

CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES IN CHINA

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Abstract

In the last thirty years, China has undergone three stages of corporate governance mechanisms, namely, (1) the “power-delegating and profit-sharing” system; (2) the “contracted managerial responsibility” system; and (3) the corporatization of large state-owned enterprises (SOEs). This paper will explore each mechanism, their advantages and disadvantages in detail. The main finding is that the various practices of corporate governance of SOEs are not suitable for China’s SOEs mainly due to the lack of sufficient incentive. Instead, a mixed mechanism of the “control-based” and the “market-oriented” mechanisms is more attractive given China’s unique institutional setting.

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1. Introduction

Today, the corporate governance practices of state-owned enterprises (SOEs) in China have received much attention. This is probably because China maintains a stably fast economic growth over the past three decades. Its annual GDP growth rate is more than eight percent over the last thirty years. However, the performance of its major economic entity, the SOEs, is still relatively poor. Many economists believe that the poor performance of the SOEs is due to the inefficiency of existing corporate governance. Thus, in this paper, we provide a preliminary survey of the practices of corporate governance of SOEs in China over the last thirty years.

As China is currently experiencing a transition from a planned economy to a market-oriented one, its economy can be best described to be in the transition stage. In addition, China has unique institutional characteristics which probably affect the corporate governance mechanism of its SOEs. In this paper, we first investigate the impact of China’s unique institutional setting to its SOEs.

Before the economic reform in 1978, SOEs in China were established in the form of administrative governance. After that, the reform of the corporate governance undertook three stages which include the “power-delegating and profit-sharing”, the “contracted managerial responsibility”, and the “market-oriented” corporate governance mechanisms. The differences among these mechanisms, their advantages and disadvantages will be addressed in this paper to find out if they are suitable to China’s SOEs.

It is understood that there are three corporate governance mechanisms adopted worldwide. One of these is the Anglo-Saxon “market-oriented” corporate governance. Another is called the “control-based” mechanism, which is widely adopted in Japan and central Europe. There still exists another mechanism, called the “contingent-state” corporate governance mechanism, which is considered to be the most attractive one for a transitional economy (Aoki, 1994). As China’s economy is still in transition, the contingent-state mechanism may be the most suitable for its SOEs. In this paper, we try to assess the abovementioned mechanisms and find out what could best fit China.

The main findings of this paper include that the various practices of corporate governance of SOEs in the past thirty years are not suitable for China’s SOEs due to the lack of sufficient incentive provision. The ongoing reform of corporate governance is a mixture of “control-based” and “market-oriented” systems. It still faces some substantial challenge though it is a significant improvement compared to the previous practice. To explore such issues, we use the methodology known as the “principal-agent” method.

This paper forms part of a small literature on China’s corporate governance. Classens and Fan (2002) provided an outstanding survey of the corporate governance literature on Asia. However, the practices in China were only briefly introduced due to the lack of available reference when the paper was written. Liu (2006) updated the survey by focusing on the economic effects and institutional determinants of corporate governance in China’s listed companies. Aside from these, some other researches also

emphasized the rent-seeking behavior in China's SOEs (Bai *et al.* 2000) and the administrative governance under China's unique institutional setting (Pistor and Xu, 2005). In contribution to the previous works cited, this paper instead placed emphasis on evaluating each practice of corporate governance in China's SOEs over the past years.

The rest of the paper is organized as follows: Section 2 provides a detailed survey of the corporate governance practices in China's SOEs; Section 3 gives a detailed discussion of the deficiency of each existing corporate governance practice; Section 4 offers some international comparison of corporate governance, followed by the policy suggestion for establishing a new corporate governance mechanism; and Section 5 consists of a brief concluding remark.

2. The Practices of Corporate Governance of SOEs in China

Over the last thirty years, the reform of the corporate governance in China's SOEs has undergone three stages: (1) the "power-delegating and profit-sharing" system, which began in 1979; (2) the "contracted managerial responsibility" system, which began in 1984; and (3) the corporatization of large SOEs, which began in 1993. In order to have a clearer picture of the corporate governance in China's SOEs, it will be appropriate to trace the key features and contents of these three different stages of corporate governance, and then analyze their advantages and disadvantages.

