

From Insider-Outsider Collusion to Insider Control in China's SOEs*

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This paper focuses on three levels of agents involved in the reform and performance of the state-owned enterprises (SOEs) in China: one outsider—the supervisory state-party organ(s)—at the top, and two insiders: managers in the middle as well as workers at the bottom. The paper identifies four distinct stages in the evolution of the enterprise system. The first stage was the pre-reform period characterized by a strong top and a weak middle and bottom, the period of strong outsider control. The second stage, during the 1980s, was mostly characterized by a weak middle with a strong top and bottom; there emerged in this stage two tiers of collusion involving both insiders and an outsider, with the upper hand being held by the outsider. The third stage, the 1990s, was characterized by a strong middle and a weak top and bottom; this period was plagued by the problem of insider control, although the insiders still had to collude with the outsiders to a certain extent. Finally, we are now observing the transition from de facto

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insider control to de jure insider control that has occurred over the past few years. We find that over the course of all these changes, while the dual collusion led to expropriation of state incomes (i.e., enterprise profits), the problem of insider control has led to asset stripping and diversion by the insider agents.

KEYWORDS: insider control; state-owned enterprises (SOEs); collusion; management buyout (MBO); China.

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Despite the general success of China's reform and opening-up policy, China is making only slow progress with the reform of large and medium-sized state-owned enterprises (SOEs). SOEs still remain one of the biggest obstacles to the complete success of reform in China. As in other transitional economies, the thrust of the SOE reform has been "decentralization," which has also resulted in the softening and dissolution of the former vertical control system. Given that monitoring mechanisms from an outside agent are not in place, dissolution of the old system has tended to give rise to the so-called "insider control" problem in China's SOEs.¹

The insider control problem refers to a situation where a firm falls into *de facto* or *de jure* control by insiders—managers and workers—without checks and balances from outsiders.² The insider control problem can also be interpreted within the framework of the principal-agent model where agents expropriate state enterprise property for their own personal benefit.³ This problem is also damaging to the future of the firms since the possibility of encroachment of minority shareholders' rights discourages

¹For a general treatment of the term, see Masahiko Aoki, "Controlling Insider Control: Issues of Corporate Governance in Transition Economies," in *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks*, ed. Masahiko Aoki and Hyung-Ki Kim (Washington, D.C.: World Bank, 1995), 3-29.

²When insider control is based on majority shareholding by insiders, it is called *de jure* insider control; insider control that is not based on majority shareholding by insiders is called *de facto* insider control.

³Keun Lee, "Property Rights and the Agency Problem in China's Enterprise Reform," *Cambridge Journal of Economics* 17 (July 1993): 179-94.

potential outsider investors. Even in the case of SOEs of which the state remains the controlling shareholder, the problem can be said to exist when insider interest is strongly reflected in the strategic decision-making of the enterprises.⁴ The insider control problem can thus be seen as a special form of the principal-agent problem when independent outsiders do not or cannot effectively check an agent's control of the enterprise.

In general, this problem was the most serious in Russia and other East European economies where the insider control problem took the form of *de jure* insider control. On the other hand, Qian argues that in China the insider control problem occurred without the insiders' holding a majority of the shares—i.e., *de facto* insider control.⁵ Qian also noted that China is both similar to and different from Russia due to the fact that the managers of SOEs are appointed and dismissed by the Communist Party and the state. Since 1999, however, there have emerged signs that the insider control problem in Chinese SOEs is becoming similar to that in Russia. In many enterprises the insiders are becoming majority shareholders through management buyouts and employee stock ownership plans.

Given this background, this paper will try to trace the evolution of the insider control problem in China, an exercise which will help highlight the subtle differences in terms of the nature of the insider control problem between China and Russia (with the latter as representative case of the Russian/East European experience). We will argue that the insider control problem was less serious in China, at least during the early stages of reform in the 1980s, and that a more correct characterization of the Chinese SOE problem is that there has been a shift from a dual collusion problem in the 1980s to a *de facto* insider control problem in the 1990s, and then finally to *de jure* insider control. We will explain this change by reference to increasing managerial rights over asset disposal and changes in the government's enterprise reform policy.

⁴Aoki, "Controlling Insider Control," 3-28.

⁵Yingyi Qian, "Reforming Corporate Governance in China," in Aoki and Kim, *Corporate Governance in Transitional Economies*, 215-52.

Since the initiation of reform, the Chinese authorities have introduced various reform measures regarding the SOEs, including profit retention schemes, the contracted management system of the 1980s, a shareholding system, and the so-called modern enterprise system of the 1990s. During the 1980s, the main problem of Chinese SOEs was the expropriation of state assets due to collusion between outside monitors (supervisory state organs and the party) and insiders (managers); as a consequence, only limited profits were remitted to the state, with too much being retained by the insiders.⁶ Since the 1990s, when the SOEs began to separate from the government (especially due to the spread of the shareholding system), the independent voices of the managers have become stronger, whereas the supervisory state organs have been gradually losing their influence or retreating to the status of non-intervening shareholders, thereby giving rise to a real insider control problem in China. Alternatively, if one were to insist that collusion between insiders and outsiders is still being maintained, we would like to point out that the nature of the collusion has changed: in early collusion the state organs had the upper hand over the managers and in the more recent behavior, the managers now enjoy the superior position. We also wish to emphasize that whereas the early target of the collusive behavior was centered on the remission and retention of profits, more recently the focus of collusive behavior has changed to the disposal and the use or abuse of enterprise assets. We also seek to analyze a more fundamental change than that of the 1990s—i.e., the emergence of *de jure* insider control, especially by managers.

