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Institution Building and Welfare Compensation in Economic Transition: An Evaluation of China's Shareholding Reform*

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In this paper, we argue that institution building and welfare compensation are the two main tasks in the transition from planned to market economy. We then evaluate China's shareholding reform initiated at the 15th Party Congress. We will show that without institutional underpinnings, the shareholding reform by itself is unlikely to solve the problems China's state sector is facing. We then argue that the key to a successful restructuring of the state sector lies in the development of the country's market-oriented institutions, in particular, financial markets, a social welfare system, and legal institutions.

1. Introduction

The 15th Party Congress has endorsed the shareholding system as the new model for the state sector. The plan is to convert state enterprises into shareholding corporations. The main objective of the proposed shareholding scheme is to separate the government from enterprises. It is hoped that with the separation, the reform will help (1) to define property rights and clarify rights and responsibilities, (2) to restructure the state assets and introduce asset management, (3) to improve workers' incentives, and (4) to improve the structure of finance.

It is not yet clear whether the government has a detailed blueprint. Some of the measures that have been taken or been proposed include forming giant

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corporations through mergers and acquisitions, forming stock cooperatives through employee buyouts, and selling off some of the state assets to non-state enterprises including foreign investors. For most large- and medium-sized state enterprises, the state would still hold either a majority or a significant minority stake. Even in the case of stock cooperatives, the state assets would likely be significant.

In practice, however, mergers and acquisitions have mainly led to changes in names rather than the needed restructuring. Employee-participated stock cooperatives have essentially been used by many enterprises as a way to force employees to either lend money to their units or to quit, without real change in the governance structure. The immediate effects have been large increases in laid off workers.

The new reform plan aims to solve the problem of increasing losses by the state sector and the potential banking crisis such losses may cause. It is widely reported that one-third of China's state-owned enterprises are losing money, one-third barely break even and only one-third are making profits; and it is also said that one in two employees of the state sector is working for a loss-making enterprise. The losses are absorbed by government subsidies, inter-firm debts, and, more importantly, the state banks. It is estimated that more than 20% of the total bank loans are non-performing. In the meantime, the state-owned sector contributes more than 70% of the state revenue and more than 50% of the urban employment (Table 1 and Table 2). It is apparent from these figures that the reform of the state sector has paramount importance in terms of urban employment, the banking sector's financial health and state revenues.

In this paper, we argue that institution building and welfare compensation are the two main tasks in the transition from planned to market economy. We then evaluate the shareholding reform based on an assessment of the causes of the losses by the state-owned enterprises, namely, the agency problem that results from an inadequate incentive and governance structure and the social burden that the state sector has had to shoulder. The real question, therefore, is how the agency problem is to be solved and how a welfare system is to be established to take up the role that is currently asked of individual enterprises. Without institutional underpinnings, the shareholding reform by itself is unlikely to solve the problems China's state sector is facing. We then argue that the key to a successful restructuring of the state sector lies in the development of the country's market-oriented institutions, in particular, financial markets, a social welfare system, and legal institutions.

2. What Has Gone Wrong with China's State Sector?

State ownership used to be the symbol of socialism. However, since the economic reform in the late seventies, the role of China's state sector in the national economy has been declining. In 1996, the state-owned industrial enterprises accounted for only 28.5% of the gross industrial output. While the share of the total assets by the state-owned industrial enterprises was 58.6%, its share of the total profits was only 27.7%. Nevertheless, the state sector is still the major contributor to state revenue and urban employment (Table 2).

What has gone wrong with China's state sector? We believe that, although China's SOEs have performed poorly relative to other enterprises, their poor performance has often been misinterpreted and exaggerated. Three major factors have contributed to the increasing losses in the state sector.