Before the economic reform in 1979, the property rights of the SOEs were completely owned by the central government and each provincial government. The managers of all enterprises were appointed directly by the central and local governments, which, in turn, were controlled by the Chinese Communist Party. In this sense, the SOEs did not have corporate governance. Instead, they were under administrative governance.

Since 1979, the government and leading economists noticed that the administrative governance was one of the main sources of low efficiency and poor performance of the SOEs. As a consequence, the first step in reforming the corporate governance of the SOEs was to expand the enterprises' autonomy. After the successful experiments of the six enterprises in Sichuan Province, which is one of the relatively rich western provinces in China, the government expanded the scale and magnitude of the said reform. The reform in this step concentrated on allowing the enterprise to retain a small amount of profits. Simultaneously, the payments that the workers received were linked to their productivity. Besides this, the selected SOEs were also allowed to have some autonomy on making decisions regarding product supply, selling superfluous materials, and establishing an independent enterprise fund.

The second step in the SOEs' corporate governance reform was to establish the "enterprise

contracted managerial responsibility" system. Since 1984, a contract has been established between the government and the managers of the SOEs in order to clarify matters regarding the managerial control right and profit allocation. The major principle of this corporate governance mechanism is that the government will charge a fixed quota for each enterprise. In particular, when the actual profit is more than the base quota, the enterprise can retain such extra profit.

Conversely, when the actual profit is less than the base quota over some period, the enterprise still has to pay all its profit to the government. In practice, the enterprise contracted managerial responsibility system takes three different types. The first type is the responsibility for paying the fixed quota. This includes several applications such as (1) the government fixed the quota, and the extra profit beyond the quota that is shared between the government and the enterprise; (2) a progressive quota of profit remittance; and (3) a simple fixed quota for those enterprises with low profit. The second type of the contracted system is that the government will charge fewer quotas for those firms that experience losses. The third type is about the rule of "two-guaranteed and one-linked". The "two-guaranteed" means that the profit remittance and the approved technology-upgrading projects should be guaranteed. The "one-linked" means that the total amount of the workers' wages shall be linked to the actual after-tax profit.

Compared to the previous "power-delegating and profit-sharing" system, the contracted system clearly grants more autonomy to the SOEs. However, its disadvantages became evident over the years. In the early 1990s, there was a strong demand within the public to call for a new corporate governance mechanism. In 1993, the parliament of China, the National People's Congress, passed the proposal titled, "*the Company Law*," which emphasized that the SOEs should establish the contemporary corporate governance gradually.

Shortly after, the government selected one hundred large SOEs as an experiment. At first, the corporate governance of the selected SOEs took two different types. Under the first type, the selected firms were required to set up the board of directors and then select the managers. However, the government can still directly appoint professional staffs as board of directors and managers of the enterprises. Under the second type, the government established an ad-hoc committee, the State-Owned Asset Management Committee, which is the legal representative of all state-owned assets then the government appointed a representative of property rights to the enterprises as the biggest stakeholder of the firms. In a nutshell, compared to the previous practice, such a mechanism was more close to the modern intrinsic requirement of corporate governance.

3. The Problems of Existing Practices of Corporate Governance

In this section we analyze the deficiency of each existing corporate governance mechanism in China's SOEs.

3.1 The Deficiency of Power-Delegating and Profit-Sharing Scheme

Without a doubt, the power-delegating and profit-sharing mechanism was a very beneficial experiment in the late 1970s. It broke the role of the traditional administrative governance. The enterprises were granted some power to allocate material resources and share some profit of the enterprises. Essentially such a mechanism provided incentive for enterprises to realize the significance of value maximization. However, since the SOEs at that moment were still not completely "firm" there was an intrinsic dilemma on the applied corporate governance mechanism. On one hand, when the government delegated much less power to the SOEs, the enterprises could not have sufficient autonomy to optimize its resource allocation. On the other hand, when the government granted too much power to the SOEs, the "insider control" problem could occur in such SOEs.