This article is organized as follows. Section one provides theoretical and general perspectives on the issues related to the problem of insider control and the expropriation of state assets in SOE reform in China. Section two discusses not only the outsider control situation during the pre-reform period but also the dual collusion problem that arose during the 1980s when enterprise reforms concentrated on incentive schemes for insiders. Section three focuses on the 1990s, when the insider control problem became more

⁶Lee, "Property Rights and the Agency Problem," 181-86.

serious as the focus of the SOE reform shifted from incentive schemes to property rights reform and then to the shareholding system. Section four introduces the recent evolution of insider control, focusing on the transition from *de facto* to *de jure* insider control. Section five provides an international comparison of insider control problems, an exercise which serves to illustrate the distinctive nature of China's insider control problem. The paper concludes with a brief summary and concluding remarks.

The "One Outsider, Two Insiders" Model of Chinese SOEs: A Framework

The very hierarchical nature of the socialist economic system makes the personal interests of agents at various levels of the hierarchy an important source of interference with the economic performance of the system, especially when these agents are not necessarily loyal stewards of the center (or the society) but are also subject to self-interest. At least five important strata exist in the Chinese hierarchy of economic management: the central (party-state) leadership, local state organs and central ministries supervising the SOEs, local/enterprise party organs, the managers, and the workers.⁷ The central leadership can be assumed to be the principal who voluntarily bears the political risk of leading the whole of society. All others can be assumed to be agents who need to be monitored or given incentives to behave properly. The principal's problem is how to enforce its enterprise reform measures through not only intermediate agents (local state or party organs) but also both managers and workers at the bottom (who are in charge of production).

⁷Formally speaking, the central party and the central state are different entities. In actuality, however, the distinction between these two is meaningless because they are intermingled. We therefore use "the central (party-state) leadership" to mean the central party leadership as well as the central state leadership. For notational convenience, we will use the expression "local state organs" to refer to the central ministries as well as the local government bodies that are directly responsible for supervising SOEs.

Our analysis in this paper focuses on three levels of agents relating to enterprise matters—supervisory state and party organs at the top, the managers at the middle, and the workers at the bottom.⁸ The state and party organs at the top are regarded as the outsiders (or outside agents) who are primarily in charge of appointing managers and handling taxation, but also have influence in such matters as the budget allocations and the supply of key materials and bank loans for SOEs. There are two groups of insiders: the managers and the workers—although the nature of the relationship between these two insider agents has varied substantially over the reform period. In such a hierarchical principal-agent model proposed by Tirole, the key issue is who controls the system, be it with or without collusion with other agents.⁹ The complex and possibly diverse nature of the collusion directly interferes with a proper working of the system according to the principal's design.

Before moving on, let us clarify some conceptual issues. The outsider in the governance of an SOE is the entity that is entitled by the central party-state to monitor—but not actually manage—the firm. In a Japanese or Western firm, by contrast, an outsider is usually a non-controlling shareholder or general investor with small shares in the firm. There have been changes in the identity of outsiders in Chinese SOEs. In the era of the planned economy, the outsiders were the central ministries or local governments to which the central party-state delegated the right and duty to monitor the SOEs. Later, with government reform in the 1990s, control of central SOEs was transferred several times, first from the central ministries to the Commission for Managing State Properties (國有資產管理委員會), and then to the Ministry of Personnel (人事部), and most recently to the State-Owned Assets Supervision and Administration Commission

⁸The state organs and the party organs are actually different entities. For simplicity, however, we treat them in this model as a single outsider. This simplification will not pose a problem since appointment of the managers, which is the most important matter in Chinese SOEs, is nominally conducted by the state organs yet has to go through pre-approval by the party organs. See also note 5 above for this point.

⁹On a formal treatment of the collusion problem in a hierarchical principal-agent model, see Jean Tirole, "Hierarchies and Bureaucracies: On the Role of the Collusion in Organization," *Journal of Law, Economics, and Organization* 2, no. 2 (1986): 181-214.

(國有資產監督管理委員會).

"Control" refers to the right to decide important, strategic matters concerning such issues as investments, personnel appointments, and profit distribution. If insiders make these decisions to further their own interests, they have insider control. Thus, insider control in the Chinese SOEs in the early reform period means that insiders, namely managers and/or workers, had more of a voice in the management of the firm. We can also make a comparison in view of Aoki's theories of the firm.¹⁰ In a typical Anglo-Saxon model firm, the voice of the workers is weak and thus "the insiders" usually refers to the controlling shareholders and their representatives on the board. In a Japanese firm (as was especially true during the postwar high-growth period), the insiders primarily include the controlling shareholders and affiliated firms in the business groups (*keiretsu*) and, secondarily, the workers or the labor unions (as the labor unions were more fully represented in management during this period than they were in Anglo-Saxon model firms).

Based on the above framework, we trace the evolution of the enterprise system over the reform decades in China. Four distinct stages are identified (see table 1).

The first stage is the pre-reform period when the outsider—the state and party organs—controlled the enterprise more or less independently from other agents. This enterprise model had a strong top but a weak middle and bottom.

The second stage appeared mostly during the 1980s, when there emerged a new model characterized by a weak middle and a strong top and bottom. During this period, two tiers of collusion came into being, with the upper hand held by the outsiders. In the upper tier, collusion emerged between the local state/party organs and the enterprises; in the lower tier, collusion between the enterprise managers and the workers began to ap-

¹⁰Masahiko Aoki, "The Japanese Firms in Transition," in *The Political Economy of Japan*, ed. Kozo Yamamura and Yasukichi Yasuda (Stanford, Calif.: Stanford University Press, 1987), 263-88; and Masahiko Aoki, "Toward an Economic Model of the Japanese Firms," *Journal of Economic Literature* 28 (March 1990): 1-27.

Table 1
Evolution of the Insider Control Problem in China's SOEs

	Pre-reform	1980s	1990s	Recent Years
Who Controls	Outsider control	Outsider-insider collusion with upper hand held by outsiders	Insider control or insider-outsider collusion with upper hand held by insiders	Emergence of <i>de jure</i> insider control
Basic Model	Strong top, weak middle and bottom	Weak middle, strong top and bottom	Strong middle, weak top and bottom	Strong middle, weak top and bottom
Consequence	Weak motivational efficiency	Expropriation of state income (profits)	Dissipation and diversion of state assets	Undervaluation of transferred state shares

pear.¹¹ The upper-tier collusion worked to reduce the state's share of firm profits by increasing the shares of the enterprise, and the lower-tier collusion worked to increase the share of the workers in firm profits by increasing worker compensation in various forms.

