Reforming the State-Enterprise Property Relationship in the People's Republic of China: The Corporatization of State-Owned Enterprises

Deborah Kay Johns
University of Michigan Law School

Follow this and additional works at: https://repository.law.umich.edu/mjil

Part of the Business Organizations Law Commons, Comparative and Foreign Law Commons, and the Property Law and Real Estate Commons

Recommended Citation
Available at: https://repository.law.umich.edu/mjil/vol16/iss3/12

This Note is brought to you for free and open access by the Michigan Journal of International Law at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Journal of International Law by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.
STUDENT NOTES

REFORMING THE STATE-ENTERPRISE PROPERTY RELATIONSHIP IN THE PEOPLE'S REPUBLIC OF CHINA: THE CORPORATIZATION OF STATE-OWNED ENTERPRISES

Deborah Kay Johns*

INTRODUCTION .................................................. 912

I. RESTRUCTURING STATE-OWNED ENTERPRISES ............... 914
   A. Impetus for Reform: The Problems of SOEs .......... 914
      1. Threat to the Health of the Economy .......... 915
      2. Social Instability ................................ 918
      3. Inability to Compete with the Nonstate Sector ... 919
   B. The Ambiguous State-Enterprise Property Relationship 920
      1. The Importance of Clear Property Rights ........ 921
      2. The Ambiguous State-Enterprise Property Relationship in China .......... 923
      3. The Culture of State Intervention .............. 924
      4. Critique of the Ambiguous Property Relationship Argument ........................................ 927
   C. Solutions ................................................. 928

II. LESSONS OF PRIVATIZATION ........................................ 930
   A. Privatization as a Solution ......................... 930
   B. Privatization in China ................................ 932

III. THE CORPORATIZED STATE-OWNED ENTERPRISE .............. 934
   A. The Modern Enterprise System ..................... 934
   B. Clarifying the State-Enterprise Property Relationship ... 936
      1. Addressing the Immediate Problems .......... 936
      2. Defining the Relationship ..................... 937
      3. Effecting the Cultural Transformation .......... 938

CONCLUSION .................................................... 939

* J.D., University of Michigan Law School (1995); China Studies Fellow, National Chengchi University, Taipei, Taiwan (1992); BSFS, Georgetown University (1991).
INTRODUCTION

Prior to 1978, the economy of the People's Republic of China (China) could be characterized as a typical command economy in which "[p]lanning was accomplished by the government, what to produce was determined by the government, manufactured products were allocated by the government, prices were set by the government, profits were remitted to the government and losses were subsidized by the government." Because this system "became an obstacle hindering further economic development," China commenced an economic reform program in 1978 to decentralize the system. In particular, much of the reform in the past seventeen years has focused on solving the efficiency and related problems of state-owned enterprises (SOEs).

SOEs generally have three features: (1) the state owns the assets; (2) the enterprises engage in the production of goods and services for sale; and (3) the enterprises' sales revenues bear some relationship to cost. As will be seen in more detail infra Part I, the SOEs' problems stem from the tension between the first two features (state ownership and the enterprises' production function). On the one hand, although state ownership of assets need not mean state control, such control is a likely consequence of ownership and is in fact the chief characteristic of Chinese SOEs. On the other hand, SOEs must use those state-owned

1. Dai Yannian, Spotlight on China's Modern Enterprise System, BEIJING REV., Feb. 28-Mar. 6, 1994, at 4. However, China's economy was never completely planned. The number of commodities planned and distributed from the center usually did not exceed several hundred, in contrast to the 60,000 such commodities in the U.S.S.R. Instead, much of the planning occurred at the local level, uncoordinated by the central government; much investment occurred outside of the plan; and, of course, a lot of planning took place only on paper. Donald C. Clarke, What's Law Got to Do with It?, 10 PAC. BASIN L.J. 1, 5-6 (1991).
3. The reform period dates from the Third Plenum of the Eleventh Central Committee of the Chinese Communist Party, held in 1978, when China's leadership announced its intention to focus on economic development. For commonly cited discussions of the initial reform period, see HARRY HARDING, CHINA'S SECOND REVOLUTION: REFORM AFTER MAO (1987); THE POLITICAL ECONOMY OF REFORM IN POST-MAO CHINA (Elizabeth Perry and Christine Wong eds., 1985).
4. See, e.g., Clarke, supra note 1, at 7; Wallace W.Y. Wang, Reforming State Enterprises in China, 6 J. CHINESE L. 89, 91-92 (1992). The SOEs' problems will be described in more detail infra part I.A.
6. Id. at 7.
7. See, e.g., Clarke, supra note 1, at 7 ("Generally, a state-owned enterprise is one that is controlled by one or more units of government at or above the county level."); Wang, supra note 4, at 91 n.5 ("In the Chinese context of state-owned enterprise, the state . . . controls the enterprise . . . ."); Gary H. Jefferson & Thomas G. Rawski, How Industrial Reform Worked
assets in order to be productive. It is these competing claims to state property that define the state-enterprise property relationship and that lie at the heart of the SOEs’ problems. This Note will examine the latest attempt to reform this state-enterprise property relationship — the “modern enterprise system.”

The modern enterprise system is characterized by the incorporation of SOEs with the state as the sole or majority shareholder and as the owner of the state-owned assets. This process is known as “corporatization” and is now governed by the Company Law of the People’s Republic of China (Company Law). Because many SOEs have already incorporated, and because the formation of the modern

in China: The Role of Innovation, Competition and Property Rights 5 (1994) (unpublished paper, on file with author) (“‘[T]he central fact’ is that ‘government and party officials’ exercise ‘all rights to control . . . ’”).

8. Wang, supra note 4, at 102.

9. The reform of SOEs can be divided into two broad categories. The reform of the state-enterprise property relationship falls most neatly into the category of internal reforms. These reforms seek to restructure SOEs to change the way that SOEs respond to their environment. Clarke, supra note 1, at 8. External reforms aim to change the environment in which SOEs operate. Id. As an example of external reforms, Clarke emphasizes the reform of the pricing mechanism, crucial to determining whether an enterprise is actually making a profit. Id. at 12. Baev further divides these external reforms into “demonopolization” (“the liquidation of privileges and peculiar advantages vested in one or more state enterprises”) and “deintegration” (“the management reform of the national economy by means of reorganizing Ministries and Government Departments, and abolishing systems of control over the distribution and consumption of commodities”). Andrei Baev, Alternatives to Privatization: Civil Law and the Transformation of State Property in Post-Socialist Economies, 12 PAC. BASIN L.J. 131, 137 (1993).

10. The modern enterprise system will be described in detail infra part III.A.


13. Bersani states that “thousands” of SOEs have issued shares. Bersani, supra note 11, at 307.
enterprise system is now the centerpiece of China's efforts to restructure the state-enterprise property relationship, an examination of the role of corporatization in reforming SOEs is warranted in order to determine whether further evolution of the SOEs is necessary.

Accordingly, Part I of this Note first describes the problems that have prodded China to restructure its SOEs and then explains the root of those problems — the state-enterprise property relationship. This part concludes with a description of the unsuccessful attempts to date to reform that relationship.

To understand why these efforts have met with little success, Part II explores the way in which most transition economies have attempted to address the ambiguity in the state-enterprise property relationship, by abolishing it through privatization. Although privatization is neither economically nor ideologically suited to China, experience with privatization does hold one lesson for China's restructuring effort: real reform of the state-enterprise property relationship requires not only a change in the legal definition of that relationship but also a cultural transformation of the underlying expectations regarding ownership rights.

Part III examines whether corporatization facilitates that cultural transformation. The Note concludes that corporatization attacks the immediate problems of the SOEs, and on paper helps delineate the respective property rights of the state and the SOEs, but in the end effects little shift in the culture of state intervention underlying the state-enterprise property relationship.

I. RESTRUCTURING STATE-OWNED ENTERPRISES

A. Impetus for Reform: The Problems of SOEs

SOEs are the backbone of China's political, economic, and social life. On the political front, "state ownership of the means of production is a goal in itself" for a socialist political order. Indeed, even after amendments in 1988 and 1993, the PRC Constitution still requires that major productive activities be carried out, at least in part, by the state.

14. See infra note 134 and accompanying text.
15. AHARONI, supra note 5, at 45.
Economically, SOEs account for forty percent of all industrial output in China and most of the employment. SOEs have also taken on the bulk of social welfare responsibilities, providing not only employment but also schools, housing, and health care for their employees and their families.