First, increasing competition has driven down the profit margin across the whole spectrum of enterprises including non-state enterprises (Jefferson and Rawski, 1994). While competition may be bad news for individual firms, it is good news for the whole economy. Table 3 shows that while the state enterprises have performed worse than non-state enterprises, the performance as measured by the ratio of pre-tax profits to total fixed assets has declined over time for both the state sector and non-state sectors. The average profit margin is not an indicator of an economy's health but rather the competitiveness of the market. In fact, the Chinese economy has been growing at an astounding ten percent a year for almost two decades. As the Chinese economy becomes increasingly market-oriented, it is natural to expect that the superficial profits for state enterprises as guaranteed by the planning system in the past would decline over the course of economic reform. Moreover, loss-making is not a unique problem within the state sector. A high percentage of non-state enterprises is also losing money. According to China's Third National Industrial Census in 1995, 33.8% of the state-owned industrial enterprises were making losses, while the percentage of loss-making enterprises for the whole industrial sector was 25%. It is interesting to note that 39.8% of Sino-foreign joint ventures and 43.8% of wholly foreign-owned firms were losing money (see Table 4).

Second, relative to non-state sectors, the state-owned enterprises have to shoulder much heavier social responsibilities. They are required to create employment for urban residents even if they already have redundant workers. In addition, the SOEs have a much higher percentage of retired workers on their payrolls. They are also expected to and do indeed provide employees with various fringe benefits such as low-cost housing and free medical care. Moreover, the state enterprises have been paying more taxes than other enterprises.

According to the 1995 census, the average ratio of total tax to pre-tax profits was 0.77 for state-owned industrial enterprises, while the figure for township enterprises and wholly foreign-owned enterprises was respectively 0.54 and 0.35 (see Table 5). When we take the state sector's contribution to tax revenue and employment into account, the difference in performance levels between state enterprises and other enterprises becomes narrower. According to the same census, in 1995, the average ratio of net profits to equity was 0.041 for all enterprises and 0.022 for SOEs while the ratio of pre-tax profits to equity was

0.184 for all enterprises and 0.177 for SOEs. In other words, when we take the tax contribution into account, the difference in performance between the state sector and non-state sectors would narrow down dramatically. When we look at the ratio of the sum of total wages, pension and pre-tax profits to equity, the difference would basically disappear.

One may have reservations about the accuracy of Chinese statistics. In the case of foreign-owned firms, one might also cite the difference in accounting standards. It is certainly reasonable to question the above statistics. But we are not trying to show that SOEs are just as efficient as other types of enterprises. We simply want to point out that SOEs may not be as inefficient as one might think based on simple statistics widely reported in the press. Financial losses of SOEs are partly offset by their contribution to social welfare. Therefore, focusing on the state sector's financial performance alone can be misleading. In fact, recent reform measures adopted by many of the SOEs have been indeed aimed at relieving themselves from welfare burdens by laying off workers, cutting on welfare expenses and forcing employees to contribute capital. These measures can certainly improve their financial health but not necessarily improve efficiency. They may simply transfer social burdens from enterprises to the workers and the society at large.

There is a popular argument that suggests the SOEs can be more inefficient than we think. It is believed that SOEs have privileged access to cheap bank loans. This gives them an added advantage over other enterprises. The data, however, show that collective-owned enterprises have a higher debt-to-equity ratio (2.53) than state-owned enterprises have (1.92). It is possible that collective enterprises borrow a lot from sources other than the state banks and at a higher rate. But the ratio of interest payments to total debt for both types of enterprises is very low (0.0405 and 0.053 respectively), implying that there is a high rate of delinquency (see Table 6). This also means that collective enterprises that borrow more may actually gain more in the form of unpaid debt. In addition, the difference in this ratio appears too small to justify the argument that SOEs enjoy extra benefits from cheap loans.

The third reason we identify for the increasing losses in the state sector is that the agency problem has become increasingly serious after the central planning and control system gradually disbanded over the course of the reform (see Qian, 1996). On the surface, the state-owned enterprises in China are in many ways similar to public corporations in a capitalist economy. In both cases, ownership and management are separated. This separation gives rise to the so-called agency problem. In a Western-style public corporation, the manager as the agent of the often numerous owners may not act in the best interests of the owners. An SOE is nominally owned by all the citizens in the country. But the management is delegated in part to government bureaucrats and in part to enterprise managers. Before the economic reform, the planning authority had more of the control power. After the reform, enterprise managers have gained a great deal of autonomy. But the bureaucrats can still exercise a significant degree of control. Particularly, they have the power to choose those who will become enterprise managers. The bureaucrats and the managers as agents of the state will seek their own interests instead of the interests of the country's citizens.