The third stage saw the rise of the insider control problem, although the insiders still had to collude with outsiders to a certain extent. The rise of the insider control problem can be ascribed to the strengthening of the power of the managers relative to other agents. Thus, we call this a model of a strong middle and a weak top and bottom. Compared to the preceding stage, where the dual collusion focused on the expropriation of state incomes (enterprise profits), insider control problem during this stage led to asset stripping and diversion by the insider agents. This change became possible because the managers and enterprises themselves not only had begun to command more discretion but also enjoyed legally-backed power over the disposal and use of enterprise assets. While such a tendency should to a certain extent be natural, it became a problem in China since there existed no check-and-balance mechanism (such as well-

¹¹Lee, "Property Rights and the Agency Problem," 184-86.

functioning capital markets or active monitoring by banks) as in other mature market economies.

The fourth and most recent stage is that of the emergence of *de jure* insider control. The insider control problem has been gaining strength in this period by the transfer of government shares to insiders, which precipitated a fundamental change in the nature of the insider control from the *de facto* insider control of the preceding stage to *de jure* insider control. This change can be attributed to ever-tightening market competition and the government's restructuring and privatization policy. There are positive aspects to this new situation, such as the improvement of corporate governance through the diversification of shareholder composition and reinforcement of manager incentives; the negative implication of this change is the undervaluation of the state shares and the legal person shares (法人股) in the process of transfer to the insiders. An additional problem is the infringement of the rights of minority shareholders.

From Outsider Control to Insider-Outsider Collusion

Outsider Control before the Reform

Before the reform, Chinese enterprises were not given autonomy to make decisions on most of the important aspects of enterprise management, including production, purchasing, marketing, employment, and uses of profits. The enterprise management system before the reform was thus represented by the "unified revenue and expenditure system" where the government controlled all the profits and revenues of the enterprises and at the same time took responsibility for all enterprise expenses and even losses. The central or local government which supervised the relevant enterprises paid for all the major expenses the enterprises incurred, including fixed investment, product development, and circulating capital; the enterprises remitted most of the profits and even transferred capital depreciation to the government.

The workers at the bottom did not have an effective voice over enterprise management; rather, the outsider (the supervisory state organs) was

in full control over the SOEs. Although workers were given the privilege or right of lifetime employment and welfare, actual influence or participation in enterprise decision-making was limited. More precisely, there was not much room left for worker initiative (other than in non-economic areas) since almost all important matters related to production, procurement, sales, wages and bonuses, and worker hiring were decided by planning. Institutions such as the workers congress, for example, were not revived until the reform period.

For these reasons, we can say that "the strong top and weak middle and bottom" model (i.e., the strong outsider model) best represents the circumstances in SOEs during the pre-reform period. A really negligible portion of profits was retained within the enterprises, and the enterprise directors commanded no discretion over production costs and uses of repair and renovation funds for fixed capital. Therefore, the possibility for the enterprises to expropriate state property by manipulating production costs was practically nil.¹² Such tendencies as giving out generous and arbitrary wages were more or less checked as well, since SOEs maintained very strict procedures and rules over payments to workers. Thus, before the reform period, the possibility that an insider control problem would emerge in the form of the expropriation of state property and irregular overpayment of wages and bonuses was very limited.¹³

A Weak Middle and a Strong Top and Bottom: the 1980s

In the initial stage of the reform efforts, the central leadership wished to free the enterprises from the former overly tight grip of local state organs. In order to improve SOE performance, Chinese authorities have continuously modified the legal and organizational basis of state-owned

¹²Lin Yifu, Cai Fang, and Li Zhou, *Zhongguo de qiji—fazhan zhanlue yu jingji gaige* (The China miracle—development strategy and economic reform) (Shanghai: Shanghai sanlian shudian/Shanghai renmin chubanshe, 1994), 198.

¹³Yuan argues that some degree of insider control problem existed even before the reform, such as in the form of the waste of resources that resulted in part from the distorted price system. See Yuan Zhigang, "Guanyu guoyou zichan liushi wenti de ruogan sikao" (Some thoughts on the problem of state asset expropriation), *Jingji yanjiu* (Economic Research), 1995, no. 4:37-41.

enterprises. Regarding decision-making within an enterprise, the "plant director responsibility system under the leadership of the party committee" was revived in 1978 on the grounds of the "necessary internal division of labor in enterprises."¹⁴ The main argument was that enterprises must respond to two separate impulses—the law of markets as well as the needs of the state, with the manager and the party committee handling each of the two impulses, respectively.¹⁵ The principle of collective leadership by the committee was soon abandoned, however, and replaced by one-man control by the party secretary.¹⁶ The workers congress was also re-instituted in 1978 to promote collective leadership. The power of the post-1978 workers congress was broader and more clearly defined than those of its predecessors, and included the ratification and monitoring of enterprise plans, budgets, contracts, and the election and recall of junior and senior cadres (including managers).¹⁷ The election of the managers by the workers congress was supposed to be prearranged by supervisory state organs, but in most cases the managers of the state-owned enterprises were directly appointed by their supervisory state organs.¹⁸ To the extent that the collective leadership was well exercised, the manager would have found it necessary to seek legitimization of his/her role and position from both the party committee and the workers congress. Consent from the work force would provide a mandate for the manager's leadership position.¹⁹

As management by the party turned out to be an inappropriate arrangement in the new economic environment, the manager responsibility

¹⁴Heath B. Chamberlain, "Party-Management Relations in Chinese Industries," *The China Quarterly*, no. 112 (1987): 631-701.

¹⁵*Ibid.*, 636.

