happens if the business goes under? Of course, the state absorbs any financial losses—it is the owner in that event. Because of this feature of transfer of property rights, I call
it “contingent privatization,” which means that the government does not give away assets in the usual sense; rather, it gives away an opportunity in exchange for an informal, noncash “bid.” If the business grows, the contractee pays back the debt and becomes the owner of the new business, and the share of the state is reduced in the economy. If the business goes under, the government takes back control.

Table 7-2. China: Returns to Capital and Labor in the State Sector, 1981–92

<table>
<thead>
<tr>
<th>Category and year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profits and taxes per value of net fixed assets and working capital in industry</td>
<td></td>
</tr>
<tr>
<td>1981</td>
<td>23.8</td>
</tr>
<tr>
<td>1986</td>
<td>20.7</td>
</tr>
<tr>
<td>1991</td>
<td>11.8</td>
</tr>
<tr>
<td>1992</td>
<td>9.7</td>
</tr>
<tr>
<td>Increases of real wages and bonuses per worker over the previous year</td>
<td></td>
</tr>
<tr>
<td>1981–85</td>
<td>4.3 (a)</td>
</tr>
<tr>
<td>1986–90</td>
<td>2.6 (a)</td>
</tr>
<tr>
<td>1991</td>
<td>3.2</td>
</tr>
<tr>
<td>1992</td>
<td>7.0</td>
</tr>
</tbody>
</table>

\(a\). Average figures in five years.


This process has some interesting features. First, this is not, strictly speaking, privatization, because the old stock is not sold. Second, the scheme by its nature focuses on new business (rather than old), on flow (rather than stock), and on growth. Third, the share of the state sector is gradually reduced as that of the private sector is increased. And fourth, because of the personal efforts involved, the process likely favors entrepreneurs who take big risks (that is, the screening effect). Regardless of the distributional issues, the contingent privatization is not always efficient.

Not surprisingly, the government seriously worries about “state assets stripping” from such spontaneous privatization. According to the National Administrative Bureau of State-Owned Property, any transfer at below fair market prices of state assets to nonstate entities—such as individuals, collectives, and joint ventures—is considered state assets stripping. There is no precise figure on the magnitude of this practice, but some estimate that about 100–300 million yuan worth of state assets flow out of the state coffers each day, or around 30–100 billion yuan every year.\(^5\)

State assets flow out in two main channels. The first channel is during and after formal property rights transformation. For example, it is estimated that in Guangdong Province, which has the most joint ventures of any province in China, about 90 percent of Sino-foreign joint ventures were formed without assets appraisal from the Chinese partner. Also, during the formation of a joint-stock company, undervaluing the present value of state assets is a common practice. A recently emerging method uses the chance of bankruptcy to liquidate state assets at low prices and divert them for private uses, which
explains why some enterprises are very enthusiastic about bankruptcy and some even made a fortune from it.5

The second channel of state assets stripping is through control rights transfers under the contract responsibility system of 1987 and the new operating mechanism of 1992. For instance, in order to fulfill the contract obligation of current profit remittance to the government and to please workers by maintaining high welfare, managers often sacrifice the future of the enterprise by reducing assets-enhancing activities—for example, by using up depreciation funds ("eating up the equipment") and by overborrowing.

The biggest social problem with the ongoing state assets stripping and spontaneous privatization (and associated corruption) is the discontent of the public. Fairness is an issue, both because it avoids social unrest that would destroy stability and because it has its own value. One of the purposes of the Russian voucher program is to address the needs of the public when state assets are quickly stripped away through spontaneous privatization (Shleifer and Boycko 1993). China does not have a similar means to please the public. State assets stripping and spontaneous privatization offer tremendous benefits to some segments of the population, such as some workers, managers, local government officials, and perhaps foreign investors too. Some economists regard this as a more effective and less costly means of transition to capitalism for China. Others disagree, and they argue that not only is the public interest not served, but continuing the practice of state assets stripping and spontaneous privatization would only promote corruption and would not lead to a stable and well-functioning market economy.

Party Control of Personnel Appointments and Dismissals

As described above, managers in enterprises have been able to secure substantial control rights in the use of assets. One important dimension of the control rights concerning an enterprise, however, is the right to appoint and to dismiss top managers of the enterprise, which is still firmly controlled by the Communist Party. This is an important difference between China and the Eastern European countries and Russia. Because of that, despite the similarity of the manager’s discretion on the use of assets in the two cases, China is still one step short of the "insider control" regime observed in the latter. The roles of the Party in China’s economic reform could be better understood through a comparison with Eastern European countries and Russia.

The Party Organization Department, although not visible, is the most important agency that has the ultimate control over personnel above a certain rank (including top managers of large and medium-size SOEs); this is the principle known as "the Party controlling personnel." For example, the legal representative of an enterprise (that is, the top manager) must be appointed and certified by the Party Organization Department when it registers with the National Administrative Bureau of Industry and Commerce, and joint-stock companies must do this as well (even in special economic zones such as Shenzhen). The Party Organization Department can arbitrate when different government agencies have conflicting interests and claims.

