

# Property Rights and Managerial Incentives within a Rural Chinese Shareholding Cooperative Enterprise\*

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*The recent rapid transformation of rural collective enterprises into shareholding cooperative enterprises (SCEs) in China has received increasing academic attention. However, there is little analysis on the exact impact of the shareholding reform upon managerial behavior in the newly created SCEs, and upon the capacity of local governments to coordinate an increasingly privatized local economy. This paper aims to address these issues through a case study of a shareholding cooperative enterprise in rural Zhejiang. The paper demonstrates that the introduction of the shareholding system has effectively improved managerial incentives for economic profitability with the emergence of a capital-owning entrepreneurial stratum. Improved economic performance in the case study enterprise and other SCEs has not been accompanied by significant expansion of these enterprises, however, due to the more cautious behavior of shareholder-managers in an increasingly competitive market. Hence, a new dilemma faced by local governments is how to maintain an administratively set high rate of economic growth in the face of the gradual privatization of the local economy. Due to the lack of attention paid by local governments to the*

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*proper operation of the governance structures of the shareholding system, moreover, problems of government intervention and opportunistic behavior of managers are still rampant in the SCEs.*

**KEYWORDS:** property rights; shareholding reforms; local governments; privatization; Zhejiang

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One of the most significant developments in China's rural economy since the early 1990s has been the rapid transformation of the ownership system in the township and village enterprises (TVEs, 鄉鎮企業). Starting from the early 1990s, property rights reform has stayed at the top of the agendas of various local governments seeking to develop the TVE sector further. The most significant part of the reform has been the widespread transformation of TVEs into shareholding cooperative enterprises (SCEs, *gufen hezuo qiye* 股份合作企業), whereby a large part of the assets of enterprises has been either sold or allocated to the managers and other employees of the enterprises, who together with local governments have become the shareholders of the enterprises.<sup>1</sup> The reform is intended to provide ownership incentives for enterprise managers and employees to optimize the economic return on capital and to separate local governments from enterprise operations.<sup>2</sup> By the end of 1993, 133,000 rural collective enterprises, accounting for 8.9 percent of such enterprises, became SCEs.<sup>3</sup>

<sup>1</sup>For general descriptions of the development of SCEs in China, see Ricky Tung, "The Development of Rural Shareholding Cooperative Enterprises in Mainland China," *Issues & Studies* 30, no. 5 (May 1994): 1-31; and Eduard B. Vermeer, "Shareholding Cooperatives: A Property Rights Analysis," in *Property Rights and Economic Reform in China*, ed. Jean C. Oi and Andrew G. Walder (Stanford, Calif.: Stanford University Press, 1999), 123-44. There has been extensive Chinese literature on this subject since the early 1990s. See, for example, Han Jun and Zhang Qingzhong, eds., *Zhongguo nongcun gufen hezuo jingji: Lilun, shijian, zhengce* (The rural shareholding cooperative economy in China: Theory, practice, and policy) (Beijing: Jingji guanli chubanshe, 1993); and Li Yining and Wang Liyan, eds., *Xiangzhen qiye gufenzhi: Zujian yu yunxing* (The shareholding system in TVEs: Formations and operations) (Beijing: Zhongguo renmin daxue chubanshe, 1994).

<sup>2</sup>Ministry of Agriculture (MOA), "Circular on Implementing and Improving the Shareholding Cooperative System in the TVEs" (MOA Document no. 24, December 1992), in *Gufen hezuozhi shiwu shouce* (A practical manual of the shareholding cooperative system), ed. Zhejiang Provincial Commission for Economic Restructuring (Hangzhou: 1993), 63-68.

<sup>3</sup>Eduard B. Vermeer, "Experiments with Rural Industrial Shareholding Cooperatives: The

The reform further gained momentum after the Chinese Communist Party's (CCP's) Fifteenth National Congress in 1997 and was promoted nationwide. By the end of the 1990s, even in areas that were traditionally the heartlands of collective enterprises, such as Jiangsu province (江蘇省), sweeping transformations of the ownership systems in their TVE sector have been carried out.<sup>4</sup>

The dramatic transformation of the TVEs into SCEs in China has received increasing academic attention. There are different views of the origins and nature of the reform process. Scholars have generally observed, however, that the reform has given rise to a stratum of shareholder-managers who have acquired substantial ownership rights over enterprise assets. This development is viewed as a direct result of either the growing power of local entrepreneurial elites, or the intentions of local governments to revitalize the financially troubled TVE sector in the increasingly competitive market environment of the 1990s. For example, Nan Lin and Xiaolan Ye found that "the shareholding system has become an important means by which *the local elites have wrested the control of collective assets from the public sector*."<sup>5</sup> This led to transference of ownership rights from local governments to corporate leaders in enterprises. Moreover, Nan Lin and Xiaolan Ye speculated that such efforts by local elites have been tacitly encouraged by the national leaders, who intend to "*privatize the economy and transfer the property rights into private hands* without using label and terminology of privatization" through deliberately vague policy.<sup>6</sup> Using a "manager empowerment thesis," Ray Yep has similarly argued that the increase in enterprise managers' bargaining power has been a crucial deter-

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Case of Zhoucun District, Shandong Province," *China Information* 10, nos. 3/4 (Winter 1995/Spring 1996): 77.

<sup>4</sup>Fang Conglai et al., "Studies of the Patterns of Property Rights Reform and Share Structure in the TVE Sector," *Jingji yanjiu* (Economic Research), January 2001, no. 1:62-68.

<sup>5</sup>Nan Lin and Xiaolan Ye, "Chinese Rural Enterprises in Transformation: The End of the Beginning," *Issues & Studies* 34, no. 11/12 (November/December 1998): 25; original emphasis. Also see Nan Lin and Chih-Jou Jay Chen, "Local Elites as Officials and Owners: Shareholding and Property Rights in Daqiu Zhuang," in Oi and Walder, *Property Rights and Economic Reform in China*, 145-70.

<sup>6</sup>Lin and Ye, "Chinese Rural Enterprises in Transformation," 26; original emphasis.

minant of the outcome of the reform. In his study of Zibo city in Shandong province (山東省淄博市), Yep found that enterprise managers were the major winner of the reform process and normally became the dominant shareholders in the reformed enterprises.<sup>7</sup> Other scholars have made similar observations on the outcome of the reform, but have identified different dynamics driving the reform process. Emphasizing the active role of local governments in promoting the shareholding reform, these scholars have viewed the reform as an adaptive response of local governments to the increasing market competition and the growing scale of local economies in the 1990s that resulted in reduced profit margins and greater difficulty in controlling managerial shirking and malfeasance in the TVEs.<sup>8</sup> To revitalize the TVE sector and maintain economic growth in an increasingly competitive market, local governments opted to provide greater incentives for responsible enterprise management and to manage agency problems by making the managers shareholders.