The crucial difference between a Western-style public corporation and a state-owned enterprise lies in their respective governance structures. In the West, the separation of ownership and control is a result of an endogenous, evolutionary process based on voluntary exchanges of private property rights in pursuit of gains from specialization (Fama and Jensen, 1983). In the process, various governance mechanisms have been developed to safeguard owners' interests from managerial infringement. They are legal and economic institutions for owner-investors to have effective control over managers and to assure themselves of a return from their investment. Managers have fiduciary duty to act in the shareholders' interest.

Laws have been enacted to prevent self-dealing activities. More importantly, in even the largest corporations, there are normally shareholders who hold significant ownership stakes. Large shareholders have both the ability and the incentives to exercise effective control rights and monitor the management. In addition to the existence of large shareholders and legal protection of investors' control and income rights, other economic mechanisms have been developed to provide incentives and discipline, including managerial stock options, independent auditing, the market for corporate control, and other specific contractual mechanisms (see Hart, 1995; Shleifer and Vishny, 1997). It must be pointed out, however, that the existence of various government mechanisms does not imply that the agency problem has been resolved in the West, but that the problem is mitigated and the agency cost that remains is the cost a modern corporate system has to pay.

In the case of China, state enterprises, by definition, have no large non-state owners. Legal systems are weak; relevant laws are often either absent or not enforced. Corruption is at epidemic level. Anti-graft policies have never been truly effective. Other economic mechanisms are, needless to say, also lacking. One does not need to look hard to find abundant examples of managerial misbehavior in China. Among the most common offenses are dining and wining on the company, buying luxury cars, traveling for pleasure at company's expense, investing carelessly in infrastructure and plant expansion, diverting state assets to set up subsidiary companies that are financially easier to manipulate, and using company funds to speculate in the property and stock markets.

Corruption by government bureaucrats takes similar forms because they are essentially the bosses of enterprise managers. They effectively have the ultimate control rights over the state enterprises but are not legally entitled to the income rights that owners of private enterprises would normally have. It is, therefore, not surprising that the Chinese government finds the socially destabilizing problem of rampant corruption by managers and cadres most difficult to crack.

Another serious agency problem with the bureaucrats is their choice of managers. *Guanxi* (connections), seniority, political correctness and factors other than management ability are often the criteria used for promotion of state enterprise managers. Firms that are making profits are often the ones that happen to have capable managers. Loss-making firms often have corrupt and incompetent managers.

It is difficult to quantify the exact impact of corruption on the state sector's poor performance. According to one recent survey in Anhui Province, as reported by the official *Economic Daily* (December 28, 1997), embezzlement and corruption played a leading role in the chronic loss in 44 out of 110 loss-making state enterprises. Poor management ability and general neglect of duties by managers were the other reasons mentioned in the report.

Another way to gauge the extent of losses due to waste or corruption is to look at how national income is allocated among households, government units and enterprise units. In 1995, China's GDP was 5847.8 billion yuan. The share for household income was only 2723.6 billion yuan. Thus more than one half of the national income was spent by either government units or other institutions (mainly enterprise units). The government's budgetary revenue was 624.2 billion yuan, and the total extra-budgetary revenue collected by central and local governments and by non-profit and administrative units was 483.1 billion yuan. Much of this revenue was used to pay government employees, including teachers and medical doctors. Even if we assume there was no such payment, it leaves at least 2016.9 billion yuan as net income for enterprise units. However, industrial enterprises reported a total profit of only 149 billion yuan while GDP generated by these industrial enterprises accounted for 31% of the total GDP. (All the figures are from *China Statistical Year Book, 1996*.) According to the above calculation, a big piece of the pie is missing from the national income accounting. This would not only lead to inadequate tax revenue but also leave a lot of room for corruption and wasteful institutional consumption.

3. What is lacking in the New Reform Initiative?

Corporate Governance: An Overlooked Issue

As we discussed earlier, the success of the modern corporate system depends on its governance structure. Corporate governance structure consists of mechanisms and institutions that protect asset owners' interests from managerial or other parties' infringement. Without these institutional underpinnings, corporatization will not automatically solve the agency problem; to the contrary, it may make the problem worse. However, the issue of corporate governance has been overlooked in China's new reform initiative.