Due to the importance of SOEs, their problems will have repercussions well beyond the SOEs themselves. The chief problem which SOEs face today is their poor economic performance. Even the Chinese government no longer contests that the SOEs are inefficient. As will be shown below, this inefficiency in turn poses a threat to China’s economic health, social stability, and political foundation. It is this cumulation of problems that has forced the government to reform the SOEs.

1. Threat to the Health of the Economy

One factor in the government’s decision to reform the SOEs is the threat that their inefficiency poses to the rest of the economy. This threat can be direct (failing to supply goods to other firms) or indirect (straining the available sources of finance).

For a discussion of the difference between SOEs and collectives, see infra part I.B.4.

20. A total of 340 million people (workers and dependents) depend on SOEs for their livelihood. *Id.; see also* Wang, *supra* note 4, at 129.
21. “Efficiency” has two components. Static efficiency involves the measurement of output per unit of inputs; the goal is to operate on the production frontier. Dynamic efficiency measures the rate of change of output per unit of inputs; the goal is new investment and innovation. Aharoni, *supra* note 5, at 172; Baev, *supra* note 9, at 139-40.

The SOEs’ inefficiency on both counts is borne out by recent statistics. Despite achieving an average annual growth rate of 7.8% from 1980 to 1992, Jefferson & Rawski, *supra* note 7, at 4, Table I, 44.5% of 100,000 audited SOEs lost money in the first nine months of 1994, representing total losses of 29.22 billion yuan, Xiao Yu, *Backing for State Firms*, S. CHINA MORNING POST, Nov. 7, 1994, at 8. Further, one-third of SOE employees are redundant. Foo Choy Peng, *State Sector Holds Key to Future*, S. CHINA MORNING POST, July 7, 1994, at 1. In short, a survey by China’s State Economic Commission found that SOEs showed few signs of vitality. Wang, *supra* note 4, at 101 n.59.
a. The SOE as Supplier

The first effect that SOE inefficiency has on the economy is direct. The state sector is dominant in such basic areas as power generation, metals, chemicals, machinery, and textiles, so many nonstate firms depend on SOEs for supplies. If those SOEs cannot perform, the productivity of many other firms will decrease.

b. Strain on Sources of Finance

A more indirect threat to the economy involves the SOEs' appetite for capital. The SOEs' inefficiency causes them to absorb many of the available sources of capital in China, harming both the institutions that supply, and the other enterprises vying to obtain, that capital.

Until 1979, SOEs were financed solely through national budget allocations. SOE inefficiency, however, has led to "voracious calls" on the treasury, with subsidies amounting to three percent of gross domestic product and sixty percent of the budget deficit in 1993.

In an early attempt to alleviate the stress on the treasury, the government began requiring SOEs to borrow their capital from banks. Today, banks supply eighty percent of the working capital for SOEs. Such financing is a poor source of working capital for SOEs, however, because the lending banks are typically "state banks" that can refuse to
fund projects or can impose stricter terms on projects that involve products that either are not in the plan or are deemed to be oversupplied, exposing SOEs to control by the state.\textsuperscript{30} Such lending is also a problem for banks because an estimated one-third, or one trillion yuan, of loans to SOEs by banks are nonperforming.\textsuperscript{31}

Another idea for financing the SOEs came in 1984 when SOEs were allowed to lend funds to other SOEs. Unfortunately, these loans often failed to earn expected profits.\textsuperscript{32} The poor bank lending practices described above coupled with the practice of interenterprise lending created "triangular debt," where one money-losing SOE is unable to pay off its debt to a bank or a second SOE because it is in turn owed money by a third SOE.\textsuperscript{33} Currently, the triangular debt among state enterprises may be as high as six hundred billion yuan.\textsuperscript{34}

Enterprises also gained the right in the early 1980s to issue non-negotiable debentures to employees.\textsuperscript{35} For enterprises with poor profit records, however, such bonds did not offer a very good investment opportunity, and enterprises relied on forced sales of bonds to employees to raise funds, causing the State Council to issue a directive requiring that internal debenture subscriptions be voluntary and short term.\textsuperscript{36}

In addition to the stress put on government, banks, other SOEs, and workers to supply capital, the SOEs' drain on available finance has hurt the efficient enterprises. For example, with so much financing going to SOEs, the capital available to other enterprises is greatly reduced.\textsuperscript{37}

\begin{itemize}
  \item 30. Zhao & Li, supra note 25, at 8. This is in addition to the control the state wields by virtue of owning the assets. See infra part I.B.
  \item 31. Tsang, supra note 29, at 1. The amount of money that banks have tied up in bad loans to SOEs has made the banks one of the greatest opponents of SOE bankruptcy; given that the government has only set aside seven billion yuan to cover the loans, the banks are unlikely to be repaid if the SOEs go bankrupt. Foo Choy Peng, supra note 21, at 1.
  \item 32. Zhao & Li, supra note 25, at 8.
  \item 33. Cycle of Debt at Heart of Problem, supra note 19, at 24. Indeed, "[i]n some companies, the debt chain has grown to previously unheard of proportions. China's largest iron and steel works . . . owes other enterprises six billion yuan . . . and, in turn, is owed eight billion yuan." Id.
  \item 34. Id.
  \item 35. Zhao & Li, supra note 25, at 8.
  \item 36. Id. at 8 (citing the Directive of the State Council on Tightening Government's Control of Internal Debentures).
  \item 37. Up to two-thirds of private enterprises have trouble obtaining credit because so much capital is tied up in SOEs. Tsang, supra note 29, at 1. Philbrick notes that "a lack of capital has been one of the most formidable obstacles to a sustainable free market" because industry and agriculture — the two vital components of a functioning economy — rely on capital to generate output, replace broken parts, and modernize outdated and inefficient processes. William C. Philbrick, The Paving of Wall Street in Eastern Europe: Establishing the Legal Infrastructure for Stock Markets in the Formerly Centrally Planned Economies, 25 L. & POL'Y INT'L BUS. 565, 565 (1994). This is no less true for a socialist market economy. In
\end{itemize}
Moreover, printing money to finance the SOEs has contributed to high inflation, which amounts to a tax on the efficient enterprises. The SOEs' inefficiency has thus begun to affect the healthier parts of the economy, creating a need for reform that the government could not ignore.

2. Social Instability

SOE inefficiency is also a source, albeit an indirect one, of social unrest. First, the savings rate in China is forty percent of disposable income, amounting to an estimated U.S. $310 billion in 1992. Some have speculated that such massive wealth constitutes a potential political threat to the Chinese Communist Party. Moreover, with few other investment outlets, Chinese citizens are eager to invest in the Shanghai and Shenzhen markets. These investment outlets are jealously guarded. Fights apparently are common in lines at brokerages, and in 1992, when corruption in the allocation of shares in a new issue was discovered, riots involving 50,000 would-be

Gansu province, for example, government officials complain that “[l]ack of investment is the main difficulty in the modernisation of state enterprises.” Chan Wai-fong, Scarce Investment Hampers Reform, S. CHINA MORNING POST, Aug. 23, 1994, at 7.

38. Kaye, supra note 22, at 51.


40. Bersani, supra note 11, at 304. The growth stems from the fact that incomes have tripled in the last ten years. See David Fairlamb, Surging, Churning China, INSTITUTIONAL INVESTOR, Jan. 1993, at 33, 35.

41. See Bersani, supra note 11, at 304 (citing an unpublished Ph.D. thesis).

42. Savings accounts typically do not have high enough rates of return to compensate for inflation. Roller Coaster Ride: China Is Trying to Curb Volatility and Enite More Investors, ASIAWEEK, Nov. 30, 1994, at 49. The same is true for government bonds, although their return is over one percent higher than savings accounts. China’s Bond Markets Come of Age: From Forced Sales to Feeding Frenzy, BUS. CHINA, July 25, 1994, available in LEXIS, News Library, Buchin File.

43. Fairlamb, supra note 40, at 35. Investing in stocks is enormously popular. Even prior to the opening of the Shanghai and Shenzhen exchanges in 1990 and 1991, respectively, trading occurred on the street, and such trades continued immediately after the openings because few companies at the time were listed on the exchanges. Securities Trading on Shanghai Exchange: Few Stocks to Buy, BUS. CHINA, Feb. 25, 1991, available in LEXIS, News Library, Buchin File. People flock to “salons” to discuss investment tips, Hundreds Flock to Shanghai Stock Market “Salon”, Reuter Asia Pacific Bus. Rep., Aug. 8, 1994, available in LEXIS, News Library, Reuapb File, and securities-related book sales have at times been as high as 700 books a day, Sun, Stock Market Fever, supra note 39, at C1. Some cities are clamoring to be the next to open legal securities exchanges, id., and illegal stock exchanges have developed to service investor demand, Lena H. Sun, China’s New Ideology: Make Money, Not Marxism, WASH. POST, July 27, 1993, at A1, A12. Another sign of high demand is the excessive prices of stocks. Securities Trading on Shanghai Exchange, supra.