Common to all these studies is a focus on how the property rights were reallocated and the consequent emergence of the shareholder-manager in the TVE sector. These studies, however, have paid relatively little attention to the impact of the reallocation of property rights on managerial behavior, enterprise operation, and government-enterprise relations in the newly created SCEs.<sup>9</sup> Thus it is unclear as to what extent the shareholder-managers in the SCEs now exhibit different managerial behavior compared

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<sup>7</sup>Ray Yep, "The Evolution of Shareholding Enterprise Reform in Rural China: A Manager Empowerment Thesis," *Pacific Affairs* 74, no. 1 (Spring 2001): 53-73.

<sup>8</sup>Laixiang Sun, "Anticipatory Ownership Reform Driven by Competition: China's Township-Village and Private Enterprises in the 1990s," *Comparative Economic Studies* 42, no. 3 (Fall 2000): 49-75; Jean C. Oi, "The Evolution of Local State Corporatism," in *Zouping in Transition: The Process of Reform in Rural North China*, ed. Andrew G. Walder (Cambridge, Mass.: Harvard University Press, 1998), 35-61; James Kai-sing Kung, "The Evolution of Property Rights in Village Enterprises: The Case of Wuxi County," in Oi and Walder, *Property Rights and Economic Reform in China*, 95-122; Susan H. Whiting, "The Regional Evolution of Ownership Forms: Shareholding Cooperatives and Rural Industry in Shanghai and Wenzhou," *ibid.*, 171-202; Hongyi Chen, *The Institutional Transition of China's Township and Village Enterprises: Market Liberalisation, Contractual Form Innovation and Privatisation* (Aldershot: Ashgate, 2000); and Shiaw-Chian Fong, "The Shareholding System in a Shandong Township: Practice and Impact," *Issues & Studies* 35, no. 4 (July/August 1999): 33-54.

<sup>9</sup>A notable exception is Kung, "The Evolution of Property Rights in Village Enterprises."

to that shown under collective ownership. What are the relationships among the managers, local governments, and employees in the SCEs? How has the reform affected the capacity of local governments to coordinate an increasingly privatized economy? Most importantly, have the shareholding reforms brought about desired managerial behavior, improved economic performance, and rationalized government-enterprise relations as originally intended by government policymakers?

This paper aims to address some of these questions through a case study of a shareholding cooperative enterprise in a suburban District X in Zhejiang (浙江), a province that pioneered the shareholding reform in the TVE sector in the early 1990s.<sup>10</sup> The enterprise, HS Company, was formerly a town-owned enterprise and was transformed into a shareholding cooperative enterprise in 1994. Between 1992 and 1996, the author visited the enterprise three times and conducted extensive interviews with the enterprise management and local officials. The first visit occurred in July 1992 when the enterprise was run as a town-owned enterprise, and the second in June 1994, just after the enterprise was transformed into a shareholding cooperative enterprise. In June 1996, two years after the enterprise adopted the shareholding system, the author visited the enterprise again. These separate visits over a period of a few years enabled the author to identify and assess the real impact of the shareholding reform upon the enterprise operations. Utilizing the data and interviews derived from these visits, the paper reports some initial findings on the impacts of the shareholding reform upon managerial behavior, enterprise-government relationships, and the local economy in the 1990s.

However, the author wants to make clear at the very start that the case of HS is by no means a showcase of the SCEs in rural China and not all findings reported in this paper can be extrapolated to generalize the overall trend in the TVE sector. This is firstly because of the great variation in the

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<sup>10</sup> As early as the mid-1980s, SCEs formed on the basis of the private business started to develop in Wenzhou city of Zhejiang. Wenzhou promulgated the first local regulations on SCEs in 1988. As discussed in the next section, since the early 1990s the provincial government of Zhejiang has actively advocated the development of SCEs among the rural collective enterprises. On the development of SCEs in Wenzhou, see Whiting, "The Regional Evolution of Ownership Forms."

practice of shareholding cooperative systems in different parts of China. Moreover, up to now, there has been no single definition of the SCE in China, and in practice the term "SCE" is often used to refer to many different types of shareholding enterprises. Some scholars make a distinction between the shareholding system and the shareholding cooperative system practiced in the TVE sector. For example, in his study of the shareholding reform in a Shandong township, Shiaw-Chian Fong suggests that while the shareholding system is conducive to the transformation of collective assets into the pocket of the managerial stratum, the shareholding cooperative system has mainly served as a mean of raising capital for TVEs and has nothing to do with privatization.<sup>11</sup> However, the shareholding cooperative system in the HS Company reported in this paper has more in common with the shareholding system than the shareholding cooperative system described in his studies. Because of this, and given that the primary intention of this paper is to illustrate how acquisition of the ownership of enterprise assets might impact managerial incentives and behavior and government-enterprise relations, the terms "shareholding system" and "shareholding cooperative system" are used interchangeably.

The paper demonstrates that the introduction of the shareholding system in HS has effectively provided shareholder-managers with greater incentives to commit themselves to the profitability of their enterprises. The shareholding reform in HS resulted in a number of innovative activities of the HS management in enterprise operations and significantly improved the performance of the enterprise. However, an ironic finding of the paper is that contrary to the expectation of local governments, improved managerial incentives in HS did not lead to significant expansion of the enterprise. Instead, investment behavior of the HS management became very cautious particularly in the harsh macroeconomic environment of the mid-1990s.

The paper hence identifies that the HS managers developed a different interest from local officials on enterprise development as the result of the reform: while local officials still sought to maintain high growth rates, shareholder-managers began to be concerned more with the return on in-

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<sup>11</sup>Fong, "The Shareholding System in a Shandong Township," 45-46.

vestments. Consequently, a dilemma faced by local governments is how to maintain a high rate of economic growth in the face of the privatization, albeit partial, of the rural collective enterprises. The paper also finds a difference in the opinions over and assessments of the effectiveness of the shareholding reforms among enterprise management and local governments; while HS managers were highly appreciative of the improved managerial incentives and autonomy under the shareholding system, local officials were disappointed with the effectiveness of the property rights reform on the further expansion of the local economy. Hence, in the second half of the 1990s, local governments in District X switched to a different strategy for local economic development by promoting the development of enterprise conglomerates (*qiye jituan* 企業集團). This changing attitude of local governments to the property rights reform, however, left the shareholding reform as a halfway house.

In regard to the government-enterprise relationships, the shareholding reform in HS also led to increased autonomy on the part of the management in enterprise operations. Yet, the paper shows that a genuine separation of local governments and the enterprise was far from realized. The capability of the management in HS to resist local government intervention in the operations of the enterprise is still poorly institutionalized and is not guaranteed. While the governance structures of the shareholding system such as board of directors have been established, they are poorly operated. To a certain extent, the autonomy of SCEs is dependent upon the goodwill of local governments to provide greater managerial incentives. Consequently, despite significant privatization, local governments have still been able to intervene in the operations of the SCE if they so desire. Moreover, agency problems and the opportunistic behavior of enterprise managers still exist in the HS and other local SCEs.