The insider control problem is "a potential phenomenon inherent in the transitional process" (Aoki, 1994). In a transitional economy, since a principal (i.e., the owner of firms) is actually absent, the agent (i.e., the manager) of the firm obtains much "private information" such as the revenue and the cost of the firm. Such private information is very difficult for the principal to monitor, especially when the accounting system is incomplete and not transparent. Hence, the insider (i.e., the managers) will "shirk" and not aim for the firm's value maximization due to the asymmetric information. Instead, the managers will search every possible chance to seek rent. It turned out that the "insider control" problem was very severe in China's SOEs in the late 1970s and early 1980s.

3.2 The Problems of the Enterprise Contracted System

After realizing that the power-delegating and profit-sharing mechanism has some intrinsic shortcomings, China's government applied a new corporate governance mechanism—the enterprise contracted system. Compared to the power-delegating and profit-sharing mechanism, clearly the contracted system is a better corporate governance mechanism because to some extent, the managers in SOEs have the power to decide on production and sale. It stimulates the production incentive of the SOEs; as a consequence, such a mechanism also increases the government surplus due to the increase of the corporate tax income.

However, similar to the power-delegating and profit-sharing mechanism, it also has the severe "insider control" problem. The essential feature of this contracted system is the share of property rights between the state and the managers. This implies that the managers have partial residual claim and residual control. Hence, the SOEs have two owners: one is the absent state; the other one are the present managers. In this way, the objectives of each of the two owners are in conflict.

As a consequence, managers will not seek for value maximization for the enterprise. It is also interesting to point out that the effect of such an "insider control" phenomenon on national welfare is ambiguous. On one hand, the negative side of the "insider control" is significant. The managers have the de facto controlling right. This means that they can collude with workers to fully implement its business strategy. Subject to this "soft" constraint, the outsider (i.e., the government) cannot easily fire the managers. On the other hand, the "insider control" phenomenon also has some advantages, at least as a Kaldor improvement. In this situation, some people get to benefit at the expense of other people's loss; and the aggregate

social welfare also improves.

The idea here is consistent with Shleifer and Vishny's position (1997) that with the administrative governance, the corruption and bribe might improve the efficiency. That is because managers can only obtain a very small share of the profit according to their contracts. Without the gray incentive, the managers would not work hard to maximize the firm's profit. However, since the accounting system is incomplete and lacks transparency, the managers can safely and easily catch more extra benefit in reality. In a nutshell, this implicit benefit is the engine of the value maximization conducted by the managers in the short run.

This raises another interesting question. In the long run, do the managers have incentive to maximize the firm's profit under this corporate governance mechanism? The answer is no for two reasons. First, the managers understand that the best strategy for keeping their positions is not to have an outstanding performance but only to have a "fair" performance. On one hand, when the performances of managers are too poor, they will be forced to resign or be dismissed by the government. On the other hand, even though their performances are outstanding, they will still not be treated as professionals with high managerial capacity. Instead, the government might take these outstanding performances for granted. For example, the government might attribute the profit to the strong foundations of the firm. Hence, it is still possible that the government will appoint other people to replace the manager. As a consequence, the optimal strategy for the managers in this game is to keep a fair performance. Second, the principal (i.e., the government) does not need to take the responsibility for the firm's operating performance. The principal of

the SOEs is different from the capitalist. This implies that the principal has an “adverse selection problem” of choosing an agent. It is no reason to believe that the principal has sufficient incentive to search for the best agent. Instead, he will just appoint the most “appropriate” person as an agent to maximize his rent (Zhang 1992). Based on these two reasons, the managers do not have the incentive to maximize the firm’s profit in the long run under this corporate governance mechanism.

3.3 The Shortcomings of the Current Practice of Corporatization

As pointed out earlier, after 1993, the large SOEs in China were required to establish modern corporate governance mechanism. The first trial of such modern corporate governance mechanism required the government to directly appoint the specialists to manage the SOEs. Actually, this is of no substantial difference from the old mode. It is true that the SOEs establish the board of directors and various managerial levels but the problem is that such sectors are not elected by the stakeholders. Instead, they are directly appointed by the government. In fact, the only difference of this corporate governance mechanism from the traditional mode is having a different brand name. Furthermore, the relationship among the board of directors, stakeholders, managers, and the labor unions are not clear at all. One good example is that the managers still ask for help from the government when the SOEs have a hard time in their operating activities.