44. Fairlamb, supra note 40, at 35.
investors broke out in Shenzhen.\textsuperscript{45} Hence, the inability of SOEs to provide an investment outlet for Chinese citizens, and the ensuing threat to social stability, is a second factor prodding the government to restructure the SOEs.\textsuperscript{46}

3. Inability to Compete with the Nonstate Sector

Another problem stemming from SOE inefficiency is an inability to compete with the nonstate sector. In contrast to SOEs, which "employ too many people, produce goods that consumers do not want, locate in economically inefficient places, [and] do not upgrade their capital stock . . . ,"\textsuperscript{47} the nonstate sector is performing well. Between 1980 and 1992, collectives grew at an average annual rate of 18.4 percent, and individual and private firms grew at average annual rates of 64.9 percent and 37.2 percent, respectively.\textsuperscript{48} Private firms now account for eighty percent of all commercial retail, catering, and service establishments,\textsuperscript{49} and the nonstate sector as a whole accounts for sixty percent of industrial output.\textsuperscript{50} This lopsided performance is a political embarrassment for a government that has enshrined the primacy of state sector leadership in its constitution.\textsuperscript{51}

The pressure on SOEs from this lopsided performance is compounded by events outside of China. China regards itself as a leader in Asia, but it is surrounded by newly industrializing countries (NICs) that have achieved phenomenal growth with a significant role for private enter-


\textsuperscript{46} Of course, the SOEs' inability to provide an investment outlet stems as much from their structure as their inefficiency. Moreover, the potential for unrest also limits the reforms that the government can undertake. Any reform will have to include eventual dismantling of the iron rice bowl, the system of guaranteed employment and social services provided by SOEs. With no national social safety net, the government fears major social discontent. Josephine Ma & Zhang Yuan, \textit{Moves to Bankrupt Ailing Enterprises}, S. CHINA MORNING Post, Oct. 20, 1994, at 12. Another source of social discontent that discourages reform is the widening income gap produced by people's ability to make money off of the stock market. Sun, \textit{China's New Ideology}, supra note 43, at A12.

\textsuperscript{47} Maxim Boycko et al., \textit{Privatizing Russia}, in \textit{BROOKINGS PAPERS ON ECONOMIC ACTIVITY} 139, 141 (William C. Brainard & George L. Perry eds., 1993).

\textsuperscript{48} Jefferson & Rawski, supra note 7, at 4, Table I. In the first half of 1994, SOEs grew at 4.4% while collectives grew at the rate of 20.3% and private and foreign-owned enterprises grew at the rate of 28.9%. Daniel Kwan, \textit{Statistics Paint Bleak Picture for State Firms}, S. CHINA MORNING Post, July 12, 1994, at 9.


\textsuperscript{50} See O'Neill, \textit{State Sector Shrinks}, supra note 18.

\textsuperscript{51} As Vice-Premier Zou Jiahua has pointed out, reforming SOEs is as much a political as an economic problem because the state-owned sector is so tied to the principles of socialism. Xiao Yu, supra note 21, at 8.
prise.\textsuperscript{52} More recently, the changes in the former Soviet bloc mean that China is the last major socialist economy.\textsuperscript{53} Reform of the SOEs has thus been turned into a matter of political pride, making China's leadership decidedly defensive about the performance of its SOEs.\textsuperscript{54}

* * *

To summarize, because SOEs are so important, their inefficiency has led to a variety of problems, including threats to the rest of the economy, to social stability, and to China's political foundation. Some have argued in response to these threats that the nonstate sector will simply replace the poorly performing state sector so that any attempts to reform the SOEs is useless.\textsuperscript{55}

There are a couple of problems with this argument, however. First, such a course of action is unpalatable to a leadership that wants to retain the primacy of the state sector. Moreover, such a conquest of the state sector is unlikely in the short term, and the threats that SOEs' inefficiency poses to the rest of the economy and to the social stability are problems requiring immediate solutions. The Chinese government thus turned to SOE reform.

In order to decide what to do about the SOEs, however, it is first necessary to understand what it is about the SOEs that have led to such poor performance and consequently to the problems discussed above. This question is the focus of the next section.

B. The Ambiguous State-Enterprise Property Relationship

Numerous SOE characteristics have been pinpointed as the source of SOEs' inefficiency, including operation under a soft budget constraint, micromanagement by the state, and the use of the SOEs to pursue aims unrelated to profit.\textsuperscript{56} While these may be typical of SOE behavior, and

\textsuperscript{52} See Lieberman, supra note 24, at 10 (pointing out that the success of NICs has been a major reason for the surge in privatization).

\textsuperscript{53} Id. at 11.

\textsuperscript{54} Officials have begun to speak of the "heavy burden [SOEs have] shouldered" over the years, without which China would not have achieved such high growth rates. This burden is said to include extremely high taxes, an unequal competitive environment given preferential treatment for other types of enterprises, and the provision of social services. Wu Naitao, '95 Goals for Reform of State-Owned Enterprises, BEIJING REV., Jan. 9–15, 1995, at 7, 9.

\textsuperscript{55} See Martin L. Weitzman & Chenggang Xu, Chinese Township Village Enterprises as Vaguely Defined Cooperatives, 18 J. COMP. ECON. 121, 121 (1994) (stating that "state enterprises, particularly medium and small ones, are pushed, outcompeted, and outgrown by non-state sector firms and are gradually replaced in the long run").

\textsuperscript{56} These types of behavior will be discussed in more detail infra part I.B.3.
may be the immediate causes of SOE inefficiency, SOEs do not by definition have these characteristics.57

Instead, these inefficient behaviors are made more likely by a more fundamental problem, the relationship between the state and the SOEs. As one scholar noted: "a decisive influence upon the enterprises' efficiency, financial performance, and social obligations . . . is exercised by the enterprises' relationships with their governments, so that, if these relationships are wrong, little will come right."58 In China, as the following sections will show, the problem that makes the relationship between the state and the enterprise "wrong" is the ambiguity in the state-enterprise property relationship with regard to the state's and the SOEs' respective claims to assets.

1. The Importance of Clear Property Rights

In theory, clear property rights are necessary for the proper functioning of a market economy.59 As Andrei Baev states:

In order for a commodity market to exist it is necessary for those subjects who initially intend to alienate and appropriate exchangeable goods . . . to be in command of the goods . . . . In other words, they must be able to possess, use and control goods in accordance with their own interests and by their own free will. Traditionally, the term "ownership" has been used for the definition of such a relationship.60

Two concepts must be explored more fully: (1) what is ownership, and (2) why does it matter.

57. As a 1983 World Bank report stated, "'[t]he key factor determining the efficiency of an enterprise is not whether it is publicly or privately owned . . . . In theory, it is possible to create the kind of incentives that will maximize efficiency under any type of ownership.'" AHARONI, supra note 5, at 42 (quoting a World Bank report); see also id. at 59–60.


59. As Wang has noted, this is a utilitarian concept of property rights with its roots in wealth maximization, making the concept seem unsuited to analysis of a socialist system. However, given that that socialist system is trying to force its enterprises to be wealth maximizers, the use of such a utilitarian theory to analyze the problems of the SOEs is worthwhile. Wang, supra note 4, at 122.

60. Baev, supra note 9, at 132.
a. Ownership Defined

The concept of "ownership" can be divided into any number of rights, but with respect to enterprise ownership, it is typically divided into two groups. First, the owner has the right to allocate the surpluses and losses from the enterprise. Second, ownership involves control over enterprise operations. The owner may exercise such control directly, in which case the owner has the right to possess and the corresponding right to exclude others from possession, as well as the right to use and dispose of the thing possessed. The owner may also exercise control indirectly, by appointing and dismissing managers and by setting the terms by which they are employed.

b. Importance of Clear Ownership Rights

The question remains as to why clear ownership rights matter. Clear ownership rights can promote efficient behavior in two ways.