The paper begins with an overview of the property rights reform in District X, focusing on the incentives of local governments in promoting the reform and the ways local regulations were stipulated. The second section presents in detail the transformation process of the HS Company. This is followed by an examination of the impact of the reform on managerial incentives and behavior, enterprise performance, and government-business relationships.



## Property Rights Reform in District X: A Brief Background

The HS Company is located in Town G of District X in the suburb of the city of Hangzhou (杭州), the capital of Zhejiang province. The district has jurisdiction over four townships, four towns, and five neighborhoods. In the post-Mao reform era, rural collectively owned industrial enterprises have developed rapidly and become the backbone of the district's economy. In 1993, rural collective enterprises produced over 96 percent of the industrial output in the district.<sup>12</sup> Town G is the most economically developed town in District X. In 1988, Town G was also one of the "one hundred national star towns and townships" in China based on its well-developed rural collective enterprises.

Systematic property rights reform in the TVE sector began in District X in late 1993 when the provincial government of Zhejiang began to actively promote reform. Since early 1993, intending to use the reform of property rights of TVEs as a critical measure to further revitalize Zhejiang's economy,<sup>13</sup> the provincial government has vigorously advocated the development of SCEs in the rural collective sector. In April 1993, the provincial government of Zhejiang issued a directive which requested its lower-level local governments to implement the shareholding cooperative system in TVEs, and called for significant progress in the development of the SCEs within two to three years.<sup>14</sup> In early 1994, Wan Xueyuan (萬學遠), the governor of Zhejiang, announced that property rights reform would be the core of provincial reform during that year.<sup>15</sup> By the end of 1995, 32,800 of Zhejiang's 75,900 rural collective enterprises had undergone reform.<sup>16</sup>

<sup>12</sup>*X-qu jingji tongji nianjian 1994* (District X economic statistical yearbook, 1994), 44, 98, 130.

<sup>13</sup>In 1992, 61 percent of the gross value of industrial output (GVIO) in Zhejiang was produced by local collective enterprises. Of this, 65 percent was contributed by TVEs. See *Zhejiang tongji nianjian 1993* (Zhejiang statistical yearbook 1993) (Beijing: Zhongguo tongji chubanshe, 1993), 138.

<sup>14</sup>"Tentative Opinions Regarding the Implementation of the Shareholding Cooperative System in the Township and Village Collective Enterprises" (Zhejiang Provincial Government Document no. 6, 1993), in *Gufen hezuozhi shiwu shouce*, 115-20.

<sup>15</sup>Wan Xueyuan, "Further Liberating Thought, Strengthening the Reform Measures," *Gaige yuebao* (Reform Monthly), February 1994, no. 2:6-7.

<sup>16</sup>*Ibid.*, July 1996, no. 7:49.



In District X, the district government responded actively to the call of the provincial government to carry out shareholding reform in the TVEs. In late 1993, the district was the first among the five districts in Hangzhou to conduct experiments in implementing the shareholding cooperative system in its TVEs. In that year, six selected experimental enterprises underwent transformation. From early 1994 the district government began to issue compulsory quotas to all township and neighborhood governments to transform local collective enterprises into SCEs. Moreover, since 1994, all newly established collective enterprises in the district have had to take the form of SCEs or limited liability companies. By mid-1996, 67 percent of all collective enterprises registered in the district had undergone property rights reform in one way or another.

The enthusiasm of the district government in promoting property rights reform is to a certain extent contrary to its relative conservative policies on local economic development in the past decade. Ever since the beginning of post-Mao economic reforms, the district government has made great efforts to develop rural collectively owned enterprises while strongly discouraging—if not suppressing—the development of the private economy in the district. Why did the district government so actively promote the property rights reforms through the introduction of private ownership in rural collective enterprises in the early 1990s?

The activism of the district government in property rights reform was primarily motivated by the pressure to further revitalize its TVE sector in the context of an increasingly competitive and unfavorable market. Since the late 1980s, economic performance of local TVEs in the district had deteriorated considerably. For example, from 1988 to 1992, the ratio between gross profit and total value of output of local TVEs in District X decreased from 8.74 percent to 5.46 percent.<sup>17</sup> In 1993, the ratio further decreased to 3.99 percent.<sup>18</sup> Actually, in the early 1990s, many TVEs in the district were only marginally profitable. For example, in 1992, a total of 780 local collective industrial enterprises in the district produced a combined profit of

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<sup>17</sup>*X-qu jingji tongji nianjian* 1988, 130; *X-qu jingji tongji nianjian* 1992, 35.

<sup>18</sup>*X-qu jingji tongji nianjian* 1993, 58.

57.17 million *yuan*. However, 43.1 percent of these profits were produced by the 20 key industrial enterprises. On average, the other 760 industrial enterprises only produced a gross profit of 42,816 *yuan* each, with a profit rate of 4.7 percent in 1992.<sup>19</sup> Many of these enterprises were only marginally profitable and were uncompetitive in the market.<sup>20</sup>

The financial consequence of the poor performance of the TVEs for local governments in District X was quite serious. In one instance, the district government's budgetary income from the corporate income tax of the TVEs dropped from 22.48 million *yuan* in 1989 to 8.21 million *yuan* in 1993.<sup>21</sup> However, a more serious problem was the heavy burden of bad debts. As the sole owners of their TVEs, local governments have to take complete responsibility for the losses of their enterprises. When facing a highly adverse market in the early 1990s, poorly performing enterprises became increasingly heavy financial burdens for these local governments. An official in the district government told this author that during that period almost all the township and village governments in the district were dragged into economic disputes arising from bankrupt enterprises, and those governments had to assume responsibility for the financial debts left by the enterprises.

The adverse macroeconomic environment in the early 1990s that sprung from the tight credit policy of the central government directly caused part of the problems in TVE performance. The economic austerity program in 1989-91 dealt a hard blow to the TVEs that were highly dependent on bank loans to operate. During the economic austerity period of 1989-91, the number of rural collective industrial enterprises in District X decreased from 961 to 649, with many enterprises going bankrupt.<sup>22</sup> In July 1993, the central government again launched a three-year program to

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<sup>19</sup> Author's calculation based on figures from *X-qu jingji tongji nianjian 1992*, 35, and *X-qu xiangzhen, zhishu, jiedao qiye tongji ziliao 1992* (Statistics of township/village, neighborhood, and district-owned enterprises), 1-3.

<sup>20</sup> The problem was common in Zhejiang. Estimates hold that in the early 1990s more than half of the rural collective enterprises in Zhejiang were either only marginally profitable or unprofitable. See *Gaige yuebao*, May 1994, no. 5:6.

<sup>21</sup> *X-qu jingji tongji nianjian 1989*, 4; *X-qu jingji tongji nianjian 1993*, 5.