In 1988 there was a plan by the Party to reform this system by shifting the authority to the government’s newly established Ministry of Personnel, but it was aborted because of the Tiananmen Square incident. There were also experiments in the mid-1980s in which managerial positions in some SOEs were auctioned off (see Groves, Hong, McMillan, and Naughton, forthcoming), but these experiments have never become a mainstream mechanism. To the contrary, after the Tiananmen Square incident, the Party reasserted its control over personnel to a greater degree. Overall, the authority of the Party Organization Department has not been seriously challenged by the previous economic reforms because it has always been regarded as the domain of political reform. As political stability and control are given first priority, political reforms are indefinitely postponed.

8
The authority of the Party in appointment—and especially in dismissal—of managers serves as an important counterbalance against managerial discretion. Although the appointment does not carry an explicit compensation package as typically observed in a capitalist firm, each managerial position is automatically associated with a huge amount of control rents from managerial discretion, especially in the fast-growing areas and in the newly emerged business lines such as real estate, security brokerage, futures trading, financial intermediaries, and the like. Therefore, although promotion within the bureaucratic hierarchy becomes less attractive than before, disciplinary dismissal by the Party severely damages managers because of the removal of the rents associated with their position. Even though some people do not want to be promoted, they still have strong incentives to maintain their positions for obtaining such rents. If managers succeed in capitalizing the rents, however, they may quit the job at some point to start their own business. By that time, the personnel control of the Party will be less effective.

The continuity of the Party's control in personnel decisions has important implications. On the one hand, this clearly does not represent a very efficient governance structure, because the selection criteria of the Party are not entirely based on economic performance, and the evaluation methods are largely primitive. But reforming the system of the Party's control, although necessary, will not be easy for obvious political reasons, especially at the present time. On the other hand, the willingness of the central government and the Party to decentralize (delegate) control rights to managers without fear of a complete loss of control is perhaps the result of the continuing Party centralization of appointments and dismissals of managers and control of their incentives. This is somewhat similar in spirit to the Japanese organizational features of the firm, where most decisions are decentralized but personnel decisions are all centralized. This "Duality Principle," as termed by Aoki (1990), may also operate in China. Indeed, the power balance between the Party/government and enterprise has to some extent prevented state assets from being stripped away at a faster pace, as seen in Eastern Europe and Russia.

Relationships between Enterprises and Local Governments

Often there is a conflict of interest between the central and local governments, and local governments collude with enterprises against the central government. This is more evident in fast-growing areas such as Guangdong. Collusion between local government and SOEs can be explained by the competition pressure among different jurisdictions and by the insecure property rights of local governments. Although the local government has the control rights of SOEs, those rights are not completely secure for two reasons. First, the local government worries about possible future reallocation of assets by the central government, and it often encourages the enterprise to pursue short-term goals of profit maximization, rather than increasing the net worth of the assets. The local government may also want to privatize SOEs under its control, or tacitly consent to or even encourage the spontaneous privatization described above, which explains why spontaneous privatization is under way despite prohibition from the central government. Second, the local government also worries about the ratchet effect, so it often helps the enterprise to hide profits. The pattern is the following: the local government allows profits to go untaxed, and the enterprise picks up the bill for some government expenditures, such as dining and traveling expenses.

Needless to say, conflict between local government and enterprises exists. Managers continue to complain about the lack of full autonomy and government interference in such areas as appointments and the imposition of unauthorized fees. Again, situations vary. In poor areas, where the industrial base is small, but fixed government expenditure is large, the local government tends to impose more fees on enterprises. But competition among jurisdictions to get rich first is one check on the local government's predatory behavior, especially in the fast-growing areas where potentially large gains prevent the local
governments from becoming predatory. Local governments in advanced areas may even make preemptive moves through reform to attract capital and skilled labor from other regions in order to better compete.

Changing Patterns of Savings and Finance

In contrast to Eastern Europe and Russia, China’s economic reform has been associated with high and stable national savings, which increased from 30 percent of gross domestic product (GDP) in the early 1980s to about 35 percent in the 1990s. More significantly, major saving sources have shifted from the government and enterprises to households. In 1978 household savings accounted for only 23 percent, enterprises for 34 percent, and government for 43 percent of total saving. In 1991 household savings increased to 71 percent, enterprise savings decreased to 25 percent, and government savings fell to a mere 4 percent of the total (table 7-3).

Not only household savings increased dramatically; the increase is closely associated with financial deepening, that is, the process of rapid increase of household financial assets. Total household bank deposits reached 1.5 trillion yuan in 1993, or about 50 percent of GDP, from merely 6 percent in 1978. Total household financial assets increased from about 19 percent of GDP in 1980 to about 70 percent of GDP in 1991. For broader measures, in 1991 the M2 to GDP ratio reached about 100 percent and total financial assets to GDP ratio topped 232 percent (table 7-4).