First, the act of defining clear ownership rights, even without regard to how those rights are allocated, can provide important incentives to use assets productively. As Demsetz stated, "property rights derive their significance from the fact that they help a man form those expectations which he can reasonably hold in dealing with others." Without those expectations, people are unable to predict whether they will have a given set of assets at their disposal and are thus less likely to make the

---

61. Wang, supra note 4, at 122–23.
62. DONALD HAY ET AL., ECONOMIC REFORM AND STATE-OWNED ENTERPRISES IN CHINA, 1979–1987 422 (1994); Weitzman & Xu, supra note 55, at 124; Wang, supra note 4, at 123. Chinese law similarly incorporates the right to "benefit" into the right of ownership. Qian, supra note 11, at 78 n.61.
63. HAY, supra note 62, at 423. Some authors have divided this notion of control into two separate ownership rights: possession and use. See Weitzman & Xu, supra note 55, at 124; Wang, supra note 4, at 123. Chinese law in effect divides this element of control into three separate rights — possession, use, and disposition. See Qian, supra note 11, at 78 n.61.
64. The owner is:

the common party to the set of contracts, can negotiate and renegotiate any or all of them, as a result can determine who will be parties to the contract and who therefore will participate in the enterprise. By these means he can determine its objectives, functions, and operations, and whether it will continue to exist or not.

HAY, supra note 62, at 423; see also Weitzman & Xu, supra note 55, at 124; Wang, supra note 4, at 123.
65. HAY, supra note 62, at 423.
most efficient use of those assets.\(^6\) At a minimum, then, a system must “parcel out some (or most) of the constituent rights of ownership into a bundle of rights which are clearly defined and legally protected.”\(^6\)

However, clear ownership rights are not necessarily enough; it is equally important that ownership rights, once allocated, are allocated in the way that is most likely to produce efficient behavior. Specifically, an enterprise has what are known as “residual risk holders.” In order for these risk holders to be willing to accept risk, they must (1) be compensated for holding that risk by being the owner (and therefore having control over the enterprise’s operations and profit and loss distribution) or (2) be able to escape the risk by selling the right to hold it.\(^6\)

If either of these two conditions exists, the owners of the enterprise are likely to behave efficiently. First, if the owners bear the risk, they have an incentive to maximize enterprise performance since the consequences of success or failure accrue to them. Second, if the risk holders are not the owners but can sell the right to bear the risk, the owners still have an incentive to be efficient, since if the enterprise does not perform well, it will be difficult to find people who will hold the risk. Thus, when defining ownership rights in a situation where no market for residual risk exists (so condition (2) above cannot be satisfied), it is important to make the owner hold the risk in order to promote efficient behavior.

2. The Ambiguous State-Enterprise Property Relationship in China

In China, ownership rights to state-owned assets are anything but well defined. One scholar has described the state-enterprise property relationship as one in which the state “legally owns the major means of production managed by the enterprises.”\(^7\) Although state ownership

---

67. See infra notes 81 and 82 and accompanying text.

68. Wang, supra note 4, at 134.

69. HAY, supra note 62, at 423. Hay notes that this is the basis of the distinction between a publicly traded and a closely held corporation. In the closely held corporation, the people in control are the ones who bear the residual risk; in a publicly traded corporation, the residual risk bearers are shareholders who do not typically have much control but who are able to escape the risk they hold by selling their shares. Id.

70. Wang, supra note 4, at 91 n.5. Technically, the major means of production are owned by “the whole people,” with ownership rights exercised by the state as the representative of the whole people. See PRC Constitution, supra note 17, art. 6 (“The basis of the socialist economic system . . . is . . . ownership by the whole people . . . ”); Conner, supra note 16, at 2 n.4 (equating ownership by the whole people with ownership by the state); see also Baev, supra note 9, at 133 (discussing the concept of state ownership in socialist theory generally).

Clarke cautions that the state is not the monolithic entity that the term implies. SOEs’ relationships may be with any one of several governmental units, and these units may have conflicting aims. Clarke, supra note 1, at 7.
does not necessarily mean the state will exercise control,\textsuperscript{71} state ownership certainly creates the potential for such control. At the same time, the SOEs are clearly expected to exercise some rights of control to carry out the enterprise's productive functions.\textsuperscript{72} Those rights have been very poorly defined,\textsuperscript{73} however, leaving a state-enterprise property relationship that is "like an incomplete contract, with only one party, the state, supplying additional terms on an ongoing basis."\textsuperscript{74} The consequence of this uncertainty is a culture of state intervention, to which this Note now turns.

3. The Culture of State Intervention

When the state and the SOE have claims on the same assets, the two entities become intertwined, increasing the likelihood that state ownership of assets will in fact result in state control. Specifically, when the SOEs' supervisory units have the legal power to make decisions regarding the use of assets assigned to the SOEs, those supervisory units become responsible to higher levels of government for the performance of the SOEs. Policy debate then begins to revolve around the needs of individual SOEs, and government power is used to address those needs.\textsuperscript{75} In the end, "it is clear that in practice the ownership of enterprises is in the hands of the institutions of the state. It is they which control managers through powers of appointment, dismissal, and the power to set remuneration, and it is they which allocate residual risk."\textsuperscript{76}

Such state control decreases the incentives for efficient behavior. First, since the state's rights trump the SOEs' rights,\textsuperscript{77} the SOEs can form no expectations about how the state will act. The state may, for example, reallocate assets from one SOE to another without paying market value compensation.\textsuperscript{78} In addition, since no market for residual risk in Chinese SOEs exists, at least not prior to the opening of the Shanghai and Shenzhen stock markets,\textsuperscript{79} the way to provide incentives

\textsuperscript{71} AHARONI, supra note 5, at 7.
\textsuperscript{72} Qian, supra note 11, at 102.
\textsuperscript{73} For more detail, see infra part I.C (discussing three major legislative attempts to delineate the state's and the SOEs' respective claims to state property).
\textsuperscript{74} Wang, supra note 4, at 123. As Baev explains, "the term 'property of the whole people' does not provide straight and clear answers to the question of 'whose is it.'" Baev, supra note 9, at 133.
\textsuperscript{75} OLIVER LETWIN, PRIVATIZING THE WORLD 29–32 (1988).
\textsuperscript{76} HAY, supra note 62, at 426.
\textsuperscript{77} Wang, supra note 4, at 123.
\textsuperscript{78} Id. at 115.
\textsuperscript{79} See HAY, supra note 62, at 426. As will be seen infra part III, active trading on the stock markets is expected to improve SOE efficiency because the risk holders can now escape risk by selling it.
for the state as owner to be efficient is to make the state bear the risk. The state in the case of China, however, may allocate that risk to others, for example, to the population through higher or lower public expenditures or to other enterprises through taxation.\textsuperscript{80}

Hence, the constraints on inefficient behavior, from the point of view of either management or the state, are minimal. The result is a variety of inefficient behaviors.

For example, due to the inability to form expectations about asset use, SOE managers are reluctant to make long term investment decisions to maintain capital and equipment.\textsuperscript{81} Moreover, since no matter how well an SOE performs, the state typically decides its profits, the SOE does not have an incentive to invest in, for example, good management.\textsuperscript{82}

In addition, when the state, through the supervisory units, makes decisions for the SOEs, and yet does not bear the risk for those decisions, the supervisory units are more likely to succumb to the temptation to use SOEs to solve problems that are unrelated to the SOEs' productive function. For example, in order to solve the problem of regional underdevelopment and unemployment, the state might force an SOE to locate in the western part of China, far away from markets.\textsuperscript{83} Although such a move would be detrimental to the SOEs' ability to turn a profit, the state is isolated from the SOEs' failure and so is not restrained from using the SOEs in this way.

The state's isolation from risk will lead to other inefficient behaviors commonly observed in SOEs as well. For example, the supervisory units will attempt to "help" their SOEs through enterprise specific regulations that provide some benefit to the SOEs, such as a supply of valuable inputs. Such regulations, of course, are detrimental to the SOEs in terms of efficiency: "high-priced inputs are supposed to go to those enterprises which, because they produce a valuable product, can afford them, not to those that can persuade their supervisory government organ to supply them."\textsuperscript{84} Yet, the state, at least in the short term, has nothing to lose from such behavior.

Another example of how the state's isolation from risk will lead to inefficient behavior involves the soft budget constraint. The soft budget constraint exists when "the difference between the profits of production and the costs of production is not a matter of life and death for the

\begin{itemize}
\item \textsuperscript{80} Id.
\item \textsuperscript{81} Wang, supra note 4, at 115--16.
\item \textsuperscript{82} Id. at 116--17.
\item \textsuperscript{83} Kaye, supra note 22, at 51.
\item \textsuperscript{84} Clarke, supra note 1, at 16. This is the problem of micromanagement.
\end{itemize}
Many of the conditions that create a soft budget constraint are directly related to the supervisory unit's responsibility for, and willingness to respond to pleas for help from, the SOEs, coupled with the state's isolation from the obvious inefficiency of allowing SOEs to operate without regard to costs.