<sup>22</sup> *X-qu jingji tongji nianjian 1989*, 85; *X-qu jingji tongji nianjian 1991*, 87.

tighten credit policy in order to fight high inflation. Harder and harder was for enterprises to collect payment of debts from other enterprises. This phenomenon, among others, reduced the efficiency of the use of capital in enterprises. For example, in District X, the yearly circulation rate of operational funds (*liudong zijin zhouzhuanlu* 流動資金週轉率) in rural industrial enterprises was on average 5.25 times in 1988, but in 1993 the rate was only 1.94.<sup>23</sup> Moreover, the TVEs have faced increasing competition from the private businesses that have developed quickly since the early 1990s, particularly after the famous tour of Deng Xiaoping (鄧小平) to south China in early 1992—a trip that removed ideological constraints on the development of the private economy.

The district government reckoned, however, that the poor performance of the TVEs had more to do with the problematic managerial incentives rooted in the collective ownership system of the TVEs. Rural enterprises owned by the township and village governments shared some fundamental problems with the traditional state-owned enterprises (SOEs) such as agency problems and excessive government intervention in enterprise operation.<sup>24</sup> Under collective ownership, enterprise managers—as self-interested agents rather than owners of the enterprises—lack adequate incentives to commit themselves to the long-term development of their enterprises. Moreover, in the absence of the risk of personal loss associated with the poor performance of the enterprises, TVE managers were not hesitant to employ various means to maximize their personal gains at the expense of their enterprises. The so-called "asset-stripping" behavior generally found in the SOEs was also rampant in the TVEs.<sup>25</sup>

Given the above factors, it is unsurprising that the district government felt the unprecedented need to reform the ownership system of the TVEs and thus embraced the shareholding cooperative system as a new incentive scheme to further revitalize the local economy. The district government

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<sup>23</sup>*X-qu jingji tongji nianjian* 1988, 130; *X-qu jingji tongji nianjian* 1993, 58-59.

<sup>24</sup>Keun Lee, "Property Rights and the Agency Problem in China's Enterprise Reform," *Cambridge Journal of Economics* 17 (June 1993): 179-94.

<sup>25</sup>X. L. Ding, "The Illicit Asset Stripping of Chinese State Firms," *The China Journal*, no. 43 (January 2000): 1-28.

hoped the transformation of TVEs into SCEs would provide an effective solution to problems in relation to managerial incentives because of the close links established under the shareholding system between individual interests and enterprise performance. By allowing managers and employees to own shares in their enterprises, the district government intended to provide clearer incentives to the enterprise managers/employees to commit themselves to the economic efficiency of their enterprises. The chief of the district's Commission for Economic Restructuring, which was responsible for designing and supervising property rights reform in local TVEs, expressed explicitly that the main purpose of the reform was to improve managerial incentives. He said: "If managers had a large amount of investment in their enterprises, they would concern themselves with the profitability of the enterprises."<sup>26</sup> Moreover, according to him, under the shareholding system, the shareholders would effectively monitor managerial behavior, and at the same time township and village governments could not intervene in the operations of the SCEs as in the past.

Local governments in District X also saw the reform as a good opportunity to reduce their responsibility for the performance of their enterprises and to spread the risk of loss among shareholders by the adoption of the shareholding system. The deputy chief of the district's Economic Commission described the above motivation of lower-level government as "casting off a burden" (*shuai baofu* 甩包袱).<sup>27</sup> Moreover, local governments generally leased and sold out those small and unprofitable enterprises that were difficult to transform into SCEs. Local officials claimed such enterprises were neither competitive in the market nor able to attract enterprise managers or employees to purchase their shares.

### **Implementing the Shareholding System in TVEs: The Case of HS**

In January 1994, the HS Company, formerly the Town G TV parts

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<sup>26</sup>Interview, June 1, 1994.

<sup>27</sup>Interview, April 30, 1994.

factory, became the first enterprise in that town to be transformed into an SCE. The enterprise was set up in late 1987 by the town government, with 50,000 *yuan* in start-up capital and a three-story workshop building that was leased by the enterprise at a nominal yearly rent of 50,000 *yuan*. The enterprise manager, Mr. Xu, is a local villager in Town G. The enterprise initially produced simple TV parts for the Hangzhou TV Sets Corporation, a state-owned enterprise. Under the technical help of the Hangzhou TV Sets Corporation, the factory later developed a number of other products and began to increase sales to other enterprises within and outside Zhejiang province. The enterprise developed rapidly in the 1980s and early 1990s. Total value of output increased from 2.8 million *yuan* in 1988 to 11 million *yuan* in 1993, an average 32 percent increase per annum. At the end of 1993, the factory had total assets of 3.5 million *yuan* that were fully owned by the town government, and a workforce of 119 employees. The enterprise was one of the twenty key enterprises in District X.

While the enterprise had once been quite profitable, earnings decreased significantly toward the end of 1993. Between 1991 and 1993, while the total value of output increased from 7 million *yuan* to 11 million *yuan*, net profits decreased, however, from 540,000 *yuan* to about 272,000 *yuan*. In 1993, only about half of the products were sold. Manager Xu ascribed the decrease in profitability to the increasing competition in the market for TV parts and the great difficulties in collecting debts from customers.<sup>28</sup>

In late 1993, when the District X government began to actively promote property rights reform in TVEs, the Town G government chose the TV parts factory as the first shareholding system experiment. This decision was based on two considerations: first, the enterprise's property rights relationship was relatively simple when compared with many other local TVEs; therefore, determining the ownership rights of the enterprise assets would be easy. Second, the enterprise management headed by Mr. Xu was quite willing to carry out shareholding reform.

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<sup>28</sup>Interviews with manager Xu and deputy manager Wu on July 18, 1992, June 24, 1994, and June 12, 1996.

To convert the enterprise into an SCE, the town government firstly made an assessment of enterprise assets and divided them into collective shares and distributed shares. Total assets were assessed as 3.5 million *yuan* that were fully owned by the town government. Among the 3.5 million *yuan* of collectively owned assets, the town government excluded the workshop building valued at 2.2 million *yuan* from the share issue and leased the building to the enterprise at a rent of 420,000 *yuan* a year. This decision was explained by Mr. Hu, the chief of the town industrial office, as aimed firstly at avoiding too large a proportion of collective shares, and secondly at enabling the town government to reap the benefit of potential increases in the value of real estate by retaining ownership over the land and property in the increasingly highly valued Hangzhou suburb.<sup>29</sup> For the rest of the 1.3 million *yuan* in assets, 200,000 *yuan* was further written off by the town government at the request of manager Xu, who argued that such assets were calculated by the town government based on a tax exemption that the enterprise did not finally receive. The remaining 1.1 million *yuan* was divided into three parts: 510,000 *yuan* (46.4 percent) became collective shares, 190,000 *yuan* (17.2 percent) was allocated to individuals as distributed shares, and 400,000 *yuan* (36.4 percent) was sold to individuals as individual shares (see table 1). All told, individuals held 53.6 percent of the total shares including their distributed shares; the town government held the other 46.4 percent.