Western economists and investors are acutely aware of the agency problem resulting from the separation of ownership and control (Berle and Means, 1932; Jensen and Meckling, 1976; Jensen, 1986). When managers have little ownership stake in their companies, they tend to act in their own self-interest rather than the owners' interests. Managerial misbehavior ranges from shirking duties and the misuse of company funds to flat-out expropriation. In the West, as we noted earlier, the separation of ownership and control is a result of an endogenous, evolutionary process. In the process, various governance mechanisms have been developed to safeguard owners' interests from managerial infringement.

In China, there is not enough time for such an evolution. The separation of ownership and management will be largely exogenous. Conscious effort needs to be made to develop corporate governance mechanisms in order to minimize the transition costs. Particular attention should be paid to the questions regarding how the managers will be governed in the post-separation corporations and how the government can make sure that the state representatives who effectively have the ownership rights of the state assets would act in the state's interests.

Corporate Governance and the State Enterprise Reform

The objective of the state enterprise reform should be to address the incentive problem of both the managers and their monitors.

To address the problem of managerial incentive, the most obvious approach is to tie managerial compensation to the managers' performances. In China, enterprise managers are provided with little contractual, personal incentive. It is more efficient to change managerial incentives from implicit or illegal benefits to explicit, legal forms of compensation. If a manager personally receives, say, 10 per cent of his company's profit, then, on the one hand, he would have good incentive to take measures to improve his company's performance; and, on the other hand, it would make corruption much more expensive both to himself and to the bribers. The amount of benefits from corruption would have to be large enough for the manager to be willing to take the risk in favor of costly illegal benefits over explicit, legal compensation. Moreover, large bribes makes corruption more visible and easier to detect.

The problem with China's current managerial incentive system is that it either provides too little personal incentive to managers or it tends to give incentives biased toward short-term accounting profits. Managerial incentive contracts in the form of equity participation or stock options would provide managers with adequate incentives to improve the firms' long-term profitability. Stock options, however, can be an effective incentive device only when stocks are or will be tradable and when stock prices reflect the firms' long-term performances. This, of course, depends on the development of a well-functioning stock market.

But incentive pay, by itself, may not be enough to deter excessive on-the-job consumption, misuse of company funds, or outright embezzlement. Monitoring is often necessary to prevent the misuse of company funds and overt or disguised managerial theft. In China, government agencies are supposed to be the monitors of enterprise managers. But the question now becomes: who monitors the monitors? After all, government officials themselves are not the owners of the state enterprises although they exercise control rights that are similar to those of owners. The absence of an effective monitoring system is at the root of China's serious corruption problem. In a typical market economy, a company either has a virtually unified structure of ownership and management, or, when the two are separated, shareholders have the rights to vote for the board of directors which, in turn, has the rights and obligations to monitor the management in the shareholders' interest. More importantly, in even the largest corporations, there are normally shareholders that hold significant ownership stakes. These large shareholders then have the incentive and ability to exercise effective control rights and monitor the management.

Some economists proposed that the State Asset Management Agencies (or Holding Companies) or state-owned banks should assume the role of large shareholders. But unless the new monitors are given adequate incentives, the outcome would not be very different. In addition, the control rights would become too concentrated. When one government agency controls a large number of enterprises, the effectiveness of monitoring is doubtful. Moreover, this may create incentives for the new agencies to adopt anti-competition measures. One alternative is for private financial intermediaries to take up the role of large stakeholders. Chinese households already have enough bank deposits to buy a significant portion of the state equity. By encouraging the formation of large private financial intermediaries such as mutual funds, China can channel the bulk of household savings to equity investments. But financial intermediaries may have their own governance problems, especially in a country that does not possess an adequate financial market and legal system.

The threat of bankruptcy due to poor performance is another disciplinary mechanism. China, however, has been reluctant to use this mechanism out of the fear for massive unemployment and social instability. But in recent years, many enterprises have been rushing to declare bankruptcy as it is the cheapest way to get rid of their debt obligations. As a consequence, the Chinese government has recently encouraged mergers and acquisitions of hopeless money losers by profit-making companies. Such administrative maneuvering may only transfer the burden from the state to those well-performing enterprises but not solve the fundamental problem.