In short, the ambiguity in the state-enterprise property relationship has created a culture of state intervention. This culture makes inefficient behavior more likely, resulting in the SOEs' poor performance and in the problems outlined supra part I.A. This analysis is not without its problems, however. In the following section, this Note responds to two of the more important objections to the ambiguous property relationship argument.

85. Id. at 9. This allows the SOEs to overhire and produce unwanted products, for example. For a more detailed explanation of the soft budget constraint, see HAY, supra note 62, at 323–66.

86. For example, the soft budget constraint can exist when the firm can influence tax rules or can get individual tax exemptions or postponements; when the enterprise receives grants from the state; and where the firm is granted credit (such as by state-controlled banks) even when the firm's ability to repay is limited. Clarke, supra note 1, at 9–10.

87. The blurred state-SOE relationship also makes it difficult to solve the soft budget constraint problem. To make firms operate under a hard budget constraint, firms that cannot turn a profit must go bankrupt. Wang, supra note 4, at 117–18.

A bankruptcy law did come into effect in 1988. Enterprise Bankruptcy Law of the People's Republic of China, reprinted and translated in [2 Bus. Reg.] China Laws for Foreign Bus. (CCH) ¶ 13-522 (Dec. 2, 1986); see also Clarke, supra note 1, at 51 (explaining that the law was passed in 1986 but did not come into effect until 1988). The law has rarely been used, however; although bankruptcies are on the rise, they still represent only a tiny fraction of the enterprises that are regularly losing money. See Wang, supra note 4, at 118 (no SOEs bankrupt up to 1991); More Than 100 Enterprises Go Bankrupt, Xinhua, July 10, 1992, available in LEXIS, News Library, Xinhua File (two SOEs bankrupt by mid-1992); Carrie Lee, Bankruptcy Rules Need Overhaul, S. CHINA MORNING POST, July 2, 1994, at 3 (twenty SOEs bankrupt by mid-1994).

The Bankruptcy Law has not forced more money-losing SOEs into bankruptcy in part because of the blurred state-SOE relationship; because ownership rights are not well defined, it has not been clear what happens to the state-owned assets of bankrupt SOEs. Wang, supra note 4, at 118. This has ostensibly changed with the passage of the Regulations on Supervising State-Owned Property of Industrial Enterprises. See infra part III.

Another important reason why firms have not gone bankrupt is, of course, the fear of widespread discontent from laid off workers. Ma & Zhang, supra note 46, at 12; Clarke, supra note 1, at 54. Moreover, it is difficult to determine which SOEs should go bankrupt. Because prices do not accurately measure profits and losses, the Bankruptcy Law contains a "fault" standard under which SOEs that lose money because of poor management (business losses) will go bankrupt and SOEs that lose money because of policies like fixed prices (policy losses) would not go bankrupt. Unfortunately, it is not always clear how to tell policy losses from business losses. Clarke, supra note 1, at 53.
4. Critique of the Ambiguous Property Relationship Argument

One problem with the argument that SOEs' inefficiency stems from the uncertainty with respect to the state's and SOEs' claims to assets is the contradiction between the theory of state intervention (that the supervisory units become more responsible for the performance of the SOE) and the theory of residual risk allocation (that the owners of the SOE do not bear risk and so do not have an incentive to be efficient). Indeed, some have argued that the relatively diffuse system of state administration in China is the impetus behind recent efficiency gains. The argument is that the supervisory units bear at least some of the residual risk and use their control to establish incentive mechanisms for managers through financial rewards, investment funds, promotions, and so forth.88

The state, however, can still allocate the residual risk to others, like the population, who have no way to divest themselves of that risk.89 Moreover, there is still considerable scope for other objectives — social ones stemming from other responsibilities of the state or private ones of the government officials in control — to play a role in government decisionmaking regarding the enterprise.90

Another problem with the ambiguous property relationship argument is that it is contradicted by the success of collective enterprises like the township-village enterprises (TVEs). It has been argued that "‘there is no fundamental distinction to be made between state and collective enterprises.’ State and collective firms have different characteristics, but in both cases, ‘the central fact’ is that ‘government and party officials’ exercise ‘all rights to control, income flows, and sale or liquidation.’"91 Moreover, the argument goes, property relationships in collectives are just as ambiguous as in SOEs.92 Nevertheless, collective enterprises, especially TVEs, are performing well.93 Under this logic, the state-enterprise property relationship cannot be causing SOE problems.

88. HAY, supra note 62, at 427.
89. "[A]lthough the decentralized structure creates some pressures on local authorities, residual risk can still be allocated to the population irrespective of the latter’s preferences and with no scope for them to divest themselves of that risk." Id. at 428 (emphasis in original).
90. Id.; see also id. at 427-30 for a more thorough discussion of the problems with single agency ownership in China.
91. Jefferson & Rawski, supra note 7, at 5. These authors even lump SOEs and collectives together for purposes of discussing the "‘surprise' element in China’s recent industrial achievements" — the continued dominance of the public sector in industrial output. Id. at 3-5.
92. See Weitzman & Xu, supra note 55, at 122 (“A TVE is . . . very far removed from having well-defined property rights.”).
93. Id. at 127-29; Jefferson & Rawski, supra note 7, at 4, Table 1.
A clear difference between the SOEs and the collectives exists, however. The state sector's share of industrial output has plummeted in the past fifteen years while the collectives' share has skyrocketed. In addition, collectives and SOEs are distinguished in the PRC Constitution and are governed by different legislation.

The question is whether the difference between SOEs and collectives can stem from the differences between the state-SOE and state-collective property relationships. The state-SOE property relationship does differ structurally from the state-collective property relationship. In a collective, the assets are owned collectively by a (relatively) small number of people, the people in the community, and the community government exercises the ownership rights as the representatives of those people. In an SOE, by contrast, the assets are owned by a more amorphous group, "the whole people," with the ownership rights exercised by government representatives at any one of several levels of government. The effect, it would seem, would be to make the collectives' managers more responsive to the actual owners of the assets, while the managers of the SOE are more responsive to the political leadership in the central government. Clarification of the state-enterprise property relationship is thus necessary to reforming the SOEs.

C. Solutions

China has attempted many times to define the SOEs' rights to use state-owned assets. The first major attempt came in 1983 with the enactment of the Provisional Rules for State Industrial Enterprises (1983 Rules). The 1983 Rules allowed for some decisions affecting state assets to be made by the SOEs, but only after they had fulfilled the tasks set out for them by their supervisory units. This meant the

---

94. Jefferson & Rawski, supra note 7, at 4, Table I (showing that, between 1978 and 1992, the state sector's share of industrial output has declined from 76% to 48.4% while the share of rural collectives has increased from 9.9% to 26.2%).
95. See PRC CONSTITUTION, supra note 17, art. 6.
96. See LICHTENSTEIN, supra note 16 (describing the legislation covering both SOEs and urban and rural collectives).
98. See supra notes 70 and accompanying text (defining the SOE).
99. See LETWIN, supra note 75, at 29–32 (suggesting that SOE managers respond to the center).
101. LICHTENSTEIN, supra note 16, at 3.
SOEs’ rights fluctuated with decisions by the supervisory units — hardly a clarification of the property relationship.

A more formal attempt to clarify the state-enterprise property relationship came in 1988 with the Law of the PRC on Industrial Enterprises Owned by the Whole People (State Industrial Enterprise Law).\(^\text{102}\) This law defines the rights of the SOE to use the state-owned assets by instituting the idea of “enterprise operating rights.” Although the State Industrial Enterprise Law clearly indicates that ownership and operating rights are separate, it defines operating rights in such a way that they seem virtually indistinguishable from ownership rights.\(^\text{103}\) Even a cursory reading of the law, however, shows what the distinction between the two types of rights must be: the phrase “in accordance with State Council Regulations” is ubiquitous in articles delineating enterprise operating rights,\(^\text{104}\) suggesting that the state has the ability to trump the SOEs’ operating rights virtually at will.\(^\text{105}\)

The last major attempt to define the state-enterprise property relationship was embodied in the 1992 Regulations on Transforming the Management Mechanisms of State-Owned Industrial Enterprises (1992 Regulations).\(^\text{106}\) The 1992 Regulations are apparently the main body of “State Council regulations” to which the State Industrial Enterprise Law referred.\(^\text{107}\) The 1992 Regulations are fairly successful in spelling out the respective rights of possession, use, and benefit of the state and the SOEs. For example, the 1992 Regulations define the functions of the government in exercising its ownership rights\(^\text{108}\) and the management’s

---


103. See Wang, \textit{supra} note 4, at 103. \textit{See also} State Industrial Enterprise Law, \textit{supra} note 102, art. 2 (defining operating rights as the right “to possess, use and legally dispose of property which the state has authorized it to operate and manage”); Civil Law of the People’s Republic of China, art. 71, \textit{reprinted and translated in} [3 Bus. Reg.] China Laws for Foreign Bus. (CCH) ¶ 19-150 (Apr. 12, 1986) (defining ownership rights as the right “to possess, use and legally dispose of” property).