The second corporate governance mechanism is to establish a three-tier network of state-owned assets management. The top tier involves the State-Owned Asset Management Committee established by the central government. It is the legal representative of all state-owned assets. The second tier is composed of the investment company authorized by the state. The lowest tier consists of the numerous SOEs.

Unfortunately, this mechanism still has many practical problems. In practice, we have two types of representatives of property right: (1) the government appoints a representative to the SOEs serving as the deputy chief manager; (2) the existing chief manager serves as the representative of the property right. In the first case, the representative does not have power to make decisions on the operating activities of the SOEs. This could be because of the lack of relevant professional knowledge or because of his non-major stream position in the SOEs. In the second case, the situation is even worse. One of the major functions of the contemporary corporate governance is that the board of directors can play a monitoring role on the managers. When the managers also serve as the board of directors, this function is totally crashed.

3.4 The Inconsistency of Corporatization with the Theory

Moreover, theoretically speaking, the corporatization of the SOEs in China is also inconsistent with the prediction of the related contract theory such as the one posited by Jensen and Meckling (1976). First, the current practice in China violates the consistency principle between the residual claim and the residual control. According to the contract theory, the residual control implies the voting right. When the residual claim is inconsistent with the residual control, the “cheap vote” phenomenon will happen. This is intuitive. When someone has voting right (i.e., residual control), he has the power to appoint the senior managers. However, he does not need to take the responsibility for the operating performance when he does not have residual claim. In other words, under this corporate governance mechanism, there is no corresponding incentive mechanism to guarantee that the principal can search and appoint high capacity professional staffs as his agents (managers). The administrative staffs cannot switch to the real stakeholders just because of the existence of the “State-Owned Asset Management Committee.”

Second, the contract theory emphasizes that the compensation remuneration should be directly relevant to the operating performance. However, the current practice of the corporate governance in China’s SOEs violates this principle. Actually, the compensation of the managers is far low to their contributions to the SOEs. It is understood that the normal profit is the reward of the ability of enterprisers. When the enterprisers cannot get the corresponding reward from their effort, who could expect them to try their every effort to maximize the firm’s profit? As a consequence, the “shirk” of the managers is relatively unavoidable. Someone might argue that various forms of honors can serve as substitutes of the compensation remuneration. However, this is true only after the managers are satisfied with the monetary compensation.

As pointed out previously, the mismatch between the compensation remuneration and the manager’s operating performance encourages the “insider control” activities. Compared to the compensation remuneration of the managers from the private enterprises and various township and village enterprises (TVEs), the monetary compensation of the managers in SOEs is still very low. Such a gap stimulates the rent-seeking behavior. This also explains why the stock of stateowned assets in the SOEs is shrinking over the years.

Third, it is understood that the residual claim should be relatively concentrated. The question is, who should hold the largest portion of the residual claims: the large stakeholders, the managers, or the workers? Traditional wisdom suggests that the residual claim should be held by the largest stakeholder of the SOEs (i.e., the government). However, as previously analyzed, this scheme will

cause the asymmetric information between the principal and the agent. As a consequence, the “cheap vote” and the “insider control” phenomenon become prevalent. An alternative scheme is to let workers have their residual claim. However, this is still not a good strategy. Although the incentives of the workers will be improved, it is no help to provide incentives to the managers. In this way, the effort levels of the managers are still hard to be monitored. The crucial point here is that the residual claim is proportional to the operating risk. Relatively speaking, the managers bear more operating risk in practice, and they are more difficult to be monitored. Therefore, in this sense, it is a better scheme to let the managers share more residual claims.

4. International Comparison and Reform Suggestions

Today, two categories of corporate governance are prevalent in a market-oriented economy. These are the control-based system and the market-oriented system. Besides these, some economists believe that the contingent-state corporate governance is suitable to the transitional economy. In this section, the pros and cons of these three different mechanisms will be compared, followed by their implication to the corporate governance of China’s SOEs.