Some Western economists believe that corporate takeovers through mergers and acquisitions are a powerful force in corporate governance because poorly performing managers are generally replaced after the takeover (Jensen, 1986). This imposes a tremendous pressure on those managers who are incompetent but refuse to step down and those who are busy promoting their own self-interest. In China, takeovers administered by the government are not motivated by the logic of corporate governance. The absence of a well-functioning capital market in transitional economies will also limit the effectiveness of corporate takeovers as a viable mechanism for China in the near term.

There are two factors other than unemployment that limit the use of bankruptcy as a governance mechanism in China. First, the Chinese legal system is weak and debtholders' interests are not very well protected. As a result, bankruptcy is often used by some companies as a way to avoid paying back their debts. Moreover, most debt obligations are in the form of loans from state banks. Under the current system, state banks do not have enough incentives to make good loans and, after default, do not make enough effort to recover the debt. Therefore, debt payment becomes a soft budget constraint rather than a hard budget constraint as in a typical market economy.

Second, Chinese enterprises have an unusually high debt-to-equity ratio (see Table 6). A high leverage ratio makes it difficult for firms to borrow money even if there are good investment projects. And if they can borrow, too much debt may encourage them to pursue highly risky projects (Jensen and Meckling, 1976). A more serious problem is that, when debt is virtually the only source of financing, firms become extremely vulnerable to default. In other words, default tends to be more a result of economic fluctuation rather than of poor performances by enterprise managers. In such situations, bankruptcy would be very inefficient. This, we believe, is the root cause of the debt crisis in China. Unless China reforms its current one-dimensional corporate finance system, all other measures such as clearing bad debts by the administration, bankruptcy and mergers will not prevent the problem from recurring.

Corporate Governance and the Supporting Institutions

The corporate governance structure is the key to solve the agency problem when ownership and control are separated. But all the governance mechanisms need to be supported by an effective legal system and a well-functioning financial market. Managerial stock options require stock prices to reflect firms' true performance. An excessively speculative market will not serve this purpose. Moreover, managers' legal compensation from their hard work should be protected while managerial corruption must be punished. Measures need to be taken to encourage the formation of large private shareholders. In particular, the state monopoly in banking and other financial sectors must be abolished, and non-state financial intermediaries should play an important role in blockholding. This requires the government to devote sufficient financial and human resources to expand and deepen China's financial market. In the mean time, an effective legal and regulatory system needs to be developed hand-in-hand with the financial market. In particular, the self-dealing activities by large shareholders to infringe upon small shareholders' interests or to manipulate the market should be prohibited and violations should be effectively prosecuted.

The governance function of bankruptcy requires that, on the one hand, debt payment and the transfer of control rights upon bankruptcy be strictly enforced by law, and, on the other hand, firms need to have more choices in the means of financing. If non-bank financial intermediaries are allowed to develop and to take large equity stakes in the firms, then a large portion of corporate finance will be transferred from bank loans to equity holdings. Consequently, the current high debt-to-capital ratio will be reduced to a more appropriate level.

4. What Should be Done?

We have argued that two major factors have contributed to the crisis of China's loss-making state sector. One is the agency problem; the other is the enormous social welfare burden. A successful reform should be able to address these two problems. The agency problem may be easy to solve for smaller SOEs if they are sold off to private owners or foreigners. For other larger enterprises in which the state or other government organizations will continue to hold significant stakes and other investors are small, the problem can get worse if an effective corporate governance structure is not established. In any case, the shareholding reform will invariably lead to massive unemployment, which is already occurring. Reports have indicated that millions of state-employed workers have been or will be laid off in 1998. Numerous small-scale protests have occurred and more will be expected as the reform deepens. If this problem is not dealt with properly, social stability and the reform itself will be jeopardized.

<u>Building Market-Oriented Institutions</u>

As we pointed out earlier, the creation of a new corporate governance structure is the key to China's enterprise reform, and that, in turn, requires the development of a well-functioning financial market and a sound legal system. However, no governance structure is universally applicable. It is difficult either to prescribe or to predict what type of governance structure will emerge in China in the long run (see Qian, 1995). But in all countries that have relatively effective corporate governance structures, functioning financial markets and relatively sound and effective legal systems have been developed. For China, therefore, the most important problem is not to find a fixed set of governance models from which to copy, but to establish and to enforce some basic rules of the market game.