<table>
<thead>
<tr>
<th>Table 7-3. China: Changing Pattern of Savings, 1978–91 (percentage)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Share of national savings</strong></td>
</tr>
<tr>
<td>Government</td>
</tr>
<tr>
<td>Enterprises</td>
</tr>
<tr>
<td>Households</td>
</tr>
</tbody>
</table>

*Source: Xie 1992, table 3-13.*
In contrast, the past fifteen years witnessed a steady decline of (consolidated) government budgetary revenue as a share of GDP, down from 35 percent in 1978 to about 16 percent in 1993. Much of the budgetary revenue decline can be attributed to the decrease of enterprise income tax and profit remittance, which fell from 21 percent of GDP in 1978 to about 5 percent in 1992. Some of the reduction of profit remittance, however, reappeared as the so-called “extra-budgetary” revenues. The extra-budgetary revenue, most of which is retained profits of enterprises, expanded moderately. Before the reform, the extra-budgetary revenue was relatively small, 9 percent of GDP in 1978 compared with the budgetary revenue of 35 percent of GDP. By 1991 the extra-budgetary revenue was up to 15 percent of GDP, while the budgetary revenue was down to 18 percent of GDP. Still, the combined budgetary and extra-budgetary revenues have declined significantly during the reform period (table 7-5).

The natural consequence of the decline of government revenue and savings and the increase of household financial savings through bank deposits is the changing sources of financing by enterprises. Budgetary financing of capital expenditure as a percent of GDP fell dramatically, from 15 percent of GDP in 1978 to less than 5 percent in 1992. Although some of the financing comes from extra-budgetary revenue (another 5 percent of GDP), the major source of financing comes from the banking sector. The share of bank loans in total budget and bank loans financing in fixed assets and working capital increased from 39 percent in 1978 to 73 percent in 1991 (table 7-6). Between 1981 and 1990, domestic bank loans for fixed investment financing increased from 13 percent to about 20 percent, and in working capital, bank loans accounted for more than 80 percent (at or above township level enterprises) (Xie 1992, p. 87).
During this period, the government ran a moderate open or official budget deficit (around 1–3 percent of GDP), of which about one-third was financed by bonds. Hidden or quasi budget deficit under the name of "policy loans" (that is, loans not on commercial terms), however, may actually equal or surpass the figure on the open budget deficit. Total seigniorage (including both inflation tax and an increase in real money balance) could be as high as 8–9 percent of GDP in some years (for example, 1990 and 1991). Very fortunately for China, much of the seigniorage in the past fifteen years has taken the form of an increase in the demand for real money balance; therefore, the government was able to keep inflation at a moderate level, although official and quasi budget deficits ("policy loans") were high.

Table 7-6. China: Changing Pattern of Financing, 1978–91 (percentage)

<table>
<thead>
<tr>
<th>Item</th>
<th>1978</th>
<th>1991</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budgetary capital expenditure/GDP*</td>
<td>15</td>
<td>5</td>
</tr>
<tr>
<td>Shares of fiscal budget and bank loans in fixed assets and working capital financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fiscal budget</td>
<td>61b</td>
<td>27c</td>
</tr>
<tr>
<td>Bank loans</td>
<td>39b</td>
<td>73c</td>
</tr>
</tbody>
</table>

Source: (a) Statistical Yearbook of China, 1992; (b) 1980 figures, Xie 1992, table 3-11; (c) 1990 figures, Xie 1992, table 3-11.

These stylized facts highlight the following points. First, bank loans are becoming the main external source of enterprise financing, while the government budget and direct financing are relatively small. Second, many enterprise problems are caused by, or are shown as, the problem of "policy loans," or bad debts in the financial system, rather than the open budget deficits in the fiscal system. And third, the interrelationship between enterprise reform and banking reform is closer than ever.

Reforming governance of SOEs in China can be viewed as a three-step process: corporatization, rearrangements of corporate control, and privatization. At the present time, the first two steps are feasible, but privatization is restricted to small-scale firms. In Eastern Europe, corporatization was carried out only as a quick prelude to privatization, and rearrangement of corporate control was carried out either during or after privatization. In China, the particular political condition dictates that the period of corporatization and rearrangements of corporate control without privatization will last longer. Privatization is not impossible, however, as we see from the recent flexibility regarding sales of small SOEs. It is also possible to privatize part of some of the large-scale enterprises in the near future as political constraints are relaxed or the performance of these enterprises becomes worse. In any event, privatization will be much slower in China than in Eastern Europe and Russia.

From the perspective of political economy, the mechanisms of corporate governance currently needed in China should satisfy three basic requirements: first, they should be politically feasible without too much resistance from the government bureaucracy; second, they should improve managerial accountability.
and limit bureaucratic interference; and third, they should facilitate the eventual diminution of state shares either through dilution by issuing new shares to the private sector, or by privatization. Of course, there is no one model of corporate governance for SOEs. But the common problems need to be addressed in a systematic way.

In the view of economists, corporate governance is a set of institutional arrangements governing the relationship among several groups of stakeholders (investors, both shareholder and creditor; managers; and workers) in order to realize economic gains from such a coalition. The structure of corporate governance concerns (a) how control rights are allocated and exercised; (b) how boards of directors, managers, and workers are monitored and evaluated; and (c) how incentives are designed and enforced. Generally, good corporate governance recognizes the complementarity of these institutional arrangements and selects a structure to limit total agency costs. The research has generally focused on the issue of how managers (insiders) are monitored and/or disciplined by investors (outsiders).

All transition economies are constrained by the scarcity of financial and skilled management resources. Hence, the desired corporate governance structure should be able to make optimal use of the available resources. From an economic perspective, an appropriate governance in a transition economy must be able to deal with two special problems associated with the transition. First, it should provide managers with incentives to restructure the enterprises, prevent them from further thefts of enterprise assets, and be able to replace them quickly when they are found incapable. Second, it should also be able to facilitate raising badly needed external capital to finance restructuring and technology upgrades.