In this enterprise, individual shareholders were comprised exclusively of managerial staff. The four managerial staff of the enterprise purchased the entire 400,000 *yuan* in individual shares. The manager of the factory, Mr. Xu, bought 200,000 *yuan* of individual shares; the deputy manager, 100,000 *yuan*; and a workshop chief and the chief of the sales division of the enterprise, 50,000 *yuan* each. The distributed shares were also exclusively proportionally distributed to these four managerial staff according to their individual shares. Manager Xu held about 26.8 percent of the total shares, including his distributed shares. None of the workers of the enterprise purchased individual shares or were allocated distributed

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<sup>29</sup>Interview with Mr. Hu, June 16, 1994.

**Table 1**  
**Share Structure of HS Company (January 1994)**

Type of Shares	Number of Shares <sup>a</sup>	% of Total Shares	Owners
<b>Total</b>	11,000	100	
Collective Shares	5,100	46.4	Town Government
Distributed Shares	1,900	17.2	HS Company
Individual Shares	4,000	36.4	Individuals
Manager Xu	2,000	18.2	
Deputy Manager Wu	1,000	9.1	
Sales Manager Chen	500	4.55	
Workshop Manager Wu	500	4.55	

<sup>a</sup>100 yuan per share.

shares. According to Ms. Wu, the deputy manager of the enterprise, this was because, first, most of the workers in the factory came from outside Town G, would eventually leave the enterprise, and thus had no interest in investing in the enterprise. Second, the performance of the enterprise became poorer toward the end of 1993, so that workers generally lacked confidence in the prospective profits of the enterprise.<sup>30</sup>

After the conversion, the enterprise was renamed the HS Electronics Shareholding Company. A board of five directors managed the enterprise. Three were from the enterprise, including manager Xu, deputy manager Wu, and the workshop chief (who was also an individual shareholder). The Town G government held the other two positions on the board. Manager Xu was the chairman of the board of directors and the general manager of the enterprise.

The distribution of shares in HS clearly indicates that in the process of the transformation of property rights, local governments gave high priority to the improvement of managerial incentives for economic efficiency and profitability. The eagerness of the Town G government to revitalize the management of enterprises led it to accept low estimates of

<sup>30</sup>Interview, June 24, 1994.



enterprise assets, as exemplified by the writing off of the 200,000 *yuan* in HS assets. Actually, according to the deputy chief of District X's Economic Commission, the enterprise's assets were significantly undervalued in the transformation process in several aspects. For example, an electricity transformer in HS was assessed at 50,000 *yuan*, less than 10 percent of its market value.<sup>31</sup> He also indicated that the rent set by the town government for the workshop building in HS was at least 30 percent lower than the market price. Indeed, according to him, in the transformation process in District X, underestimation became the norm to a certain extent. For example, noncollectable debts of enterprises were normally excluded from the calculation of enterprise assets. When an enterprise later collected back such money, it went into the pockets of the enterprise managers.<sup>32</sup> Moreover, invisible assets such as intellectual property rights have usually been excluded from the assessment of assets because they are hard to value.<sup>33</sup>

### Assessing Property Rights Reform in HS

#### *Improved Managerial Incentives in HS*

As discussed earlier, one of the primary motivations of local governments in promoting the transformation of TVEs into SCEs has been to offer greater incentives to enterprise managers to seek profitability in their operations in the context of an increasingly competitive market. This author's interviews with local officials and SCE managers indicate that transformations into SCEs have worked to improve the incentives of managers to pur-

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<sup>31</sup>Interview, April 30, 1994.

<sup>32</sup>In 1992, the total noncollectable debts of HS amounted to around 2 million *yuan* due to the nationwide problem of "triangle debts" (*sanjiu zhai* 三角債). These noncollectable debts were all excluded from the enterprise's assets during the property rights reform.

<sup>33</sup>HS is, however, not a unique case. Other studies showed similar features in the process of evaluation and distribution of enterprise assets elsewhere in China. On the quite common occurrence of the undervaluation of enterprise assets during the shareholding reform, for example, see Vermeer, "Shareholding Cooperatives: A Property Rights Analysis," 132-36. Likewise, Yep argued that "local government may deliberately choose to keep the asset value at a low level in order to facilitate managers' purchase." See Yep, "The Evolution of Shareholding Enterprise Reform in Rural China," 64-65.

sue economic efficiency. The reform of the ownership system of collective enterprises gives rise to the emergence of capital-owning managers, who are mostly the majority individual shareholders in the SCEs. The acquisition of property rights over the assets of their enterprises has significantly changed the motivation and behavior of enterprise managers. As the majority individual shareholders of enterprises, managers have interests that are closely connected with the profitability and development of their enterprises.

As mentioned above, before the transformation, HS Company's profit decreased significantly between 1991 and 1993. As soon as the enterprise was transformed into an SCE, whereupon all four managers held large amounts of individual shares, the management in HS carried out significant reform in the management and operations of the enterprise in order to raise profitability. An example is illustrative. The workshop of HS was a three-story building rented from the Town G government. After the transformation, the Town G government increased the rent from 50,000 *yuan* to 420,000 *yuan* a year. Under these circumstances, manager Xu thought that HS did not need such a big workshop. Therefore, he reorganized the product lines into one floor of the workshop and leased out the other two levels at a rent of 380,000 *yuan* a year. The company also rented access to its electricity transformer to another enterprise for 170,000 *yuan* a year.

The management has also budgeted expenditure in HS more cautiously. The enterprise once had a canteen to provide subsidized lunches for its employees and to treat relevant business guests and local cadres visiting the enterprise. While HS employees paid only 15 *yuan* a month for their lunches, the enterprise spent at least 2,000 *yuan* a month on the salaries of the canteen staff members alone. Moreover, every month, the enterprise used to spend about 10,000 *yuan* to wine and dine local cadres and business guests. That expenditure alone was equivalent to almost half of the company's profits in 1993. Shortly after the enterprise's transformation into an SCE, the company closed the canteen. Instead, the enterprise provided a monthly lunch subsidy of 30 *yuan* to all employees, and asked a local fast food company to supply boxed fast food for the employees. With the closing down of the canteen, fewer local cadres came to the enterprise to discuss work at lunchtimes; when they did come, the enterprise provided

fast food for them.<sup>34</sup> The closure of the canteen and other adjustments in the enterprise also resulted in a dismissal of fifteen employees.

The enterprise also tightened its expenditure in many other aspects. According to deputy manager Wu, the enterprise's efforts to reduce production costs through buying cheaper raw materials saved HS around 390,000 *yuan* in 1994. Expenditures on nonproductive activities were cut as well. For example, there were many training seminars organized by various levels of local governments in District X, both for enterprise managers and other staff members including family planning or Communist Youth League personnel. Many of these programs simply provided an opportunity for managers and other staff members to enjoy enterprise-paid travel. Before the transformation, HS managers would willingly spend money on such activities, both for themselves and for other staff members. However, since the property rights reform, the HS management has been reluctant to spend money for such purposes. According to deputy manager Wu: "We would not spend enterprise money on those publicly funded tourist-like projects any more; we don't let [the staff] attend those activities now." She concluded:

In my opinion, the best thing about the shareholding cooperative system is that the managers have become very much concerned with the operation of their enterprises, in particular with the spending of the enterprise's money. This is because the money of the enterprise is no longer public money (*gongkuan* 公款); it is private money.<sup>35</sup>

In HS, the adoption of the shareholding system clearly created a new sense of identity among shareholder-managers as owners of the enterprise rather than the agents of the Town G government in the enterprise like in the past. For example, since 1987, deputy manager Wu worked back and forth between HS and the Town G government subject to the demand of the town government. However, when she became an individual shareholder of HS in 1994, she felt a strong bond between her and the HS Company.