Some authors have emphasized the important role that nonstandard (or informal) institutions have played in China's economic growth in the past two decades. But even Oliver Williamson (1994), a persuasive critic of legal centralism, considers it important to have good laws and a strong judiciary in the background for any system of private ordering to work. Not having them limits how far one can push a private ordering regime. He believes that the lack of a sound legal system as an ultimate appeal mechanism was probably a weakness in China.

Institutions take time to build. The rush to mass corporatization or any big bang style reform may not solve the real problems. The performance of the state sector is not so bad as to warrant an urgent solution. To the contrary, such a rush may destabilize the economy and cause social unrest. It is not to say that the Chinese government does not need to do anything with the state sector before a well-functioning financial market and an effective legal institution are in place.

The development of market institutions needs participation of market players. The point we are trying to establish is that institution building should go hand-in-hand with corporatization. The pace of reform should be gradual and in accordance with the development of the financial market and legal systems. Past successful reforms, such as the agricultural reform and the development of township-village enterprises, have often been initiated from the bottom. A corporatization drive through command is likely to change the form but not the substance.

Although institutions take time to grow, investment in institution building can speed up the process. It is, therefore, better for the Chinese government to spend more money and exert more effort on developing the country's financial market and legal systems than on injecting more capital into state enterprises or, say, building more airports.

Making Transition a Pareto Improvement

One immediate consequence of the new reform initiative has been the mass layoff. In the past, the government was reluctant to push the state sector reform forward because of the difficulty of dealing with the unemployment problem. The government now appears to be determined to take the risk. However, laying off workers will not necessarily improve the efficiency of the state sector. For example, a loss-making textile firm can become profitable without doing anything other than laying off its redundant workers. But this is achieved only at the expense of the laid-off workers. The size of the pie may not have increased; it is only redistributed. As a consequence, the management of the now-profitable firm would feel less inclined to do anything extra while the laid-off workers would feel disgruntled and would very possibly cause serious social problems.

To be sure, laying off redundant workers would put the accounting costs more in line with the real economic costs and hence improve the efficiency of decision-making at the firm level. In addition, if the laid-off workers can find new jobs, then the size of the pie would increase. In most cases, however, the laid-off workers would be made worse off if they were not at least partly compensated. If the transition can increase the size of the pie, then, in principle, those who are made worse off in the transition can be compensated. If they are not, they would have strong incentives to resist the change or to express their dissatisfaction in a socially destabilizing fashion after the change.

In reality, making transition a strict Pareto improvement is not possible. But in order for an efficient reform measure to be carried out smoothly, certain degree of compensation is necessary. An operational question is how to make the welfare compensation and who should contribute to the compensation fund. The Chinese government does not seem to have a working approach to the problem. It currently appears to be asking the local governments, who themselves may not have a working approach either, to shoulder the major portion of the burden. Local governments, however, neither enjoy the full benefits of making the compensation nor bear the full social costs of an inadequate compensation. Therefore, it would be more efficient for the central government to assume the task of welfare compensation in the transition process. In other words, a centralized social welfare system should be established. However, before such a system can be established, the government may have to pay a significant social and political cost for the mass layoff if it is to press ahead with the corporatization campaign.

The fund for compensation should, in theory, come from those who are made better off by the transition. One way to do this is to increase both corporate and income taxes. In fact, China does not even have to raise the tax rate. What may be needed is stricter enforcement of the existing tax system. Although the Chinese economy has been growing at a double digit rate, the share of the state revenue has been declining in the course from 25.67% in 1980 to 10.71% in 1995 (see Table 2). One reason is the deliberate decentralization efforts in the past. The other is the widely-acknowledged problem of tax evasion due to lax tax collection.

A centralized redistribution system, of course, has its cost. One cost is the reduced incentives due to tax increases. The other is the possible corruption in and the abuse of the system. Some of the costs are inevitable while some can be mitigated by an improved anti-graft system. Therefore, an effective anti-graft system is necessary to solve both the agency problem and the compensation problem.