¹⁶This change came about mainly because committee members were simply too overburdened to practice collective leadership, and many issues were actually of such a nature as to be handled by administrative organs. *Ibid.*

¹⁷Richard Morris, "Trade Unions in China," *The Australian Journal of Chinese Affairs*, no. 13 (1985): 51-67.

¹⁸Based on Ng Sek Hong and Russell Lansbury, "The Workers' Congress in Chinese Enterprises," in *Management Reforms in China*, ed. Malcolm Warner (London: Frances Printer, 1987), 149-62.

¹⁹*Ibid.*, in various places.

system (MRS) was introduced as a new model for the enterprise leadership system in 1984 with the intention of separating management from politics.²⁰ Under the MRS, the party no longer held supreme power in enterprises. According to a state regulation on the MRS, the party committee's role was reduced to the areas of "party organization" and "ideological work." The manager assumed unified leadership over economic matters including production, marketing, purchasing, investment, wage and bonus policies, worker training, and use of enterprise funds. The manager represented the enterprise externally, and thus exercised more independent control over management matters than before. Furthermore, the manager could override the "management committee" in case of a conflict of opinion among committee members, including the party secretary.

Such a leadership system in the initial model can be seen as a structure with one agent (manager) and multiple supervisors—the enterprise party committee and secretary, local state organs, and possibly the workers congress. The manager had to deal with diverse and sometimes conflicting demands. Even though the manager's duties have increased since the reforms, his/her power has not increased correspondingly.

The initial reform design was not successful, however. The contracted management system (CMS) sought to encourage enterprise autonomy and independence by formalizing distribution and control relations between local state organs and enterprises; the manager was not, however, in a position to ignore the interests of local state organs. The individual manager's authority was still a delegated one with fairly restricted power, and, most critically, local state organs retained an important stick: the power to appoint and discharge the manager. Furthermore, a manager had to receive approval from local state organs regarding the appointment and discharge of such key enterprise figures as chief engineers, chief accountants, and deputy managers.

²⁰PRC State Economic Commission, *Guanche quanmin suoyouzhi gongye qiye sange tiaoli tuixing changzhang fuzezhi* (Let's promote the factory manager responsibility system in state-owned industrial enterprises through the implementation of three regulations) (Beijing: Jingji guanli chubanshe, 1987), 18.

In other words, while the MRS might have freed the managers from interference by the party secretary, the system did not liberate the managers from control by local state organs. While the managerial autonomy from the state organs was still weak, the managers did not enjoy power over workers, either. Most critically, the manager had not yet been granted the right to hire and fire ordinary workers, and was required to obtain advance approval from the workers congress for changes in bonus payment schemes and worker-related welfare and discipline policies.²¹ The labor contract system under which workers were hired with three- to five-year contracts applied only to newly admitted workers, and most existing workers were guaranteed permanent job tenures.²² When we consider the almost permanent job tenure of both managers and workers, as well as the collective evaluation of the manager by workers in Chinese enterprises, we can speculate that there should exist a tendency toward manager-worker collusion under such a scenario.

Insider-Outsider Collusion Leading to Profit Expropriation

Under the initial profit retention or contract system, enterprises negotiated for annual profit remittance quotas with their supervisory organs, retaining various portions of the above-quota profits. The profit retention system then evolved into the tax-for-profit system, then changed to the contracted management system, and finally morphed into the shareholding system.²³ In the contracted management system, state enterprises signed a contract with the state over mutual responsibilities, rights, and benefits associated with the management of the enterprises. With this

²¹Also taking this view is An Jian et al., in *Zhonghua renmin gongheguo quanmin suoyou zhi gongye qiye fa shiyi* (Explanations of the PRC's state industrial enterprise law) (Beijing: Gongshang chubanshe, 1988).

²²Gordon White, "The Politics of Economic Reform in Chinese Industry: The Introduction of the Labor Contract System," *The China Quarterly*, no. 111 (1987): 365-89; and Michal Kozec, "Efficiency Wages and Enterprise Behavior in China," *Journal of Communist Studies* 3, no. 1 (1988): 3-26.

²³David Bachman, "Implementing Chinese Tax Policy," in *Policy Implementation after Mao*, ed. David M. Lampton (Berkeley: University of California Press, 1987), 119-53; and Keun Lee and Shelley Mark, "Privatization in China's Industry," *China Economic Review* 2, no. 2 (Fall 1991): 157-73.

contract, the right to manage the means of production was given to the enterprises, which were assumed to be responsible for profits and losses. The CMS emphasized profit remittance to the state, following the same methods as those that had been used under the old profit contract system to decide the amount of the profits to be remitted to the state.

With the progress in reform, state revenue decreased significantly; the expected improvement in state enterprise performance did not, however, materialize. One of the main reasons for the failure was the emergence of collusion between local state organs and enterprise managers. In the Chinese case, local state organs were somewhat resistant to the central initiatives and wanted to keep the enterprises under their control. In return, the local state organs provided paternalistic protection for enterprises, which resulted in a softening of the enterprise budget constraint in the forms of "soft subsidies" and "soft taxation."²⁴ In the implementation of the profit retention system and the contract management system, many cases were found where firms reported losses or profits short of basic quota profits—yet local state organs dealt with them very "generously." Very often, however, unexpectedly large profits were subject to irregular exploitation or collection of "semi-taxes" such as social donations or fees by local state organs. Given such "soft" and arbitrary enforcement, the effect of the profit retention scheme in strengthening enterprise incentives was limited.

In sum, local supervisory organs sought to maintain their discretionary control over enterprises, rather than serve the central leadership's reform effort. While discretionary control could mean greater adaptability for local state organs, such adaptability typically resulted in arbitrary intervention over enterprise matters. With neither adequate risk-sharing nor a strictly enforced incentive-payoff scheme, the profit retention or contract scheme failed to increase the attractiveness of incentives. As a result of the collusion, Chinese society bore residual risks in the form of reduced state revenues and uncertain improvement of economic efficiency.