104. \textit{See State Industrial Enterprise Law, supra} note 102, arts. 27, 28, 29, 34; \textit{see also id.} art. 24 (“unless State Council regulations prescribe otherwise”); \textit{id.} arts. 31 and 34 (“in accordance with the law and State Council regulations”); \textit{id.} art. 33 (“Except if the law or statutory regulations prescribe otherwise”); \textit{see also LICHTENSTEIN, supra} note 16, at 4-5.

105. LICHTENSTEIN, \textit{supra} note 16, at 4-5.


authority and gives the SOEs the right to complain and eventually to sue to enforce those rights. The 1992 Regulations also further clarify the SOEs’ responsibility for profits and losses.

The result has been interesting. Although managers started “earning smartly[,] ... the fruits of their exertions tended to pile up in the bank accounts of their offshore subsidiaries or putative partners, rather than on the balance sheets of the mother enterprises.” It therefore appears that something more than defining the state-enterprise property relationship on paper is needed to change behavior; to determine what that “something more” might be, the next section examines how other economies in transition have dealt with the problems of the SOEs.

II. LESSONS OF PRIVATIZATION

A. Privatization as a Solution

Inefficient SOEs are certainly not unique to China. It is therefore useful to examine the primary solution for SOE inefficiency sweeping the world: privatization.

Privatization is somewhat difficult to define. From a legal point of view, “privatization is the single act of transferring ... the legal title of state property, which was in the possession of state enterprises for restricted purposes of producing certain goods under owner-state control, to individual or associated owners” in order for owners to acquire

109. Id. arts. 6-22.
110. Id. arts. 47-49.
111. Id. arts. 23-30.
112. Kaye, supra note 22, at 52. Moreover, the government admits that it has had some trouble in implementing the 1992 Regulations. See Wu, supra note 54, at 11 (stating that one of the keys to the reform of SOEs was the implementation of the 1992 Regulations).
113. Lieberman, for example, states that SOEs in general are characterized in part by “poor financial performance, overstaffing, dependence on subsidies and unilateral budget transfers, [and] highly centralized and politicized organizations ... .” Lieberman, supra note 24, at 10.
114. Almost 7,000 SOEs in 70 countries were privatized between 1980 and 1992. World Bank: Privatization is Increasing Globally, BUS. AMERCA, June 1, 1992, at 19. Privatization was chosen as the solution to SOE inefficiency for a number of reasons: (1) the successful economic performance of Japan and the Asian Newly Industrialized Countries, all of which allowed a very significant role for the private sector; (2) growing recognition that other models of economic development, such as the command economy, had outlived their usefulness; (3) the development of new managerial practices like “total quality control” that can have profound effects on productivity and competitiveness and that have in large part passed by countries not adopting models relying on private enterprise; (4) the importance of SOEs in the economy coupled with their poor economic performance; and (5) the ideological commitment to private enterprise expressed by advanced industrial countries like the United States and the United Kingdom. Lieberman, supra note 24, at 10.
"certain legal absolute rights of possession, to use and command said property in accordance with their free will, their own interest, and by their own power over property."

The idea is that the transfer of assets will solve the ambiguity in the state-enterprise property relationship by doing away with the relationship altogether. One consequence of the asset transfer is that the lines between the SOEs and the state become clearer. Indeed, the very mechanisms that allowed the state to influence the firms are dismantled. Moreover, privatization ends the responsibility of government units for the performance of the SOE in general and keeps governmental units from making a number of specific decisions, like whom to appoint as manager. Finally, when shareholders gain the right to profits, it becomes difficult for politicians to exert influence over the enterprise because the shareholders constitute a political constituency opposed to government intervention.

Privatization also affects managers’ incentives. The enterprise becomes subject to the disciplines of the financial market place, meaning that the need to achieve adequate returns in order to obtain access to private sector financing is likely to make managers focus on “cost control, responsibility to the customer, commercial advantage, and the economic case for any specific investment.” Privatization thus seems to address the incentive problems related to state ownership.

Privatization in practice has proven to be much more complex, however. First, privatization is but one aspect — the enterprise restructuring aspect — of the entire process of decentralization. More fun-

---

116. Although they can never be entirely clear. For example, the government can still repossess property through eminent domain powers, even in a substantially privatized economy.
118. Letwin, *supra* note 75, at 33.
119. Boycko, *supra* note 47, at 145. One author cautions that it is impossible to tell whether privatized firms operate better than they did when they were government owned because no firm can operate simultaneously under private and public ownership. That means any successes may result from third party factors that have nothing to do with privatization. Letwin, *supra* note 75, at 35–37. Nevertheless, the disparity in performance between the private and state sectors makes it reasonable to suppose that shareholders would be less than pleased with state intervention.
120. Letwin, *supra* note 75, at 33.
121. Baev, *supra* note 9, at 136–37; *see also* *supra* note 9 (discussing Baev’s division of decentralization into demonopolization, deintegration, and privatization). The success of other aspects of reform are crucial to the success of privatization. Reform of pricing is essential, for example. To measure a firm’s success based on profits and losses does not make the firm efficient when those profits and losses are generated from artificially low prices. Clarke, *supra* note 1, at 12.
damentally, however, privatization has proven to be more than just a legal shift in title to the assets. It cannot be ignored that privatization is also (1) "a process of socio-economic transformation of the foundation of socialist centralized economies by means of transferring state assets and state enterprises to the private sector" and (2) a political transformation. There are indications that the socio-economic and political transformations do not always accompany the legal transfer. Specifically, assets may be transferred to new owners who do not understand their new role because they operate with a set of expectations about rights developed from historical intervention by the state. The state may also be reluctant to come to terms with its new role. Finally, the people to whom ownership is transferred may simply be overwhelmed by the new authority and abuse it. In such circumstances, privatization will not result in any change in behavior because the state-enterprise property relationship has only been abolished on paper. Reform must thus effect both a legal transformation and a cultural transformation.

B. Privatization in China

Privatization itself has been rejected as a solution in China for a variety of reasons. First, while it is true that the private sector in China is flourishing, privatization requires a willingness to "abolish[] the basis of the whole socialist command system, the concept of state ownership." This the government is most definitely not willing to do.

122. Baev, supra note 9, at 150 (emphasis added).
123. Boycko, supra note 47, at 143.
124. In a recent report on the success of privatization around the world, the World Bank did not explicitly discuss this cultural transformation, but their "check list" of factors that tended to be present in successful privatization programs suggested that in those programs some sort of cultural transformation had taken place. The list includes:

(1) The more market-friendly a country's policy framework ... the less difficulty it will have in privatizing an SOE, and the higher the likelihood that the sale will turn out positively.
(2) SOEs functioning in competitive markets, or in markets easily made competitive, are prime candidates for privatization ... [T]hey require little or no regulation.
(3) 
(4) Countries can benefit from privatizing management ...

125. See supra part I.A.3.
126. Baev, supra note 9, at 137.
127. It is not that there have not been arguments for privatization within the scholarly community in China. At one point during the debates over whether to allow stock markets in China, for example, scholars proposed a system whereby the value of enterprises would be
Moreover, privatization is but a step — the last step — in the structural reform of SOEs. Many commentators have noted that it is first necessary for the SOEs to restructure and only once restructuring is complete to privatize. 128 Thus, even if the Chinese leadership was willing to do away with the socialist system of ownership entirely, SOEs may not be at a stage in structural development where privatization is possible.

Nevertheless, privatization holds one lesson for China. The problem with China’s previous attempts at restructuring the SOEs, particularly the 1992 Regulations, is that they have changed the relationship between the state and the SOEs on paper but have not addressed the culture of state intervention that the ambiguous state-enterprise relationship fostered. The 1992 Regulations are unlikely to separate the SOE from the government, not because the regulations are deficient, 129 or because the legal system is less than developed, 130 but because the SOEs have relationships, and concomitant expectations about those relationships, with each other and with the government that keep them from behaving according to the rules set down in the regulations. 131 SOE managers have thus reacted to the 1992 Regulations by appropriating the resulting profits for themselves: they expect that, regardless of what the 1992 Regulations give them, the profits will be confiscated by the government or other SOEs.