Short-Term Policies

Given that well-functioning financial markets and legal systems take time to develop, many mechanisms such as large shareholdership, the market for corporate control and bankruptcy will not be able to play significant roles in corporate governance. We believe that giving managers substantial incentives can be a useful short-term mechanism. As we pointed out earlier, state enterprise managers are currently given too few explicit, personal incentives. This makes corruption both inevitable and acceptable. If they are going to get what they want anyway, then why not give it to them in a legal and much more efficient way? To prevent short-term behavior, stock options should be used as much as possible. Managers would then have incentives to think in the long-term so that they would benefit from when the firms one day go public.

Carrots alone are not enough unless used together with sticks. No incentive system will work if business and bureaucracy lack a minimum degree of honesty and cleanness. Corruption is eating a big piece of the pie. If it can be contained to a reasonable degree, a lot of the losses in the state sector would be recovered. China's current anti-graft policies have serious loopholes. People are still not convinced that the government is committed at this time. It seems that only the unlucky ones or the small fish will be caught. The organizational structure is also ill-devised for the task. We do not have space to elaborate on this point here. But it is quite clear that China needs an independent, centralized anti-graft institution. On the other hand, anti-graft will work only if it is combined with positive rewards. If the Chinese government is really serious about fighting corruption, then, without positive rewards, what are the incentives for the cadres and managers to serve in the interests of their masters?

Another implication of our analysis is that the reform of small to medium-sized enterprises should proceed ahead of larger enterprises. This is because the separation of ownership and control and hence the resulting agency problem is likely to be much more modest for smaller enterprises. Moreover, the corporate governance of these enterprises would rely less on the capital market. In fact, China's small-sized township and village enterprises (TVEs) have been the driving force of the past economic growth. China should continue to encourage their development and restructuring and should consider the TVEs as an important force in creating employment opportunities for workers laid off from the state enterprises.

Cheap Talk versus Real Actions

If one closely follows the official news, it seems that the Chinese government is more or less aware of the problems we have addressed and is moving in the right direction. The government has held many national meetings on financial reform, anti-corruption and law enforcement. The government's work report to the Ninth National People's Congress has identified all the major problems with the Chinese economy, and the government has vowed to take measures to solve the problems. But unless concrete measures are specified and implemented, all discussions and reports may become cheap talk. In fact, it has become the norm that after the government declares that a certain year is the most important year for the reform or a certain reform is the most crucial task for the nation, few substantial measures would follow and, in the end, little would be achieved. The government should realize that institution building takes more than meetings and documents. It takes real resources and effort. Market-oriented institutions as the intangible infrastructure for the market economy needs investment just as physical infrastructure does. Resources invested in institution building will be well spent.

5. Conclusion

In this paper, we have argued that the shareholding reform is unlikely to rescue China's state sector in the near term. The success of enterprise reform depends on the development of market-oriented institutions, especially financial markets, a social welfare system and legal institutions. However, the development of these institutions cannot be completed in a big-bang fashion. Therefore, mass corporatization may not succeed for the lack of an institutional foundation. On the other hand, the process of institution-building can be speeded up if sufficient resources and effort are devoted to the task. This is, of course, not an easy task and the rewards may not be seen in the short term. But, it will be the most rewarding task for China to sustain its long-term growth. Any reform plan that neglects this key element may end in failure.

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Table 1. State Revenue as Percentage of GDP and
State Sector's Share of Tax Revenue

Year	Government Revenue as Percentage of GDP	State Sector's Share of Government Revenue
1980	25.67	86.84
1985	22.36	77.63
1989	15.76	70.44
1990	15.84	71.33
1991	14.57	71.31
1992	13.08	71.28
1993	12.56	71.64
1994	11.19	71.43
1995	10.71	71.15

Data Source: Calculated from *China Statistical Yearbook, 1997.*

Table 2. The State Sector in the National Economy (1996)

Categories	*Share of the State Sector(%)*
Employment	16.3
Employment in Urban Areas	56.7
Number of Staff and Workers	73.6
State Revenue	71.1*
Investment in fixed assets	52.5
Gross Industrial Output	28.5
Industrial Value Added	48.5
Gross Construction Output	35.9
Total Wholesale and Retail Value	63.9
Total Assets of Industrial Enterprises	58.6
Total Profits of Industrial Enterprises	27.7
Total Tax Paid by Industrial Enterprises	63.5

* Figure for 1995.