²⁴Janos Kornai, "Soft Budget Constraint," *Kyklos* 39, no. 1 (1986): 3-30.

Expropriation of state property (i.e., profits) by agents also occurred in the use of retained enterprise profits in the form of giving out excessive wages and bonuses and welfare payments. Walder observed that a tacit agreement emerged between managers and workers, with both parties seeking to retain as much money as possible in the workers fund, while distributing it as equally as possible.²⁵ He argued that, despite the large pay increases, there was an upsurge of contention, even open conflict, over wage and bonus matters due to the lack of consensus over fair quotas and related payments. Managers sidestepped this potential problem by paying out bonuses equally, thereby accommodating worker demands regarding the use of retained profits for bonuses and housing construction. In return, the manager was able to expect worker cooperation and stability of production. Thus, the link between bonus payments and work performance was weak and subject to negotiation.²⁶

The above observation is consistent with the following statistical evidence. From 1978 to 1988, Chinese gross national product (GNP) increased at an annual rate of 9.6 percent (at constant prices), yet the profit remittance from the SOEs to the government budget decreased 11.4 percent per annum from 1978 to 1984 and later increased 1.5 percent per annum from 1984 to 1988, showing a mere 0.2 percent annual increase over the entire period. On the other hand, the bonus payment for employees and retained earnings in the SOEs increased at an annual rate of 41.1 percent and 22.9 percent, respectively, over the same period. Despite the fact that this amount was paid out to the employees as bonuses and retained in the firms, the economic efficiency of the SOEs did not improve at all. The gross profit rate (profit/capital) decreased 1.6 percent annually and production per unit of fixed capital increased merely 0.9 percent annually.²⁷

²⁵Andrew G. Walder, "Wage Reform and the Web of Factory Interests," *The China Quarterly*, no. 109 (1987): 22-41.

²⁶Gene Tidrick and Jiyuan Chen, eds., *China's Industrial Reform* (New York: Oxford University Press, 1987), 184.

²⁷Calculated from various issues of *China Statistical Yearbook* (Beijing: China Statistics Press).

Profit Expropriation during the Early Stage of the Shareholding System

The mixed achievement with the contracted management system led to debate on the strategies of enterprise reform. Two contrasting perspectives on continuing enterprise reform emerged in the mid-1980s.²⁸ The first group sought to further improve the CMS. The second and newer group focused on property rights relations in the enterprises, arguing that the source of the problem was that ambiguous property rights relations between the state and the enterprise lead to ambiguous distribution and control relations. This latter group also argued that the CMS did not promote the efficient allocation of resources. They argued that under the CMS, there was no automatic mechanism whereby inefficient enterprises were closed or merged in order to allow more efficient new enterprises to be created. This line of argumentation provided theoretical justification for the experiments with the shareholding system that began in the late 1980s.

Below, we will discuss the continuing tendency of profit expropriation under the shareholding system, especially in its early days. The following analysis will be based on an examination of shareholding corporations in China. Three corporations will receive particular attention: Zigongshi Zhutiechang (自貢市鑄鐵廠, Zigong City Steel Corporation, hereafter ZZC), Jialing Industrial Corporation (嘉陵工業股份有限公司, hereafter JIC), and Beijing Tianqiao General Department Store Corporation (北京天橋百貨股份有限公司, hereafter BTGD), which were transformed from traditional state-owned enterprises into shareholding corporations in the late 1980s.²⁹

²⁸See note 22 above and Wu Shuqing, "Dui guoying dazhongxing qiye gufenhua de wojian" (My view on transforming large and medium-sized state enterprises into joint-stock companies), *Zhongguo jingji tizhi gaige* (Chinese Economic System Reform), 1987, no. 4:26-29.

²⁹Information about BTGD is drawn from authors' interview with the vice-manager of this company in Beijing in summer 1991. For other companies and BTGD, we relied on the following: "Zhongguo Jialing gongye gufen youxian gongsi zhangcheng" (The constitution of Jialing Industrial Corporation, Ltd.), *Jingji guanli* (Economic Management), 1988, no. 1: 15-19; Mou Zhujun et al., "Wochang shixing qiye gufenzhi de changshi yu tihui" (An experience in transforming our factory into a joint-stock company), *ibid.*, 20-25; PRC Ministry of Commerce, "Guoying shangye shixing gufenzhi yili—Beijing Tianqiao baihuo gufen

Stocks of the shareholding company consisted of state, enterprise, and individual shares. State shares were owned by the state and managed under the responsibility of the State Assets Management Bureau (國有資產管理局). Under the shareholding system, the enterprise first paid income tax, and then the remaining profit was divided into an accumulation fund, a collective welfare fund, and a risk fund. The final residual profit was distributed as dividends. Dividends for both state and enterprise shares were calculated at 6 percent of the value of their respectively owned stocks. In other words, the state's claim for dividends, as a shareholder, consisted of both fixed and variable payments. The fixed portion of dividends was a pre-set rate of return (6 percent) for the value of state shares. This basic dividend could either go to the state budget or be reinvested in the enterprise to increase the value of state shares. The variable portion of the dividends referred to extra dividends exceeding the fixed-rate dividends. This variable portion was the only real residual claim in the sense that it represented the claim for uncertain residual financial flows. Since these extra dividends were in fact to be reinvested, however, we can say that the state was not an "alienable" residual claimant. Dividends for enterprise shares were in principle to be put into production development funds for investment purposes. Since dividends for enterprise shares were reinvested, the enterprise was not an alienable residual claimant either. The board determined how to use the dividends paid for enterprise and collective shares. For instance, the board could take a portion of enterprise dividends for manager bonuses, reinvestment, or workers' welfare and awards.