Even with private ownership, property rights allocation among many stakeholders and forms of corporate governance in a publicly held corporation are much more complicated than they are in a small, family-owned and operated business (Milgrom and Roberts 1992). Because property rights consist of rights of control in many dimensions, and most modern business organizations involve many stakeholders, it is important to know how and why control rights along different dimensions are allocated and incomes shared among these stakeholders. Therefore, in studying the issues of reforming governance of large and medium-size SOEs, it is more relevant to make use of the studies of corporate governance and finance in modern corporations in the West, because the potential agency problem is more pervasive than it would be in a simple case of an owner-managed private firm.

; bCorporatization and Corporate Control

Corporatization in China is first associated with defining property rights of legal entities, that is, corporate property rights. After corporatization, an enterprise, as a legal entity, has property rights over its assets. According to the Chinese company law passed in December 1993, three major forms of companies will be identified: joint-stock companies (including a small number of enterprises to be publicly traded), limited liability companies, and wholly state-owned companies. In the future, boards of directors will be established to represent the interests of shareholders. The boards will make major and strategic decisions, including appointments and dismissals of top managers. Generally, board members and managers will not be government officials from the civil service.

Economists agree that corporatization is a useful step of enterprise reform even without privatization. Corporatization helps to hold directors responsible for the assets of the company, prevent further asset thefts, provide a mechanism for information exchanges, set a stage for selling shares, and separate the state from enterprises (Lipton and Sachs 1990; Shleifer and Boycko 1993). That is why corporatization was carried out before privatization in Eastern Europe and Russia. The idea of corporatization only started to gain more and more approval in China from the government, enterprises, and economists in 1993.
A more complicated and controversial issue regards rearrangement of corporate control. The experience in the West shows that governance structure can take a variety of forms. In many corporations, outsiders such as block shareholders (core investors), investment funds, strategic investors, or banks are active in corporate governance through their representations on the board, in particular in decisions leading to the dismissal of top managers. In the case of Japan, a typical large corporation is actually controlled by insiders, because all board members are managers, but managers can be replaced by the main bank when the corporation is in financial trouble.

Experience in Eastern Europe and Russia has shown that during transition, insiders obtain substantial control of enterprises. In the cases of Hungary and Russia, insiders are managers, and in the case of Poland, they are workers. This could have happened because of privatization schemes (as in Russia) or because of weak government supervision and spontaneous privatization (as in Hungary, Poland, and Russia, as well). Economists are in agreement that such governance by insiders without the possibility of outsider intervention is generally not good for the health of the economy. Distortions arise from insiders' control because they may act out of self-interest rather than in the interest of the owners (that is, value maximization), and there is often a short-term bias toward managers' preferences compared with those of the owners. Insider control often implies that (a) managers may refuse to restructure; (b) bad managers cannot be replaced without incurring substantial costs (because they are bad, they are also unlikely to find good replacements for themselves); and, especially, (c) no new capital can be raised at a low cost. All of these are important considerations for transition. One of the themes of reforming corporate governance in Eastern Europe and Russia is how to institutionalize corporate control by outsiders in the process of privatization (Phelps, Frydman, Rapaczynski, and Shleifer 1993).

The case of China is similar, but differs from those in Eastern Europe and Russia as discussed earlier. Complications in China arise because of the majority of public ownership of enterprises, the unwillingness of the government to privatize, and the continuity of the Party's role in personnel decisions. Although corporatization has already become an official reform policy in China, the role of the Party after corporatization it is still not clear. Will the Party send its representatives to the board, will the board be required to get approval from the Party for personnel decisions, or will the Party stop making personnel decisions below a certain rank altogether?

Economists in China hold different views regarding the current trend toward managerial control in enterprises and advocate different approaches in reforming corporate governance as well. In one view, shared by those described above concerning insider control, the tendency toward managerial control of enterprises is regarded as bad and requiring balance. Because of political constraints in China, according to this view, state-sponsored financial intermediaries such as investment companies or commercial banks can be used to minimize such a problem. In another view, shared by those who support privatization, spontaneous privatization and insider control by managers and workers is the (second) best choice for China, because formal privatization is impossible. The needed strategy for reforming corporate governance, according to this view, is not to reassert ownership rights by the state, but rather to continue the trend of giving managers more control and eventually making them de facto owners. In this view, spontaneous privatization is good and should continue.

Alternative Governance Structures

In reforming corporate governance, China needs diversity. This is not just because China is a large country and variations are huge across different regions and industries. Diversity also has value because the kind of enterprise reforms to be carried out in China are unprecedented and must encompass a wide range of experiments. Even in the capitalist economies, one observes that organization of firms varies greatly both across countries (for example, the United States, Japan, and Germany) and within each
country. The most dangerous policy in enterprise reform in China is perhaps the insistence on one particular model.