<sup>34</sup>Although such changes obviously disadvantaged local cadres, Chief Hu of the town industrial office commented that such moves in HS were good for enterprise performance and reflected the effectiveness of property rights reform. Interview, June 16, 1994.

<sup>35</sup>Interview, June 24, 1994.

When, in late 1994, the Town G government asked her to work in the town government's property rights reform office, she turned down the request and decided to stay in the company because, as a shareholder, she had a greater stake in the development of the enterprise.<sup>36</sup>

The economic performance of HS has improved significantly since the transformation. In 1994, gross profits of HS reached a record high of 560,000 *yuan*, much higher than that of the previous year. After subtracting various fees and taxes paid to local governments, the rate of dividends was as high as 29.8 percent. In addition to this, individual shares received an interest payment that was 30 percent higher than a one-year term bank interest rate, and was calculated as part of the production costs of the enterprise. While it is difficult to differentiate the pure effects of the improvement in managerial incentives from other factors affecting the economic performance of HS, the greater incentive of HS managers for profitability has undoubtedly contributed positively to enterprise performance. Yet, in 1995, the economic performance of HS was not as strong as in 1994. The gross profit was 420,700 *yuan* in that year with a dividend of 19.8 percent. The enterprise management attributed this fact to the rapid increase in the price of raw materials and difficulties in collecting sales incomes from customers.

However, by mid-1996 improved economic performance in HS had not been accompanied by significant expansion of enterprise scale. In fact, the size of HS actually decreased significantly. By mid-1996, the company had only 74 employees, 37.8 percent less than the original number of 119 before the shareholding reform. Moreover, the scale of TV parts production declined according to market conditions. On paper, the total value of output in HS in 1994 and 1995 was reported as around 30 million *yuan* and 62 million *yuan* respectively, a significant increase from the previous year. However, deputy manager Wu told this author that such figures were not reliable because under the instruction of the Town G government, the figures include the outputs of the two enterprises that rented HS workshop. The real output of HS according to Ms. Wu was around 6 million *yuan* in

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<sup>36</sup>Interview, June 12, 1996.

**Table 2**  
**Main Indicators of HS Company, 1988-95**

Year	Gross Value of Output ( <i>yuan</i> )	Total Profit ( <i>yuan</i> )	Number of Employees
1988	2,810,000	295,000	94
1989	5,662,200	500,000	107
1990	6,600,000	530,000	103
1991	7,000,000	540,000	122
1992	10,708,500	190,400	146
1993	11,820,000	272,000	119
1994	30,000,000	564,700	94
1995	61,720,000	420,700	74

\*See explanations in note 32 above.

1994 and 1995, a significant decrease from 1993 (see table 2).<sup>37</sup>

New investments have also been made in HS to form new sources of income for the enterprise, but in a much more cautious way. Interviews with HS managers indicated that they put great emphasis on the returns of the company's investments. Between 1994 and 1995, a total of 1.2 million *yuan* was invested by HS, of which 800,000 *yuan* was used to build a new two-story building, a move which would attract an estimated 200,000 *yuan* rental income for the enterprise; the rest was spent on the upgrading of equipment. Because of increasing market competitiveness, the HS Company did not want to expand on its TV parts production line.<sup>38</sup>

Therefore, ironically, despite the improvement in the commitment of enterprise managers to economic performance of the enterprises, the expectations of the district government of achieving rapid growth in the SCEs and in the local economy had not been met by mid-1996. While local governments hoped that the acquiring of enterprise ownership by enterprise managers would considerably motivate them to seek further expansion of

<sup>37</sup>Deputy manager Wu also said that HS had no interest in falsely reporting the output of the enterprise, but was forced to do so by the Town G government. Considering the significant cut in HS workforce, it is hard to believe that the company's total value of output could have almost tripled between 1993 and 1994, and doubled between 1994 and 1995.

<sup>38</sup>Interview, June 12, 1996.

the enterprises, in District X SCE managers have generally shown higher levels of concern for market risks and are more cautious in making decisions about investments, particularly when facing the harsh market environments of high inflation, tight credit policy, and increasingly high market competition in the period 1994-96. As HS deputy manager Wu said: "In the past, who cared if the enterprise fails? However, now we [shareholder-managers] have to take the risk of loss. Of course, if the enterprise performs well, individuals can share the benefits."<sup>39</sup>

Such a change in managerial behavior indicates that as a result of the reform, SCE managers developed a different interest from local officials on enterprise development; SCE managers have now begun to be concerned more with the return on the investment while local officials still place priority on maintaining a high growth rate. Moreover, another disappointing result for local governments was that with the improved incentive for profitability and return on their individual investments, many SCE managers would readily turn to measures such as dismissing employees—as happened in the case of HS.<sup>40</sup> Although the lay-off of enterprise employees might be in the interest of enterprises, it is obviously not in the interest of local governments, however, which are responsible for the employment of local residents; the lay-offs have also often led to the resistance of enterprise employees and local residents to the property rights reform.

Disappointed with the effectiveness of the SCEs in promoting local economic growth, the district government in early 1996 stopped issuing quotas for the transformation of TVEs. The district government instead initiated a different strategy to further develop the local TVE sector by establishing and promoting enterprise conglomerates (*qiye jituan*). For those enterprises that had not adopted the shareholding system so far (partly because of their large size), the district government no longer required them to be transformed into SCEs. Instead, the government began to form enter-

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<sup>39</sup>Ibid.

<sup>40</sup>Kung's study on shareholding reforms in Wuxi county reported similar practices among shareholder-managers; in one case the workforce was immediately reduced by 25 percent after the shareholding reform. See Kung, "The Evolution of Property Rights in Village Enterprises," 117.

prise conglomerates based on these enterprises by merging other local smaller TVEs into the conglomerates. According to local officials, the rationale for the development of enterprise conglomerates was that they had greater capability to take risks and would be more competitive in the market due to improved economies of scale. Therefore, the district government hoped that enterprise conglomerates would be able to be the new engine for local economic growth. However, when asked that whether the enterprise conglomerates would face the problem of improper managerial incentives, the deputy chief of the district's Economic Commission responded, "It's quite likely, but at present we still need to do this to maintain expansion of the local economy."<sup>41</sup>

### *Governing the SCEs:*

#### *Changing Business-Government Relationship in HS*

According to the relevant regulations enforced in District X, the SCEs are supposed to have an independent management system to protect them from the interference of local governments. In the SCEs, the meeting of shareholders (*gudong dahui* 股東大會) is the highest organ of power. As the standing agency of the meeting of shareholders, a board of directors elected by all shareholders governs the SCEs. Enterprise managers should be appointed by the board of directors rather than by local governments, implement the decisions made by the board, and make management decisions regarding the day-to-day operations of the enterprises. Managerial behavior is monitored by the board of directors to avoid agency problems.