Regarding individual shares, the practice was that both interest and dividends were paid on individual worker shares. In the case of ZZC, the interest rate was set at 10 percent. Thus, individual shares were more like bonds. The sum of interest payments and dividends was not to exceed 18 percent of total stock value. In other words, individual workers' claims

youxian gongsi" (An example of implementing the shareholding system for a state-owned commercial enterprise—Beijing Tianqiao General Department Store Corporation) (1988); and Li Rongxia, "Beijing's First Share Success," *Beijing Review*, April 10-16, 1989, 10-16. Also see Lee and Mark, "Privatization in China's Industry," 157-73.

as shareholders also consisted of both fixed and variable portions, with maximum limits for the rates of return. Thus, we can say that individual shareholders were "constrained, alienable residual claimants."

In sum, in the early Chinese shareholding system, neither the state nor the enterprise was an alienable residual claimant. They contracted to reinvest their uncertain net cash flows. Only individual shareholders had alienable residual claims, and therefore had definite interest in taking out as much profits as possible. The coexistence of the inalienable residual claimants and the alienable residual claimants provided incentives for individual shareholders to expropriate state assets. While the state had definite interest in excluding, or at least constraining, the alienable residual claims of others (such as individual shareholders), the evidence was that the restriction on such claims was soft. Despite the fact that the official limits were usually set at 15 to 18 percent, Wu and Cheng reported that the sum of the basic fixed and extra dividends was as high as 20 to 40 percent of the stock value in some cases in 1986, and even 50 to 80 percent in 1988.³⁰ Wu and Cheng then argued that such high dividend payments for individual shareholders were possible because enterprises undervalued, and/or did not allow extra dividends for, state shares. These phenomena signify irregular expropriation of the state property by individuals with alienable claims.

Since there was no personified holder of state shares, the state had to appoint someone to represent its interest. There was no guarantee that this person would fully represent the state's interests, however, since the shares were not his personal property. Whoever took the position of state representative—either at the shareholders' meeting or on the board of directors—was simply an agent for the state. In many cases, no state representatives were appointed so that the positions on the board simply remained vacant. In the late 1980s, Chinese authorities set up the State

³⁰Wu Fumin Wu and Cheng Wanquan, "While Letting the 'Tiger' Return to the Hill, We Must Prevent it from Hurting People—The Effects of the Shareholding System on Inflation," *Jingji cankao* (Economic References), February 1, 1989, 4, translated in JPRS, *FBIS-CHI-89-031* (February 16, 1989): 29-30.

Assets Management Bureau directly under the State Council, which would operate as something like a general investment company to protect and increase the value of state assets. This move did not solve the problem, however.³¹

In sum, the insider-controlled board, combined with the lack of independent outsiders in the Chinese shareholding system, led to excessive payment of dividends to individual investors; this serves as an example of collusion between the lower-level state bureaucracy and the enterprise personnel in the expropriation or inefficient protection of state property. Such collusion is reminiscent of similar collusion regarding the determination and enforcement of the profit remission quota in the profit contract system.

From Insider-Outsider Collusion to *de Facto* Insider Control

A Strong Middle and a Weak Top and Bottom: the 1990s

The preceding section argued that Chinese SOEs in the 1980s could be basically characterized as fitting a "weak middle and strong top and bottom" model, where managerial authority and discretion were pretty weak. This model underwent some important changes in the 1990s, especially with the changing practices within the shareholding corporations. Table 2 examines the trend of managerial autonomy in Chinese SOEs in terms of the fourteen different areas officially identified and designated by the "Regulations on Transforming the Management Mechanism of the State-Owned Industrial Enterprises" (全民所有制工業企業轉換機制條例) issued in July 1992 by the central government. This regulation intended to expand enterprise autonomy by giving these fourteen rights to the managers. There are three important changes noticeable from this table.

First, there was a substantial increase of managerial rights over asset disposal, investment, and mergers and acquisitions (M&A) matters. Qian

³¹Linru Zhao, "A Discussion of Our Country's Experiment on the Shareholding System," *Renmin ribao*, April 3, 1989, 6, translated in *FBIS-CHI-89-071* (April 14, 1989): 34-37.

Table 2
Managerial Autonomy in Firms in China, 1993-1997 (%)

Items	1993	1994			1995	1997
		Total	Shareholding companies	Non-shareholding companies		
Production decisions	88.7	94	97.1	93.3	97.3	98.3
Pricing of products	75.9	73.6	82	71.8	85.4	92
Sale of products	88.5	90.5	95.9	89.3	95.9	96.8
Procurement	90.9	95	96.1	94.8	97.8	98.8
Foreign trade	15.3	25.8	41.8	22	41.3	54
Investment decisions	38.9	61.2	74.6	58.3	72.8	82.5
Use of retained profits	63.7	73.8	83	72.1	88.3	90.6
Asset disposal	29.4	46.6	60.4	43.5	68.2	76.5
Mergers and acquisitions	23.3	39.7	53.1	36.4	59.7	61.4
Hiring	43.5	61	77.6	57.3	74.8	84.3
Personnel management	53.7	73.3	81	71.7	83.5	90.3
Wages and bonuses	70.2	86	92.8	84.5	93.1	96
Organizational changes	79.3	90.5	94.5	89.6	94.4	97.3
Refusal of unauthorized charges	7	10.3	14.3	9.4	17.4	35.1

Notes: The majority of the companies surveyed are state-owned manufacturing companies. Shareholding companies in this sample are those that were transformed from traditional state-owned enterprises. The numbers indicate the portion of the managers who responded that they have decision-making authority over the matter in question. After 1997, the same kind of survey was not conducted, reflecting the transition of reform focus from separation of ownership and management to both the building of the modern corporation system and reform of ownership itself. The survey conducted in 2002 only asked about the overall degree of realization of managerial autonomy, with 95.6 percent of the respondent managers of state-owned enterprises answering that managerial autonomy had been basically realized.