The government believes that corporatizing the SOEs will help to change this relationship by making it more difficult for either the gov-

128. Wang, supra note 4, at 130; Lieberman, supra note 24, at 15.
129. See supra part I.C.
130. Although the legal system clearly has its problems. Clarke cites the judges' lack of education, corruption in the system, the potential that judges' decisions will be overridden by higher authorities inside and outside of the court system, and the lack of enforcement capabilities. Clarke, supra note 1, at 57.
131. Id. at 41. Often, the supervisory unit or another SOE typically has something to withhold that the SOE wants, restricting the SOE's actions. As examples, Clarke says that schools can refuse to admit the children of employees from an SOE, thereby obtaining some form of exaction from the SOE. In the case where the SOE complained to higher authorities, the SOE was "told to pay up for the sake of good relations." Id.
ernment or the managers to behave as they do under the current regime. The final section of this Note examines whether corporatization will effect the much needed cultural transformation.

III. THE CORPORATIZED STATE-OWNED ENTERPRISE

A. The Modern Enterprise System

The latest effort to restructure the state-enterprise property relationship is the “modern enterprise system.” According to the government, the way to clarify property relationships in a way that changes behavior is to establish the “legal entity status” of the SOEs, which means that “the state possesses ownership of the property and that enterprises possess independent legal property rights and accordingly enjoy rights and shoulder responsibilities under civil law.”\(^1\) The SOEs can achieve the “legal entity status” by assuming the form of a modern enterprise. Although “modern enterprises” include sole proprietorships and partnerships,\(^2\) the chief structural form of the modern enterprise system is the corporation because, of the three, the corporation most clearly establishes the legal entity status of the SOEs.\(^3\)

---


133. Id. at 54.

134. Geng, supra note 24, at 5 (“The key to the goal lies in the establishment of an enterprise corporate system.”); Establish a Modern Enterprise System, supra note 132, at 57 (“The corporation is an effective organizational pattern of the modern enterprise system.”). The government has already selected 100 large- and medium-sized SOEs to experiment with implementing this most extreme version of the modern enterprise system until 1996, with full implementation by 2000. Xiao Yu, supra note 21, at 8.

The government is moving rather slowly with corporatization for several reasons. First, the leadership has been alarmed by the rapid privatization in Russia. Mark O’Neill, China Wary of Stock Ownership for State Firms, Reuters Asia Pacific Bus. Rep., Dec. 8, 1993, available in LEXIS, News Library, Reuapb File. Second, with only weak monetary and budgetary tools, the government fears a further loss of control over the SOEs. Id. Moreover, the government sees Chinese investors and the Chinese stock markets as immature. Id.; see also infra note 141 (discussing the lack of sophistication among Chinese investors). Finally, the government does not believe that many of the SOEs are ready for corporatization. Establish a Modern Enterprise System, supra note 132, at 55 (“The majority of enterprises that have not practiced the corporate system should continue to stick to and perfect the factory director (manager) responsibility system [established under the State Industrial Enterprise Law and the 1992 Regulations].”). The state also believes that whether an SOE is ready for corporatization depends in part on the type of activity in which the SOE is involved. For example, enterprises engaging in special industries like national defense should be put under direct state control and management or, at most, reorganized as state wholly owned companies. Id. at 57.

For those enterprises that do not corporatize, the chance of becoming a modern enterprise is to “continue to conscientiously implement the” State Industrial Enterprise Law and the 1992 Regulations. Id. at 57. Since this Note has already examined the efficacy of these
Under the Company Law, SOEs may become either limited liability companies, possibly wholly state-owned, or majority state-owned joint stock limited companies. If the SOEs incorporate as a joint stock limited company, the shares owned by individuals can be listed on one of China's two stock exchanges or, more likely, be traded over the counter. With either a joint stock limited company or a limited liability company, the state remains the owner of the assets that it owned prior to incorporation. Under the 1994 Regulation on Supervision of Property of State-Owned Enterprises, these assets are to be managed by "organizations specializing in the control of state-owned assets."

mechanisms, see supra parts I.C and II.B, this section focuses only on the corporation as the means of establishing a modern enterprise system.

135. A limited liability company has 2 to 50 shareholders who are liable toward the company to the extent of their capital contribution, and the company is not obligated to establish a shareholders' general meeting or a board of directors. Ho, supra note 12, at 10. If an SOE becomes a limited liability company that is wholly owned by the state, it is called a "state wholly-owned company." Art & Gu, supra note 11. Since the government fears the immaturity of Chinese investors, it has recommended that SOEs reorganize as limited liability companies rather than joint stock limited companies. Establish a Modern Enterprise System, supra note 132, at 58.

136. A joint stock limited company has more than 50 shareholders who are liable toward the company to the extent of the shares they hold, and the company is obligated to set up a shareholders' general meeting and a board of directors. Ho, supra note 12, at 10. In the past, it has been typical for the state to maintain 51 to 80% of the shares. Bersani, supra note 11, at 306. The SOEs can issue two other types of shares as well. First is the legal person shares. Legal persons can be government institutions (thereby increasing the government's control), universities, SOE subsidiaries, or collectives. The individual shares typically make up 20 to 25% of the total number of shares. Most of these are in turn owned by employees of the issuer, and individuals typically cannot own more than 0.5% of the shares. Roberta Karmel, Tossing Capitalism in Shanghai, NEW YORK L.J., Aug. 19, 1993, at 3; Qian, supra note 11, at 87.

137. See supra note 136 (discussing types of shares).

138. Ho, supra note 12, at 12.

139. Company Law, supra note 12, art. 4 ("The ownership of State-owned assets in a company shall reside with the State."). The Company Law speaks of limited circumstances where a state wholly owned company that is performing well will be able to exercise ownership rights over assets. Id. art. 72. For differing views as to whether the state must transfer ownership in the assets to the enterprise in order to achieve the benefits of corporatization, see Guo Feng, Gufenzhi Qiye Suoyouquan Wenti de Tantao [A Discussion of the Problems of Ownership in Equity Stock Enterprises], 3 ZHONGGUO FAXUE 3 (1988); Wang Liming, Lun Gufenzhi Qiye Suoyouquan de Erehong Jiegou: Yu Guo Feng Tongzhi Shangque [Discussing the Dual Structure of Ownership in Equity Stock Enterprises: A Reply to Comrade Guo Feng], 1 ZHONGGUO FAXUE 47 (1989). See also Wang, supra note 4, at 119-20 and nn. 149-55 (citing several Chinese writers on the issue of equity stock enterprises in China).

140. China to Stem Losses of State Assets, Xinhua, Aug. 4, 1994, available in LEXIS, News Library, Xinhua File. The new system will consist of "a well-organized work administration system, a scientific index system for estimating the economic returns of the state-owned assets management, a market system on property rights transfer and a complete set of legislations and law enforcement system on the state-owned assets management." China to Establish New State-Owned Assets Management System, Xinhua, Nov. 2, 1994, available in LEXIS, News Library, Xinhua File.
As stated above, the government argues above all that this system will establish clearly defined property rights and change the behavior of both the state and the SOEs. Although the system is still in a developmental stage so that its success is difficult to predict, the next section of this Note explores whether the modern enterprise system is likely to define property rights in such a way that the underlying culture of state intervention is changed.

B. Clarifying the State-Enterprise Property Relationship

1. Addressing the Immediate Problems

The process of corporatization undoubtedly addresses the immediate circumstances that prodded the government to restructure SOEs. Although China's stock system is immature, by allowing SOEs to issue some shares to the public, the corporate form allows the SOEs to tap into the billions of yuan held by Chinese investors, alleviating the strain on capital that China faces. Moreover, supplying shares to the public

141. China officially has two stock exchanges and an over the counter trading system. The system suffers from a host of problems that could hamper its ability to provide financing for companies that trade their shares. One is the lack of sophistication among Chinese investors, many of whom believe that the stocks present a risk free investment because "'the authorities would never let a company fail.'" Sun, Stock Market Fever, supra note 39, at C1. This may be true for now. Despite repeated assertions that ailing SOEs will be forced into bankruptcy, of the one-third to one-half of SOEs losing money, few have gone bankrupt. See supra note 87. Indeed, the government has proved willing to bail out the stock markets before. See Andrew Brown, Beijing Bows to Public Anger, Rescues Markets, Reuter Asia-Pacific Bus. Rep., Aug. 1, 1994, available in LEXIS, News Library, Reuapb File (reporting that because the government feared another round of riots like the ones in 1992 opted to shore up the falling prices on the stock market that had wiped out the savings of many ordinary Chinese). As reality sets in, however, the stock markets may present a bumpy ride to unwary Chinese, causing them to lose interest, at least until the more questionable enterprises are weeded out. See Philip Shenon, A Nail-Biting Ride in Shanghai, N.Y. TIMES, Aug. 6, 1994, § 1, at 33 (reporting that many ordinary investors were planning to recover their losses from the August 1994 slump and then take their money out of the stock markets for good).