4.1 International Comparison

The control-based system is prevalent in Japan, German, and many other continental European countries. One of the key features of this corporate governance mechanism is that the ownership of listed companies is strongly concentrated in a main bank. The relationship between the main bank and the enterprise is stable over the years. Usually the main bank holds both equity and debt of the enterprise, and is the largest stakeholder of the enterprise. In practice the main bank has the ability to appoint the senior level managers. The advantage of this feature is that it can solve the insufficient investment problem faced by the enterprise. In particular, the main bank could finance long term investment projects.

Another feature of the bank-oriented corporate governance is that the cross-share holdings in the control chain are significant. This phenomenon is very common in several central European countries such as Austria, Germany, and Sweden (La Porta, 1999). The advantage of this strategy is that it strengthens the related benefits among the firms and it mitigates the hostile takeovers. However, the disadvantage than can be predicted is that the firm’s operating behavior is hard to be monitored. The bankers would monitor the managers, but the question is who would supervise these bankers? Also, such bankers are not afraid of the hostile takeovers due to the crossshareholding. This also reduces their incentive to maximize the firm’s actual profit. The market-oriented type of corporate governance is

popular in the Anglo-Saxon area. On one hand, the listed companies are financed from the general public via issuing bonds and stocks. Actually, since the listed companies have to face the threat of the outside control (i.e., the hostile takeover), the market-oriented corporate governance has a better incentive mechanism. On the other hand, the bank only plays a minimal role on finance due to the legal restriction raised by the Glass-Steagall Act in 1933 in the United States. This act emphasizes that the commercial bank can only provide the short term but not the long term loan. Hence, such a corporate governance mechanism is relatively impotent to finance large investment projects.

In a nutshell, these two mechanisms have their own advantages and disadvantages. Now the question is: which one is more suitable to China’s SOEs? Put it in another way, can we directly apply one of them for China’s SOEs?

The answer is no. This is mainly because China’s economy is still at the transitional stage. The transitional economy is “path dependent” for two reasons. First, the path of China’s transitional economy is “backward-looking.” We need to consider the effects of the previously planned economy on the current market-oriented economy. Besides the regular labor unions in the listed companies, China’s SOEs also have some special interest groups such as the unions of workers’ representatives and the unions of Chinese Communist Party’s representatives. Such special interest-groups could play some roles on the formation of the corporate governance in China’s SOEs. Second, the path of China’s transitional economy is also “forward-looking.” Once we choose one type of corporate governance mechanism, it would be very difficult to switch to the other type.

Suppose that the market-oriented corporate governance is applied directly for China’s SOEs, “the insider control” problem could give the managers a “moral hazard” behavior. To avoid this, there is a need to have a perfect capital market and also a competitive labor market. However, both do not exist in China today. The capital market in China has been established yet it is still far from perfect (Wu, 2005). At the same time, the labor market is still segmented. Labor in the rural areas cannot freely move to the urban areas (Cai, *et al.*, 1997). Hence, the “insider control” problem still clearly exists in China’s SOEs. In other words, the pure market-oriented corporate governance is not perfectly suitable to China’s SOEs.

Another possibility is to establish the contingent governance mechanism. This mechanism emphasizes that the residual claim is a contingent-state claim. The control right of the company will be automatically transferred from the insider to the outsider when the listed company faces an operational difficulty. When the insider can successfully keep the internal financial account balance, he still has residual claim. Otherwise, he will lose his the residual claim. Hence, this mechanism can provide the performance incentive for the insider. However, the contingent

governance is valid in a transitional economy only if there is a matured commercial bank that could serve as the main banking institution. At present, China is still a long way far from establishing a matured banking system.

4.2 Suggestions on Further Reform

This paper has argued that neither the pure market-oriented nor the contingent-state corporate governance systems are suitable to China's SOEs; thus what option is left now for China's SOEs? Based on the above analysis, two types of corporate governance may be applicable. The first mechanism is that the residual claim should be held by the managers. In particular, this could be a good mechanism for small and medium-sized SOEs. In practice, a mechanism that allows the managers to purchase large shares of the enterprise stocks may be used. Since it is not a good idea to let either the representative of state-owned assets or workers hold the residual claim, the solution is to disperse the residual claim into the hands of the managers. However, one thing should be clear: what is the relationship between the new stakeholders (i.e., the managers) and the old stakeholders (i.e., the representatives of the state-owned assets)?