Sources: All these sample surveys are implemented by the same organization, China Entrepreneurs Survey System, (CESS, Zhongguo qiyejia diaocha xitong) and the results for the different years are reported in the following works: Zhou Shulian, "Zhongguo de qiye gaige he gongye fazhan" (Enterprise reform and industrial development in China), in *Sishiwei jingji xuejia guanyu tuijin guoyou qiye gaige de duojiaodu sikao* (Forty economists' views on the promotion of state-owned enterprise reform), ed. Song Tao and Wei Xinghua (Beijing: Jingji kexue chubanshe, 1996), 246; Zhang Zhuoyuan, "Xietiao renshi kexue gui hua duofang shiyan jiji tuijin guoyou qiye gaige" (Balanced understanding, scientific planning, multi-directional experiment, and active promotion of state-owned enterprise reform), *ibid.*, 91; Institute of Industrial Economics, Chinese Academy of Social Sciences, *Zhongguo gongye fazhan baogao* (Report on industrial development in China) (Beijing: Jingji guanli chubanshe, 1998); and CESS, "Qiye jingyingzhe dui hongguan jingji xingshi ji jingji tizhi gaige redian de panduan he pingjia" (Enterprise managers' judgment and evaluation of the macro-economic trend and hot issues of economic system reform), <http://www.cess.gov.cn>.

argues that, while having had rights to use state assets, the managers had no or very limited rights over asset disposal.³² That statement must have been correct at least until the early 1990s. For example, managerial discretion over asset disposal and M&A was pretty low in 1993, as less than 30 percent of the managers responded that they had authority over this matter that year (see table 2). Over the four-year period from 1993 to 1997, however, managerial discretion over these matters jumped by about 40 percentage points to reach 70 percent. This change is very significant in that substantial property rights over the enterprises, which formerly lay in the hands of the supervisory state organs, have now been turned over to the enterprises. As is also noticeable from table 2, increasing managerial autonomy in the 1980s was mainly limited to more traditional areas such as production, marketing, and procurement matters. The *de facto* control over enterprise assets by the managers in the 1990s of course could, on the one hand, have contributed to more efficient resource allocation by facilitating asset transfer, liquidation, and M&A; on the other hand, however, increased managerial power that remained unchecked and not properly monitored could lead to an insider control problem, with such consequences as the irregular expropriation of state property and excessive managerial perquisites.

Also worthy of notice is that increasing managerial autonomy in property rights over assets is tied to the implementation of the shareholding system. In table 2, the 1994 columns show the difference between the shareholding and traditional SOEs. In matters regarding investment decisions, M&A, and asset disposal, the difference in managerial power between the two groups is substantial. Thus, we can infer that transformation of the SOEs into shareholding corporations has contributed to increasing enterprise self-control over property rights, as was intended when the government decided to grant enterprises "legal person" status with valid rights over asset disposal. Increasing enterprise autonomy with the transformation into the shareholding corporations has been confirmed by varied

³²Qian, "Reforming Corporate Governance in China," 222.

researchers, including Lee and Mark.³³ This autonomy was one of two important benefits of the system, together with increased capital capacity.

Second, we also notice an important increase in managerial power over personnel matters, including hiring. In the 1980s, managerial autonomy increased substantially regarding decision-making over wages and bonuses, but not over hiring and other personnel matters. In all these areas, managerial autonomy had been relatively low in the past, yet increased in the late 1990s by more than 40 percentage points. This change in the 1990s implies a strengthening of managerial relative to worker power. Thus, we can say that weakening of worker power was a trend of the 1990s. The power of the workers congress was reduced, mainly to matters directly related to worker welfare. The weakening of worker power was also a result of the implementation of the shareholding system. With this system, the so-called "new three organizations" (新三會, *xin sanhui*) were instituted, whereas the "old three organizations" (老三會, *lao sanhui*) had lost power.³⁴

There is a third point we should mention. The power of the supervisory state and party organs has been greatly reduced, not only in such areas as production and procurement but also in terms of asset disposal and investment. State/party power has not, however, completely disappeared yet. Evidence of this staying power is the item on "the right of refusal to pay unauthorized charges" in table 2. The fact that managers still find it hard to reject requests from state or party organs for some kinds of irregular or arbitrary remissions or contributions underscores the continuing power of state and party bureaucrats. More importantly, state/party power is still strong in terms of the appointment of the managers of the SOEs, including the shareholding corporations dominated by state shares. That should be regarded as natural in that the state is the dominant shareholder and that bureaucrats are supposed to act on behalf of the state in board meetings.

³³Lee and Mark, "Privatization in China's Industry," 157-73.

³⁴The "new three organizations" include the shareholders' general meeting, the board of directors, and the board of auditors. The "old three organizations" include the party committee, the workers congress, and the trade union.

Based on the above discussion, we argue that the decision-making power of Chinese SOEs in the 1990s can be characterized as having "a strong middle and a weak top and bottom." Since the power of the state and party organs were not being totally ignored, however, we hold that there still remained room for outsider-insider collusion, but insider-outsider collusion now with the upper hand held by the insiders. Without insider cooperation, the outsider cannot effectively gain any benefit from the enterprise; this signifies that the insiders or managers were in a position to control enterprise property by the end of the 1990s.

We feel that managers in Chinese SOEs are now very similar to managers in American firms which feature a dispersed distribution of shares. There remain some important differences, however, mainly due to the transitional nature of the Chinese market economy. Most importantly, rudimentary capital markets make the insider control problem more serious, especially in such matters as irregular asset disposal or diversion and hence dissipation of state property.

Asset Stripping by Insiders

As discussed in the preceding sections, even from the early stage with the implementation of the shareholding system, state assets were often undervalued in the initial evaluation of enterprise assets for transformation into shareholding corporations. This is an example of the insider control problem where there is no one to represent the interests of the state on the board, as it was often the case that the state shareholder remained obscure and existed in name only. With the progress of the shareholding system as well as the manager's increasing power over asset disposal, the problem became more serious and widespread during the 1990s. In other words, the managerial right over state asset disposal and M&A was abused through sales of state assets at cheaper prices or even by letting other units or individuals use them for free.