One possible governance structure is through a management and employee buyout (MEBO), which enables managers and employees to obtain control by buying up the majority interests, as seen in some cases in Russia and Eastern Europe. This could be a good solution for small-scale SOEs or collectives, but it would not be formally feasible for large and medium-size enterprises in China.¹⁰

The second promising governance structure in China is through joint ventures with foreigners. China attracted more than US$20 billion annually in foreign direct investment (FDI) in 1992 and 1993. This provided a rare opportunity to utilize foreign physical and human resources for enterprise reforms. The practice of taking a part of an SOE and forming a joint venture with foreigners has become more and more popular in recent years and has received the nickname of “grafting” (jiajie) in China. In addition to the tax benefits, availability of cheap labor, and the huge potential market in China, the incentives for foreign investors to invest and form joint ventures with Chinese SOEs also come from the weak ownership claims of the state. Very often, managers from SOEs collude with foreigners in underestimating the value of assets contributed by the Chinese partners. A similar pattern is also observed in Hungary.¹¹

The third alternative comes from transformation of current enterprise groupings. There were fifty-five large enterprise groups in China approved by the State Council by the end of 1993. Some Chinese economists and government officials believe that these groups have a bright future in corporate restructuring because they have advantages of linkages in production, supply, and marketing. After restructuring, the parent company will be transformed into an assets management company (still to be owned by the state) when it stops the production supervision it now performs.

The most difficult part of reform concerns large and medium-size SOEs that cannot find foreign partners and are in no particular grouping. The same is true for Eastern Europe and Russia, where, after privatization, the large and medium-size enterprises have many dispersed investors. The problem with ownership and corporate control of these enterprises in China differs from that in Eastern Europe and Russia (because of no privatization); the central issue is how the state shares should be represented in a less harmful way. A more specific question in this regard concerns whether state-owned (or sponsored) financial intermediaries should be established between incorporated SOEs and the State Assets Management Committee (SAMC). If these intermediaries need to be established, then in what forms? And who will play the prominent role in corporate governance: holding companies, investment companies, assets management companies, commercial banks, or a combination of these?

Opponents of using state-owned financial intermediaries argue that this will result in the same bureaucracy as before, and maybe worse, particularly if the intermediaries are based on existing branch ministries or bureaus (however, private financial intermediaries would be acceptable). It is very likely that these future holding companies or assets management firms might want to take back decisionmaking authority from the enterprises, becoming a “mother-in-law cum boss.” Because the intermediaries like to hold power, this could also be bad for future privatization.

Without intermediaries, the SAMC would appoint directors of the boards of corporations directly, which would eliminate one layer of bureaucracy. Obviously the SAMC must employ an internal hierarchy (again, perhaps organized by industry) to make appointments of directors, collect information, evaluate their performance, and so forth. As the capacity of the state to monitor lessens, managers of enterprises will continue to enjoy the control rights they currently hold, and more and more will become de facto owners, which will naturally lead to future privatization. This approach is consistent with the view that state ownership is totally hopeless, no matter what form it takes. Therefore, the purpose of the current enterprise reform is to make de facto privatization easier.

Proponents of using financial intermediaries argue their case on several grounds. First, if spontaneous privatization and state assets stripping are serious political issues to be dealt with to avoid political
backlash, then the best chance for the state to reclaim ownership rights is to use financial institutions, rather than ministries or bureaus as in the past. Second, with transforming government functions, many branch ministries and bureaus will be eliminated, and the organizational facilities and human knowledge could be useful (after some retraining) in these intermediaries. Third, from an international perspective, institutional ownership in corporations (such as financial intermediaries) is a common feature of all mature market economies, particularly those associated with large corporations, and especially in Japan. And finally, holding companies and other financial intermediaries were also used in the public sector in other market economies; although they did not work very well, they were better than the existing Chinese system. Given the political constraints in China, this is worth trying.

The Role of Nonbank Financial Intermediaries

Most economists from the West agree that the stock market will play a limited role in corporate control through takeovers or proxy fights in the transition economies in the near future; this role tends to be overestimated, however, by people inside the transition economies. The experience of continental Europe and Japan shows that the block investors (or core investors) and banks have played an important role in outsider control. Given the wealth distribution in transition economies, the core investors are more likely to be institutional investors of a variety of financial intermediaries (except for possible foreign investors). In Eastern Europe and Russia, these intermediaries are known as "privatization intermediaries." Examples include private investment funds in the Czech Republic and Russia and state-sponsored mutual funds in Poland.

There are two basic problems concerning the role of financial intermediaries in corporate governance. The first is that these intermediaries may play too small a role that leads to de facto insider control. Experience in the West has shown that pension funds and mutual funds have never been active in corporate control, even when they hold substantial shares in a company (and in most cases, they do not—for example, if they follow the index investment strategy). The same problems appeared in investment funds and mutual funds in Eastern Europe and Russia. One possible remedy, in the context of Eastern Europe, requires government regulation to restrict the extent of diversification of these intermediaries and make the “exit option” more costly to exercise. Of course, there is the usual tradeoff between risk diversification and incentives to monitor.

The other problem more relevant for China is that these intermediaries may become “too active” in corporate governance. This is more relevant in China precisely because these intermediaries are likely to be state-owned holding companies or assets management companies and to be established based on the existing institutional facilities and personnel from places such as branch ministries. In these cases there is a real danger that these intermediaries will become active interventionists—bureaucratic and political.