One possible scheme to distinguish their relationship is to change the state-owned stakeholders into the assuming the role of creditors of the enterprises. This scheme is attractive for two reasons. First, the state can get a fixed income when the operating performance of the firm is in a good shape; however, the state can switch into the insider when the operating performance of the enterprise is poor. Second, when the company becomes bankrupt, the SOEs should pay the debt first to the State according to the *Law of Company* passed in the early 1990s. This, in turn, guarantees that the State will not suffer loss even in the case of bankruptcy.

It is equally important that the new stakeholders (i.e., the former managers) cannot continue to serve at the managerial level. The idea is simple. The stakeholders are those who are rich in capital endowment, whereas the managers are those with high managerial capacity. Although the original managers might also have high managerial capacity, their new task is to handle the enterprise's assets via their voting right. However, they can appoint the people who are excellent in the operating activities as managers. Under this corporate governance mechanism, the "insider control" problem can be mitigated to a minimum level. The only challenge in this scheme is that it requires the former managers to have sufficient capital endowments. This is exactly the case in the small and medium-sized SOEs in China. In practice, the gray income of such managers are significant given the existence of the severe "insider control" phenomenon.

This leads us to the question as to what is the most feasible corporate governance mechanism for

large SOEs? Is it correct to just privatize the large SOEs in the same way we applied the mechanism for the small and medium-sized SOEs? The answer is no. This is because the large SOEs are extremely crucial for the betterment of China's economy. Once the reform of the SOEs failed, it would be a disaster for the whole national economy. For example, the failure of the SOEs reform could cause a large scale of unemployment and layoffs. Therefore, privatization might not be the best mechanism for the large SOEs in China given its potential huge negative effects.

Another feasible mechanism for the large SOEs is to establish an institute serving as a supervising outsider. The top candidate of such an institute is a commercial bank or other nonfinancial institutes. This is exactly the mode taken by the "control-based" corporate governance. Fortunately, it has been observed that the recent corporate governance reform is following this track.

In the late 1999, the Chinese government took a further step on the corporate governance reform. It required all large SOEs with good performance to have initial public offering (IPO), establish joint ventures with foreign firms, and have cross-shareholding among different SOEs. As pointed out by Wu (2005), in particular, this corporate governance reform took three steps: (1) the administrative function and business function within the SOEs were separated; (2) the competition within the monopolistic industries such as the petroleum and telecommunications industries was promoted; and (3) IPO on foreign stock market was implemented. Accordingly, the ongoing reform is a mixed mechanism between the "control-based" and the "market-oriented" systems.

5. Concluding Remarks

This paper is an overview of the practices of the corporate governance reform of SOEs in China over the last thirty years. More importantly, it explores the advantages and disadvantages of each mechanism.

In China, the practice of establishing an appropriate corporate governance of SOEs has been in existence for more than thirty years. It started from a trial of granting autonomy to the SOEs from the government. Shortly thereafter, the contracted responsibility system was emphasized to improve the incentive for the managers. Although these two mechanisms were prevalent in the 1980s among China's SOEs, they caused an intrinsic inconsistent dilemma. Also, the severe "insider control" problem seriously discounted the incentives raised by these two mechanisms for the SOEs.

Recently, the SOEs in China experienced a large scale of corporization. This paper argues that the conventional market-oriented corporate governance system does not fit the unique setting of China's institutions. Instead, a mixed mechanism between the market-oriented and the controlbased system appears to be a better fit for China's economy. Therefore, it is

suggested that China should establish two different corporate governance mechanisms based on the size of the SOE.

For the small and medium-sized SOEs, the best mechanism is to let the original managers hold the residual claim. However, it is also suggested that a main bank would serve as an outsider observer of the enterprise for the large SOEs.

Another challenge is that China's commercial banks also have a lot of problems such as bad loans and poor reputation. The mixed corporate governance could work well only if China has a healthy banking system. Hence, establishing a mature banking system is a relevant topic for future research.

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