Exacerbating this has been the chronically weak disclosure rules on both exchanges. Many foreigners and domestic investors are, for this reason, pulling out. Fairlamb, supra note 40, at 34; see also Brett Fromson, Veteran Investor Casts Global Net: Marc Faber Cautious on Emerging Markets, WASH. POST, July 11, 1993, at H1, H10 (reporting that many in the government choose to keep their money outside of China). Some companies have opted to list overseas (where disclosure laws are harsher) to instill investor confidence. Julia Sze, The Allure of B Shares: China Opens Securities Markets for Increased Foreign Investment, CHINA BUS. REV., Jan. 1993, at 42.

Still, these problems can be solved with the "soon to be enacted" securities law. But see Andrew Browne, Arguments Hold Up China Securities Law, Reuter Asia-Pacific Bus. Rep., Nov. 29, 1994, available in LEXIS, News Library, Reuapb File (reporting that opposition has upheld the passage of the securities law for two years).

142. Moreover, it can do so through a preferable means of financing — equity. Philbrick, supra note 37, at 575–77. For example, issuing shares in a company in exchange for invest-
helps to soak up the enormous amount of investment demand in China. There is also evidence that "mixed companies" perform better than public companies and so will be able to compete better with the private sector. At the same time, since the government retains ownership of the assets, augmented by its majority shareholdership in the corporation, the banner of socialism is kept intact.

2. Defining the Relationship

The "modern enterprise system" also goes some distance towards defining the respective rights of the SOEs and the state to state assets. The biggest problem is that the state retains ownership rights over the state-owned assets and will establish specialized agencies to "supervise" the assets. Precisely what the "supervision" entails is as yet unclear because the government is still in the process of drafting the relevant legislation.

Other rights are more clearly delineated, however. For example, the Regulations on the Supervision of State-Owned Property of Industrial Enterprises clearly explain how state-owned assets may be sold: only the state may sell the state-owned assets, the state may not sell them to private operators, and the SOE must use the money to pay bank debts and "redundancies" and then to restructure other unprofitable SOEs.

The Company Law also clearly defines the right to benefit. The law requires that the company allocate ten percent of its after tax profit to an official accumulation fund and five to ten percent to an official public welfare fund. If the company's official accumulation fund is insufficient to make up for losses sustained during the previous year, the current year's profit must first be used to make up those losses before

\[\text{ment capital entails no obligation to make payouts, as with bonds; enterprises can choose to pay dividends only when there is a profit. Id.}\]

143. Interestingly, Philbrick suggests that of the two components of a securities market — the supply of and demand for shares — the demand side may be harder to develop. See id. at S90-94. This is definitely not the case in China. See supra part I.A.2.


146. Company Law, supra note 12, art. 4; Chan, Guidelines Set, supra note 127, at 8 (discussing the Regulations on the Supervision of State-Owned Property of Industrial Enterprises). This solves the bankruptcy problem, at least to the extent that the ambiguous property relationship kept SOEs from filing for bankruptcy.

147. Company Law, supra note 12, art. 177. Where the aggregate amount of the official accumulation fund has already reached in excess of 50% of the company's registered capital, further allocations are not required. Id.
the current year's allocations to the two funds. Profits may then be allocated to a discretionary accumulation fund with approval from the shareholders, which is essentially retained earnings, or distributed to the shareholders. Thus, this system certainly seems "to parcel out some (or most) of the constituent rights of ownership into a bundle of rights which are clearly defined and legally protected."}

3. Effecting the Cultural Transformation

As has been demonstrated, however, to reform the SOEs, corporatization must do more than paper over the symptoms and define the property relationship; it must change the culture of state intervention that the ambiguous relationship has fostered. Some have argued that taking the corporate form makes it harder for either the state or the SOEs to behave as they do under the current system. Even though the government owns assets, the argument goes, the residual riskholders (the shareholders) are now able to escape their risk by selling their shares. The majority owner (the state) thus has an incentive to appoint managers who will maximize profits and otherwise behave efficiently.

The modern enterprise system has not been implemented in a way that should ease one's mind about state intervention, however. The Company Law contains provisions that continue to allow state intervention in unpredictable ways, hindering the crucial formation of expectations. First, majority shareholders in China have enormous power, more so than their counterparts in a typical western corporation. This power

148. Id.
149. Id. art 7.
150. Wang, supra note 4, at 134.
151. The outlook is not necessarily bright. Despite repeated assertions that the modern enterprise system clarifies the state-enterprise property relationship, the Vice-Minister of the State Commission for Restructuring the Economy stated in a recent interview that the 1994 Regulations "would assure managers of enterprises their rights in managing their firms and avoid the sensitive issues of the ownership of companies." Daniel Kwan, Way Clear to Close Ailing State Firms, S. CHINA MORNING POST, Aug. 6, 1994, at 8 (emphasis added).
152. Boycko, supra note 47, at 143; see also Economist Views State Firms Under Modern Enterprise System, Xinhua, Mar. 12, 1994, available in LEXIS, News Library, Xinhua File ("[M]ajor state enterprises will have multiple principal holders of their property rights, instead of just one principal holder, that is, the state.").
153. The shareholders have the usual powers of shareholders in western corporations, like electing and dismissing members of the Board of Directors, setting salaries for the Board, considering their reports, inspecting financial records, and deciding on issuance of additional shares and on such fundamental changes as mergers, dissolution, and liquidation. Art & Gu, supra note 11. They also have powers far beyond what the western shareholder has: to decide the policy of management and the plan of investment of the company, approve the budget, decide on issuance of bonds, consider and approve the plan of distribution of profits and recovery of losses, and decide on issuance of dividends. Id. The responsibilities of the board of directors are typical of western corporations and include selecting managers and making key business decisions. Id.; see also Company Law, supra note 12, art. 46.
is significant because in corporatized SOEs it is the state that will be wielding the shareholders' rights.

Another avenue of state intervention might be the concept of the "legal representative," a natural person authorized to act on behalf of a legal person, in this case, the corporation. This legal representative is personally responsible for the failures of the legal person and could be subjected to administrative penalties, fines, and imprisonment for offenses like "engaging in business beyond the company's authorized scope." Finally, another opening for state intervention is the as yet undefined state asset management agencies, discussed above.

Conversely, there may be nothing to counterbalance the state's power. The ability of the shareholders to escape risk by selling shares is questionable given the immaturity of the stock markets, so the pressure on the state, and subsequently on the managers, to behave efficiently is reduced. Additionally, the Company Law does not do anything to force the supervisory units to bear the risk of their decisions. In short, the modern enterprise system has left an enormous amount of room for the state to continue to intervene in the affairs of the SOEs after corporatization. It is thus hard to conclude that the clarification of the property relationship that has occurred on paper will result in real changes in the way the state or the SOEs behave.

CONCLUSION.

The problems arising from the SOEs' poor performance have convinced China's leadership that its SOEs are in need of restructuring. Despite anomalies like the TVE, the cause of these problems appears to be the ambiguous state-enterprise property relationship, which has created a culture of state intervention. Attempts to solve the problem to date, however, have failed. The first couple of attempts failed because they did not define the relationship clearly enough; the last attempt failed even though the property relationship appeared to have been spelled out quite clearly on paper. An examination of the phenomenon of privatization suggested that the problem lay in the fact that the attempts to solve the problem to date had not effected a crucial cultural transformation in conceptions of ownership rights.

Although corporatization creates an organizational structure that would seem to make it difficult for the state to intervene, the special characteristics of the Company Law and the rest of the "modern enter-

154. Art & Gu, supra note 11.
155. See supra note 141.
prise system” make it virtually impossible for the corporatized SOE to realize this potential because the state and the SOE remain intertwined. Thus, although corporatizing SOEs may be a step in the right direction, corporatization must not be the last step in the process of restructuring SOEs.

This Note does not suggest that corporatization is useless; indeed, corporatization will alleviate many of the stresses that China’s economy faces. However, this Note cautions that this success does not mean that SOE reform is complete. If the Company Law does not succeed in bringing about the cultural transformation in attitudes towards state intervention, SOEs will continue to exhibit many of the inefficient behaviors and to cause many of the problems described in this Note. As China implements the Company Law, then, the task for reformers is to understand the importance of the cultural transformation in order to make a realistic evaluation of the successes and failures of corporatization and to plan for the future evolution of SOEs.