Several steps could be taken to limit such a problem. First, it is well known that politicians and bureaucrats often have objectives other than profits and economic efficiency, which is believed by many economists to be the major deficiency of public ownership and the fatal factor of socialist economies. To address this issue, the state financial intermediaries together with the SAMC could be strictly separated from the ordinary government bureaucracy for social regulation and administration ("government A"). To this end, a separate “government B,” which consists of the SAMC and the state financial intermediaries, could be set up under the supervision of the People’s Congress and given the mission or objective of value maximization of the state assets. Evaluation and rewards for people working in “government B” would be based exclusively on their financial performance, as in the private sector.

Second, although separation of the assets management function of government B from the regulation function of government A is crucial, it is hardly sufficient to achieve economic efficiency. The government regulations could be designed to force financial intermediaries to sufficiently diversify their
portfolios to prevent them from establishing monopolies in product market. Financial intermediaries in market economies serve the purpose of coordination, control, and commitment, and they do so in an environment of competition. One crucial difference between the proposed financial intermediaries and the former ministerial system of planning is the possibility of competition among financial intermediaries when they have diversified and the potential for overlapping portfolios, even though they are still state-sponsored. It is hoped that capital market competition will not only better discipline managers of firms, but also provide better information for the evaluation of managers of these intermediaries.

Finally, it should be noted that these proposals are, at best, social experiments that have no precedent. Although no theory proves they are doomed to fail, there is also no theory to guarantee their success. Therefore, steps should be taken to prepare for dilution of state ownership in these financial intermediaries either by selling shares to domestic nonstate investors (private or collective), or in the case of investment funds such as pension funds, by spinning off the funds management company to private firms. In the latter case, although shares of the investment funds are still owned by the state, the funds could be managed by, for instance, Fidelity Management Company.

The Role of Banks in Corporate Governance

As discussed earlier, the banking system in China has become the most important external source of financing of enterprises, and therefore the relationships between banks and enterprises are naturally close. China’s reform is entering a stage in which the enterprise and banking reforms intertwine and become the major bottleneck. In relation to enterprise reform, the role of banks is instrumental to solving the massive bad debt problems of enterprises and to satisfying the demand for new capital. In addition, because of their abilities in financing and monitoring, banks also have potential special leverages in corporate governance.

Banks have financial resources as well as monitoring capacity, and banks do not interfere with enterprises on a daily basis. As creditors, banks’ decisions generally are important only at the time loans are to be approved and when things go wrong; in between, banks accumulate information (that is, selective intervention). In comparison, the equity financial intermediaries discussed above usually have limited capacity to mobilize financial resources, and at the same time they may not refrain from constant intervention on a daily basis, which is likely if they are transformed from the former industrial ministries. Perhaps no single group will become the dominant institution in corporate governance in China; instead, some kind of “shared governance” may arise in which banks play an important role as the counterbalance to the inside-managers in enterprises on the one hand, and as the check on a possible abuse of power by holding companies on the other.

The postwar Japanese experience with corporate governance led by main banks illustrates such a possibility (Aoki 1994). Unlike corporate governance with only equity investors or diffused creditors, such as bondholders or arm’s-length commercial banks, the Japanese main banks play an active role in corporate governance. First, the syndicated monitoring led by main banks at the times of ex ante, interim, and ex post is more effective in disciplining enterprise managers. Second, the syndicated monitoring also saves scarce monitoring resources. Third, the “contingent control” mechanism underlying bank loans features no external intervention from the bank during the normal states of enterprise operation (the insider control) and an automatic shift of control rights to the main bank during the bad states (the outsider control). This mechanism provides incentives for enterprise managers in normal times and facilitates restructuring by banks in bad times.

The process of enterprise financial restructuring usually provides a good opportunity for banks to engage in close relationships with the enterprises. In Japan, one historical reason for the rise of close bank-firm relationships has been the banks’ active participation in the postwar reorganization of firms (see
Hoshi, in this volume). Similarly, the development of a close relationship between banks and enterprises in China will likely depend on the following factors: the extent of banks' involvement in the process of dealing with bad debts; the way bad debts are absorbed by the banks; regulations on equity holdings by banks; the political power of the banks compared with the holding companies; and so forth.

Some Chinese economists are in favor of a Chinese-style main-bank system in which banks are allowed to hold some equity shares in enterprises and play major roles in corporate governance (Wu 1993). Because the adoption of a universal banking system in China is currently out of the question, the state banks in China opt for separating commercial and investment departments inside the banks, with the latter holding equity shares.

Nevertheless, a precondition for the banks to take major roles in corporate governance in China is that they must have the capability—and especially the incentives—to do so. This requires some fundamental reforms in the banking sector, the issue I will turn to next.

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**aNeeded Banking Reforms**

Banking reform is complementary to enterprise reform, especially so in China's reform at this stage. Most people blame bad debts on SOEs. Of course, if enterprises perform well, there should be no bad debt problem in the first place. The causality could also be in the other direction, however: because the banking system fails in its role as an efficient allocator of financial resources and as the monitor of enterprises, the enterprises perform badly. This is a plausible linkage because the banking sector is far less market-oriented than all the other nonfinancial sectors. It is well known that the specialized banks are more subject to political control than industrial enterprises. Despite the diminishing role of planning in all other sectors amid the deepening of reforms, the central government recently increased administrative control over specialized banks, which in turn rely more on administrative means for allocating credits. This is partly the result of a general lack of economic instruments to achieve macroeconomic stability, but the recent tendency is also reinforced by two interrelated phenomena: interest rates fell far below the market equilibrium because of inflation and large financial resources flows outside state regulation were encouraged by the local governments, known as “raising capital in an unorganized way” (luanjizi). Clearly, the existing banking system in China is unable to perform the needed tasks in enterprise restructuring and to play a role in corporate governance. Banking reforms are especially needed in two areas: reforming incentives for the existing banks and the creation of new commercial banks.