Under such a governance structure, the power of local governments to intervene in the operation of the SCEs is supposed to be greatly constrained. According to the above regulations, local governments can only join the decision-making process in the SCEs as shareholders. Their rights and responsibilities are proportionally determined by the amount of shares they hold. In Town G, local cadres also promised to support the operation of such a management structure in the SCEs. As the chief of the town industrial office said: "While we remain the administrative department of

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<sup>41</sup>Interview, June 7, 1996.



enterprises after the property rights reform, we will not interfere in the operation of enterprises anymore—we leave everything to them. We only give our opinions through the board of directors."<sup>42</sup>

In HS, after the transformation, a board of five directors managed the company. To a certain extent, as in the allocation of distributed shares, the composition of the board of directors in HS has also reflected the intentions of the local government to provide greater incentives for the shareholder-managers in HS. Three members of the board were from the enterprise, including manager Xu, deputy manager Wu, and the workshop chief who was also an individual shareholder. The Town G government held the other two positions on the board. Despite the fact that the town government is still the largest shareholder after the shareholding reform, manager Xu, as the largest individual shareholder, has taken up the position of the chairman of the board of directors. In HS, because the only individual shareholders are the four managerial staff members of the company who also hold all distributed shares, the meeting of shareholders is almost identical with the board of directors. Hence, the board has become the most important organ in the operation of HS.

Has such a governance system increased the autonomy of the management of HS in the operation of the company? When visiting HS again in 1996, two years after transformation into an SCE, this author could not draw a clear conclusion. On the one hand, HS now indeed has greater decision-making power than ever before. HS managers acknowledged that after the reform, the town government for the most part has not interfered in the operation of the enterprise and has let the enterprise management make decisions on the development of the enterprise. This view could be supported by the previous examples of the increasing autonomy of management in making decisions on the enterprise operations.

On the other hand, however, HS managers also indicated that they did not see much difference in the relationship between the enterprise and the town government from the pre-reform era. For these managers, the adoption of the SCE system did not mean that they are free from the administra-

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<sup>42</sup>Interview, June 16, 1994.

tive interference by the town government. For example, the town government still makes decisions over the appointments of key personnel in the enterprise. In 1995, the town government appointed a new party deputy secretary to HS. Manager Xu had to arrange 100,000 *yuan* of individual shares as well as a certain amount of distributed shares for him. The new party deputy secretary has also become the vice-chairman of the board.

Indeed, the Town G government has often failed to show respect for the authority of the board in the management and operations of the SCEs. The formal allocation of board membership does not necessarily reveal the extent of government representation on, and intervention in, a board. For example, while the town government holds two of the five positions on the board of directors, manager Xu, as the chairman of the board, is not sure which two officials actually hold these positions. He was completely confused at the 1995 annual board meeting: six town officials, including the town party secretary and the town head, came to HS to attend the board meeting and signed the meeting statement.<sup>43</sup>

How should one explain the continuing interference of the Town G government in the operations of HS? In particular, why should the town government give great leeway to enterprise managers to make autonomous decisions in some important aspects of enterprise operations (such as employment and investment), and yet continue to interfere with the proper functioning of enterprise governance?<sup>44</sup> This seemingly contradictory behavior of the town government is primarily driven by the intention of the government to enhance managerial incentives while maintaining control over enterprises in the face of property rights reform. These actions are also due to the slow changes in the ways that the government regulates local enterprises in the context of property rights reform. Despite the establishment of the new governance structure in the SCEs after the property rights reform, the Town G government is still inclined to resort to old means to administer this new type of enterprise. For example, the Town G government often conveys its instructions to enterprises through various

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<sup>43</sup>Interview, June 12, 1996.

<sup>44</sup>The author is grateful to an anonymous referee for raising this important question.

economic working meetings, rather than through the board of directors. Moreover, the town government still issues targets to HS and other SCEs in terms of total output of production, profits, and the increase in value of assets—although such targets are really only guidelines and the government is handing down fewer directives than in the past. Given this fact, it is unsurprising to hear from deputy manager Wu that: "There are not many changes in our relationship with the town government. While as a matter of formality, a board meeting is convened once at the year-end, both we [the enterprise] and the town government understand that both sides are still in a relationship of superior to inferior (*shangxia ji guanxi* 上下級關係)." <sup>45</sup>

Hence, the evidence from HS indicated that despite the establishment of governance organs such as boards of directors, the relationship between government and business is far from institutionalized. That is, while the property rights reform has led to an increase in the power of shareholder-managers in their operations of enterprises, this increased autonomy has to a greater extent been dependent upon the goodwill of the town government to provide managerial incentives; this autonomy, however, is not based on the legal and institutional arrangements of the shareholding system. Implementation of the shareholding system in HS and other local SCEs has therefore not led to a fundamental change in the ways that local government intervenes in the affairs of local enterprises.

### *Agency Problems*

If the adoption of the shareholding system cannot sufficiently protect enterprises from the continuing administrative intervention of local government, then what about its effects in preventing agency problems in SCEs? In District X, the original expectation by local governments was that when managers became the majority individual shareholders, they would be less interested in behaving opportunistically because of their ownership incentives. In practice, however, agency problems are still prevalent in the SCEs. Despite improved managerial incentives for prof-

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<sup>45</sup>Interview, June 12, 1996.

itability, shareholder-managers are still able to behave opportunistically in the SCEs.

In the SCEs, the board of directors and the meeting of shareholders appear unable to effectively monitor the opportunistic behavior of managers. These two institutions are often poorly established in the first place. For the most part, managers often hold key positions on the board of directors in the SCEs. As in the case of HS, manager Xu simultaneously holds the position of the board chairman even though the town government is the largest shareholder of HS. This situation has made it difficult to control or monitor the managers through the board of directors.

More importantly, very few boards of directors and/or meetings of shareholders operate effectively in the SCEs. While this is partly a result of the continuing intervention of local governments in the operations of the SCEs, a larger reason is the nonexistence of a personalized holder of collective shares in the SCEs,<sup>46</sup> one who has a definitive interest in protecting collective shares from expropriation by managers. Local officials who represent collective shares do not actually own these shares and their remuneration is not closely linked to the returns on collective investments. Therefore, there is no guarantee that these representatives of collective shares from the local government will act in the interests of the collective.