Data Source: Calculated from *China Statistical Yearbook*, 1997.

Table 3. The Ever-Declining Profit Margin:
State-Owned versus Non-State Industrial Enterprises
(Measured by the Ratio of Pre-Tax Profits to Total Fixed Assets)

Year	*All Industrial Enterprises*	*State-Owned Industrial Enterprises*	*Non-State Industrial Enterprises*
1985	23.92	22.40	33.30
1990	13.52	12.90	22.26
1995	11.23	9.29	15.48
1996	9.89	7.87	13.96

Data Source: Calculated from *China Statistical Yearbook*, 1997.

Table 4. The Loss-Making State Sector in Comparison with Non-state Sectors

Enterprise Type	Share of Gross Industrial Output (%)	Percentage of Loss-Making Enterprises (%)
TOTAL	**100.00**	**25.1**
State-owned	47.12	33.8
Large	28.95	28.2
Medium	9.65	34.9
Small	8.52	33.9
Collective Owned	28.83	21.1
County Level	4.99	31.8
Township Level	17.45	15.9
Private	0.27	16.7
Joint Owned	1.19	28.8
Shareholding	4.96	21.7
Sino-Foreign Joint Venture*	14.28	39.8
Wholly Foreign Owned*	3.21	43.8
Others	0.14	24.9

* The figure includes joint ventures with or firms wholly owned by investors from Hong Kong, Macau and Taiwan.

Data Source: *The Data of the Third National Industrial Census of the People's Republic of China in 1995*.

Table 5. The Performance of the State versus Non-State Industrial Enterprises at or above the Township Level

Enterprise Type	Ratio of Total Tax to Pre-Tax Profits	Ratio of Net Profits to Equity	Ratio of Pretax Profits to Equity	Ratio of the Sum of Total Wages, Pension and Pretax Profits to Equity
TOTAL	**0.68**	**0.041**	**0.184**	**0.370**
State-owned	0.77	0.022	0.177	0.367
Large	0.68	0.043	0.202	0.357
Medium	1.05	-0.021	0.145	0.402
Small	1.19	-0.029	0.092	0.372
Collective Owned	0.64	0.063	0.255	0.570
County Level	0.90	-0.003	0.159	0.460
Township Level	0.54	0.114	0.330	0.612
Private	0.34	0.216	0.372	0.526
Joint Owned	0.67	0.041	0.178	0.371
Shareholding	0.45	0.082	0.186	0.289
Sino-Foreign Joint Venture	0.48	0.074	0.170	0.248
Wholly Foreign Owned	0.35	0.062	0.102	0.223
Mainland-HK-Macau-Taiwan Joint-Venture	0.51	0.061	0.140	0.255
HK-Macau-Taiwan Wholly Owned	0.49	0.030	0.065	0.198
Others	0.43	0.062	0.135	0.242

Data Source: *The Data of the Third National Industrial Census of the People's Republic of China in 1995*

Table 6. The Leverage Status of State-Owned and Collective Industrial Enterprises at or above the Township Level

Enterprise Type	Total Assets (billion yuan)	Total Debt (billion yuan)	Total Equity (billion yuan)	Debt-to-Equity Ratio	Total Interest Payment	Ratio of Interest Payment to Total Debt
TOTAL	7,923.4	5,175.1	2,748.3	1.88		
State-owned	4,747.2	3,124.2	1,623.0	1.92	126.51	0.0405
Large	2,989.6	1,863.8	1,125.8	1.66	71.64	0.0384
Medium	945.1	678.8	266.2	2.55	30.41	0.0448
Small	812.6	581.6	231.0	2.52	24.46	0.0421
Collective Owned	1,436.0	1,029.2	406.9	2.53	54.59	0.0530
County-level	327.8	247.5	80.3	3.08	11.89	0.0480
Township-level	703.2	492.3	210.9	2.33	30.91	0.0628

Data Source: *The Data of the Third National Industrial Census in 1995.*

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