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**bReforming Incentives for the Existing Banks**

The recent experience in Eastern European countries has shown that privatization of state banks is much slower than privatization of nonfinancial firms. But even without privatization, state banks, after some restructuring, have shown some changed behavior—they have become more prudent in lending and have more incentives in monitoring restructuring of firms (Dittus 1993). This suggests that reforming incentives of the existing state banks without privatization offers promising possibilities.

After all, state banks are SOEs in the financial sector. Because of the special importance of the banking sector to the economy, banks in China are generally placed outside the coverage of reform policies applied to nonfinancial enterprises, such as anti-trust regulation, entry of nonstate enterprises, and corporatization, to name but a few important ones. Lack of these reforms is certainly responsible for the failure in the banking sector. There are three immediate tasks needed in the reform of the existing state banks in order to improve banks' incentives: (a) removing all the policy loan obligations; (b) cleaning up the balance sheets; and (c) corporatizing state banks into joint-stock companies. Full
commercialization of specialized banks can only be achieved after stopping policy loans, cleaning up the balance sheets, and corporatization.

First, removing policy loans from the portfolio of state banks addresses the flow problem that directly affects banks' current and future behavior and incentives. The problems with the policy loans have been long recognized. Since January 1994, three policy banks have been established that are supposed to take the responsibility for policy loans. Because each of the three policy banks has specific development missions, they are really development banks in infrastructure, export-import, and agriculture. Therefore they started to take away only loans for development purposes from the specialized banks and they are unable to remove all policy loans from the specialized banks. As a result, the remaining part of the policy loans (the hardcore of the problem) is still the responsibility of specialized banks—the flow problem continues.

Policy loans are really disguised fiscal subsidies to loss-making enterprises. These subsidies cannot be terminated immediately without mass layoffs and should be continued for some time. The key is to terminate them with a fixed timetable. State banks should not continue to assume fiscal responsibility. Hence, there is a need to let some other nonbank government agency deal with the problem and turn “policy loans” into explicit fiscal subsidies, as in some Eastern European countries.

Second, the scale of nonperforming debts in China is massive. If 20 to 30 percent of total outstanding loans are regarded as nonperforming, which is a reasonable estimate, bad debts would amount to 17 to 25 percent of GDP by the end of 1993, as the total outstanding loan to GDP ratio is 84 percent. This would translate into about 530–800 billion yuan (A Statistical Survey of China, 1994). Although this stock problem is, by-and-large, a result of the past problem, it nevertheless affects current incentives. On the one hand, with debt-overhang, banks have no incentives to restructure enterprises. On the other hand, unconditional and complete recapitalization of banks is also not desirable because burdens of the bad debts are completely removed from the enterprises and banks, and banks are underutilized in restructuring enterprises.

Therefore, a good method of recapitalization of banks should provide banks with incentives to restructure firms and should also be feasible in financial terms. Many Eastern European countries have opted to use government bonds to recapitalize banks; some of the recapitalizations are unconditional and others are conditional (Dittus 1993). In comparison, postwar Japan mainly relied on the stock market before it collapsed for the recapitalization of banks (Hoshi, in this volume). Given the scale of the problem, the nascent stock market, as well as the limited capacity of issuing government bonds, China can adopt a partial recapitalization scheme that combines government bonds with the stocks.

Third, in conjunction with removing policy loans and cleaning up the balance sheets, a critical step in the conversion of specialized banks into commercial banks is corporatization. Corporatization is important even without privatization, as we have argued in the context of enterprise reform. After corporatization, the bank can still be initially fully state-owned, with several different state agencies holding shares. In Shenzhen Special Economic Zones, some joint-stock banks (with all shares held by the state agencies) have much a lower incidence of nonperforming loans compared with state specialized banks. This provides some evidence of the benefits of corporatization. Corporatization of banks also enables the banks to issue new shares in the stock market for recapitalization purposes.

;Creation of New Commercial Banks

Reforming existing specialized banks is certainly important, but it is likely to be very difficult. Therefore, the banking reform should include a concurrent plan for allowing entry of new commercial banks. There are several advantages to creating new commercial banks. New banks have fresh ownership and governance structures to start with; they have no bad debt problems, which plague the existing banks;
they will not have policy loans obligations; and they have to compete with the existing banks for growth. The reform experience of the past fifteen years in the industrial sector has provided relevant lessons in this regard: how difficult it is to reform the existing enterprises, and how important and valuable it is for the new entry of the nonstate enterprises in both outputs produced and competition pressure so generated for the state sector. The value of the new commercial banks will be similar, coming also from competition pressure on the existing banks. Competition is crucial for providing banks with incentives for monitoring enterprise performance and playing an active role in corporate governance.