Indeed, during fieldwork in Town G, this author felt that local officials who represent the town government on the board generally have little incentive to enforce discipline over the SCE managers. For example, Mr. Hu, the chief of the town industrial office who represents the town government on several SCE boards in Town G, complained that the management of HS and other SCEs did not usually follow the rules laid in the founding charter of the SCEs. According to SCE regulations, SCE managers should regularly report on their work to the board, and the board of directors should assess their performance. However, according to Mr. Hu, HS does not hold regular board meetings; usually such meetings are held

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<sup>46</sup>This point was also made by Kuen Lee in his study of property rights reform in SOEs. See Lee, "Property Rights and the Agency Problem in China's Enterprise Reform," 189. Also see Wang Hongling, "The Impact of Government Principals and Nongovernment Principals on the Governance Structure of Enterprises: An Empirical Study of the Ownership Transformation of China's TVEs," *Jingji yanjiu*, July 2000, no. 7:56-62.

only once a year. Moreover, before such meetings are called, no necessary information is provided by HS to the board in advance to enable the board to make a judgment on the operations and performance of the enterprises. Therefore, when the board does convene, the members cannot easily comment on the decisions made and/or proposed by the managers regarding operations, investment, and the payment of dividends. Chief Hu commented: "We know all those problems. However, we usually have very good personal relations with the SCE managers like manager Xu in HS, so in consideration of our relations, we would not require them strictly to stick to the SCE regulations in their operations."<sup>47</sup>

Hence, despite the foundation of a new management system under the shareholding system, shareholder-managers still have a great interest and capacity to act opportunistically. In the SCEs, collective ownership and private ownership coexist. The agency problem therefore often emerges as the expropriation of the collective assets by share-owning managers as well as by individual shareholders. According to the deputy chief of the district's Economic Commission, there are several ways for SCE managers to expropriate assets. First, many managers usually underreport the rate of profit in order to avoid paying dividends to the collective shares. He complained that while many managers reported a high rate of profits to receive large bonuses in the past, they have tended to report low or even no profits at all after the transformation of enterprises into SCEs.

Moreover, according to the deputy chief, only about half the enterprise managers in District X paid their investments in full when the transformation to the SCEs was made.<sup>48</sup> Installment payment arrangements are popular. Actually, by mid-1996 HS manager Xu has not paid for his individual shares in full, despite having already received a large amount of share dividends. Many enterprise managers in District X have even managed to acquire their individual shares without actually ever paying for

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<sup>47</sup>Interview with Mr. Hu on June 11, 1996. One SCE manager this author interviewed in 1996 in District X also noted that he had never bothered to hold a board meeting since the enterprise became an SCE in 1994 because his village and town governments, both of which were shareholders in this SCE, have never requested him to do so.

<sup>48</sup>Interview, July 29, 1996.

them. For example, some managers used bank loans made out to their enterprises to pay their individual share purchases; they still receive guaranteed interest payment on their individual shares, however, which is normally higher than bank interest on one-year term deposits. At the same time, the enterprise also has to pay the interest for the bank loan. In such cases, managers profit personally at the expense of both the collective and other individual employee-shareholders.

Third, some enterprises issue higher dividends to individual shares than to collective shares. For example, in another SCE in District X visited by the author in 1996, while collective shares and distributed shares received a dividend of 5.24 *yuan* per share when dividends were issued for the year 1994, individual shares were entitled to a dividend of 10.48 *yuan* in addition to their guaranteed interest.<sup>49</sup>

Thus, the adoption of SCEs does not solve the problems of the opportunistic behavior of enterprise managers. Due to the improper foundations and operation of the managerial institutions in the SCEs, managerial behavior is still poorly monitored. Enterprise managers have still been able to put their personal interests over the interests of other shareholders, particularly the government shareholders.

### Conclusion

The adoption of the shareholding system in HS has resulted in some fundamental changes in managerial incentives and behavior and given rise to a capital-owning entrepreneurial stratum in the TVE sector. This case study has indicated that to a certain extent, the process was driven by the intention of the local government to further revitalize local TVEs in an increasingly competitive and harsh market situation. Scholars such as Nan Lin and Xiaolan Ye found that privatization through the shareholding system was primarily the result of attempts by local corporate leaders to wrest control of collective assets from local governments under the tactical en-

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<sup>49</sup>Interview, July 19, 1996.

couragement of national leaders. In Lin and Ye's studies, local governments played a rather passive role in the privatization process. This paper, however, has indicated that local governments are also one of the major driving forces, if not the most important one, behind the process of the shareholding reform in the TVE sector. Moreover, the economic imperative of local governments to maintain a viable local economy should continue to play an important role in further reform in the local TVE sector.

Privatization through shareholding reform, albeit still incomplete, has had significant effects. Having acquired part of the ownership of the enterprise, the shareholder-managers in HS have acted similarly to their counterparts in the private enterprises and showed great commitment to the economic performance of their enterprise. Managerial innovations and rationalization in HS after the reform clearly indicate the fact that new dynamics based on capital ownership are at work transforming China's TVE sector. Consequently the shareholding system in HS has contributed significantly to the profitability of the enterprise.

The reform has also contributed to the development of the independent interests of the capital-owning managers from local governments. The case study indicates that after the reform, a divergence of interests between the local government and SCE managers has begun to emerge in regard to enterprise development. While shareholder-managers place great emphasis on economic returns when making investment decisions and hence act cautiously in the face of adverse markets, local governments still try to seek rapid expansion of local enterprises in order to maintain a high economic growth rate. The abrupt changes in the attitude of local governments in District X to the shareholding reform in early 1996 clearly reflected a dilemma faced by local governments: how to improve enterprise performance while maintaining an administratively determined rate of economic growth.

The effects of the shareholding system in HS on enterprise-government relations are, however, more complex. On the one hand, both government and enterprise all acknowledge that the reform has definitely improved the autonomy of the enterprise. The Town G government has exhibited a strong commitment to granting managerial autonomy to HS and other SCEs and to regulating government relations with the enterprise via



the shareholding system. The manager of HS also felt his autonomy in operation over the enterprise has improved. On the other hand, however, there is evidence suggesting that enterprises are still subject to the intervention of local governments. A careful examination of the nature of enterprise autonomy in HS suggests that the improved autonomy after the reform has indeed little to do with the shareholding system, but is rather a result of the local government's actions to improve managerial incentives. Therefore, despite enterprise managers having acquired greater decision-making power in enterprise operations, such powers have been poorly institutionalized. This is partly because of the poor operation of the governing organs (boards of directors) and partly because of the way that local governments continue to manage local enterprises through administrative means in the context of the gradual privatization process.

The property rights reform has been least successful in the area of monitoring the agency problem in the SCEs. The acquisition of enterprise ownership and the improved managerial incentives for profitability in SCEs has not stopped shareholder-managers from acting opportunistically to maximize their personal gain at the expense of other shareholders. In the case of HS, the manager was able to allocate to himself a substantial amount of dividends for shares he has not actually paid in full. In other cases, some managers also attempted to avoid paying dividends on shares owned by the local government through manipulation of profits reporting. Hence, evidence in this paper suggests that without a properly established and functioning governance system such as boards of directors and meetings of shareholders, the simple privatization of enterprise assets and separation of government from enterprise operation would have only limited potential for the long-term healthy development of the reformed TVEs.