To date, China has four specialized banks that dominate the market. Although there were encouraging signs recently for allowing foreign banks to open their branches in China or form joint ventures with the Chinese, the process is likely to be slow and restricted. The process of entry of new banks could be vastly improved if China created new regional commercial banks sponsored mainly by provincial governments. These banks are not private banks to start with, so there should be no political difficulties. Local governments should also be enthusiastic.

One practical method to establish new regional-based commercial banks is to convert the existing branch facilities of the central bank at the county and municipal levels (Qian, forthcoming). China's central bank has branches all the way down to the county level and employs more than 170,000. When the central bank is downsized, the lower-level branches at the city and county levels will be abolished and the personnel and branch facilities will be released. Then transprovince regional commercial banks could be created, each encompassing three to four provinces. These regional commercial banks will be joint-stock companies with shares held by the concerned provinces (with no single province having a controlling share to prevent a single province from monopolizing the market), and possibly with minority shares held by the central government. Of course the ownership structure will evolve, possibly involving foreign or private partners in the future.

In addition to the advantage of making the best use of the existing branches and personnel, which could reduce the cost of reemployment of the redundant central bank employees, another important advantage of the scheme is to gain political support from local governments for reorganization of the central bank. China's past experience has shown that local government's influence on the central bank branches is the major reason for monetary instability. The proposed transprovince central bank reorganization (Qian, forthcoming) intends to centralize monetary policy and to dramatically reduce local influence by eliminating province-based branches. Obviously, this reorganization will meet with strong local resistance. If the central government implements the central bank reorganization plan together with creation of new regional commercial banks, the local resistance will diminish substantially.

The third advantage is that the new banks will serve to channel local financial resources in a more organized way. One problem with the current banking system is that local enterprises are reluctant to use state banks for fear of state credit quotas and administrative controls from the central government. Regional commercial banks, when properly regulated, will be more effective in mobilizing financial resources, in part because they are supported by local governments and in part because they are legal entities.

Finally, with the establishment of a dozen or so new commercial banks at one stroke, a competitive banking environment could be formed quickly. The national commercial banks have to face competition from regional commercial banks, and vice versa. Of course, we can foresee possible protectionism arising—for example, local governments may use administrative means to force local enterprises to deposit in their banks and to restrict lending activities. These are natural incentives from the local governments; the role of central government is to prevent such practices on the one hand and to encourage competition by allowing entry on the other. Realization of the advantages of competition depends on proper regulations. Overregulation, however, may become self-defeating if the regulation prevents healthy competition between national and regional commercial banks, and between state banks...
and nonstate banks. Therefore, the design of regulation in areas such as branch opening, bond issuing capacity, and lending restrictions should be carefully studied.

Concluding Remarks

Since January 1994, China has proceeded successfully in tax, fiscal, and foreign exchange reforms in its second stage of economic reforms. It is now time for China to concentrate on the most difficult part of all: enterprise reform and financial and banking reform. In this respect, reforming corporate governance and finance forms the key linkage between the two reforms.

Given the huge size of the country and the varying institutional and political constraints facing different sectors of China, reforming corporate governance and finance should not follow a single model. Even within the state sector, there could be a variety of approaches. Unlike some other reforms in aspects of macroeconomic management control (such as the fiscal and financial control) where externality is strong, enterprise reforms are necessary for a wide range of experiments. In property rights and enterprise reforms, China needs diversity. In this sense, the most dangerous reform strategy is to insist on a single organizational model for all enterprises in the country.
References


Chapter 7—Footnotes

I am grateful to Masahiko Aoki, John Earle, Lawrence Lau, John McMillan, Juro Teranishi, and Ernst-Ludwig von Thadden for helpful discussions and comments.

1. Governance and finance issues in TVEs are studied in Che and Qian 1994.

2. Several empirical works have shown that the policies of enterprise reforms in the past have improved SOEs’ incentives and increased productivity to some extent. For incentive effects, see Groves, Hong, McMillan, and Naughton, forthcoming; for productivity, see Jefferson and Rawski 1994.

3. In the past few years, transformation without formal privatization has been typical in Hungary (Voszka 1993), and it is also called “decentralized reorganization” (Stark 1993).

4. This is called “fake foreign capital” in China. The incentive of doing so is twofold: to be qualified for tax benefits and to gain greater autonomy from the government.


6. China Business Times, June 29, 1994. This type of “bankruptcy” is given the nickname “fake death” (jiasi) in China.

7. The supervising branch ministry or bureau of an enterprise makes nominal appointments after approval from the Party Organization Department or makes low-level appointments.

8. The criteria are not entirely political either. The managers generally may pass the political screening as long as they are not involved in political incidents such as the Tiananmen Square incident.

9. Much of the principal-agent theory developed in the past twenty years addresses this issue. See Hart and Holmstrom 1987 for a survey of that literature.
10. Frydman, Rapaczynski, Earle, and Turkewitz (1994) examine the experiences of the Czech Republic, Poland, and Hungary on the privatization of small, nonmanufacturing business units. It contains practical lessons and operational recommendations for implementing small-scale privatization programs that might be useful for China.


12. Proposals were also made to transform these intermediaries into a kind of universal bank by extending their activities to a wide range of financial services (see Phelps, Frydman, Rapaczynski, and Shleifer 1993).

13. See, for example, Kornai 1992 and Shleifer and Vishny 1994.

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