In the 1990s, the tendency became strong in the cases of Sino-foreign joint ventures, which often served as a way to restructure Chinese SOEs. When the Chinese SOEs got "married" (外資嫁接, *waizi jiajie*) with foreign management know-how, technology, and capital, it was often the case

that asset revaluation was not carried out. Rather, assets were estimated at their book value only.³⁵ A 1992 joint investigation undertaken by six Chinese government ministries that spanned nine localities discovered that only 24 percent of those enterprises for which asset revaluation was regarded as necessary for the implementation of the Sino-foreign joint venture, actually conducted such revaluation. In the cases where asset revaluation was actually carried out, the values of assets actually decreased on average by more than 70 percent.³⁶ Such examples indicate the seriousness of the asset dissipation problem in China. Even in those cases where asset revaluations were conducted, the Chinese sides were often on bad terms with their foreign partners. For example, only 79 percent of the revalued assets were counted as the Chinese share in the case of a certain chemical factory in Nanchang City (南昌市), although the part of the assets used for the joint venture was the key production facility of the factory. However, reports held that it was the managers and the state bureaucrats in charge that pushed the deal despite strong opposition from the workers and other relevant parties. In the newly established joint venture, the original Chinese manager was treated very well and became the general manager.³⁷ This case is an example of insider control backed by insider-outsider collusion.

Another case of the insider control problem is related to the emergence of business groups in China. A survey has found that there are three important ways to form enterprise groups in China: spin-offs, M&A, and joint ventures.³⁸ Out of the three, the most frequent form has turned out

³⁵Qian, "Reforming Corporate Governance in China," 227.

³⁶Liu buwei lianhe jianchazu (Six Ministries' Joint Investigation Team), "Guanyu dui bufen shengshi guanche zhixing Guowuyuan 91 hao ling he liu buwei jinji tongzhi qingkuang de jiancha baogao" (An investigation report on the implementation of the State Council's directive no. 91 and six ministries' urgent notification), *Guoyou zichan guanli* (State Assets Management), 1993, no. 7:20-24.

³⁷Han Chaohua, "Guoyou zichan guanli tizhi zhong de daili wenti—yige guoyou zichan liushi anli de qishi" (The agency problem in the state asset management system—lessons from a case of state asset expropriation), *Jingji yanjiu*, 1995, no. 5:34-43.

³⁸This survey was conducted by the Institute of Economics of the Chinese Academy of Social Sciences in 1996 for about 670 SOEs in the four provinces of Jiangsu (江苏), Sichuan (四川), Shanxi (山西), and Jilin (吉林); the authors have access to some part of the survey results.

to be the establishment of subsidiaries through spin-offs. A spin-off sometimes involves the establishment of a new firm not only with the parent firm's money but also with investment from other independent companies. Entry or expansion into new business areas in a group is often accompanied by implicit or explicit asset diversion from old to new business areas. Such diversion has also allowed diverse types of expropriation of state property in the form of tax evasion, debt reduction, and dividend manipulation. For example, Fan documents several opportunistic cases of leaving profits to subsidiaries and debts to parents.³⁹

Thus, setting up a new subsidiary within a group has two different implications. On the one hand, it should be interpreted as a positive phenomenon: a firm's competitiveness is increasing by entering into a new business area, dealing with redundant workers, and so on. On the other hand, creating a new subsidiary also involves asset diversion that often serves as leeway for private profiteering and asset stripping; this is possible because setting up another layer of enterprises in the form of subsidiaries tends to lead to information manipulation by adding more agency chains hidden from the eyes of outsiders, including supervisory state organs.

Actually, Hahn observed that many parent companies were diverting their assets to the benefit of subsidiaries in a diverse, irregular manner.⁴⁰ He found that the motivation for this behavior was to bypass state regulations with a view to increasing the companies' benefits at the expense of the state, which is both the tax collector and the major shareholder of these companies. Upon examination of the published balance sheet of the listed group-type companies in China, Hahn found that long-term investment by parent companies in subsidiaries was low only in the accounting books, but that in reality many fixed or variable assets were used for business ac-

³⁹Fan Gang, "Lun zichan chongzu" (A study on asset reorganization), in *Qiye gaige zhong de zichan chongzu: anli yanjiu yu lilun fenxi* (Asset reorganization in enterprise reform: case studies and theoretical analyses), ed. Ma Hong (Beijing: Jingji guanli chubanshe, 1996), 125-32.

⁴⁰Hahn Donghoon, "Guanyu Zhongguo qiye jituan yu guojia konggu gongsi de yanjiu" (A study on enterprise groups and state shareholding companies in China) (Ph.D. dissertation, Beijing University, 1997).

tivities of subsidiaries in irregular ways. On the balance sheets of such companies, there are many arbitrary items such as "unrealized receivables from related companies" and "internal transactions" within the category of variable assets.⁴¹ Our interviews with the staffs of several companies indicate that the amounts listed under these items are *de facto* long-term investments that were utilized by subsidiary companies.

The Recent Transition from *de Facto* to *de Jure* Insider Control

Restructuring and Privatization

There are contrasting views on the causes of the poor performance of SOEs in China: some blame the bad internal mechanisms of the enterprises, while others point to the burdens imposed externally on the enterprises. From the "internal mechanism" point of view, enterprise performance can be improved through reforms in management mechanisms. The "imposed burden" view, on the other hand, argues that the cause of the poor performance is the legacy of the planned economy which imposed excessive burdens on the enterprises.

The reform measures implemented from the early 1980s to the mid-1990s—e.g., the profit retention system, tax-for-profit system, contracted management system, and corporatization—were all based on the internal mechanism view. With the continuous deterioration of SOE performance, however, the government's posture toward SOE reform has changed, beginning in the late 1990s, to the imposed burden view.⁴² From

⁴¹The data for the enterprises are from the annual reports published in the January to May issues of *Shanghai zhengquan bao* (Shanghai Securities News), *Zhengquan shibao* (Securities Times), and *Zhongguo zhengquan bao* (China Securities News) for the years of 1995, 1996, and 1997. The annual reports provide the financial statements of the parent companies and the consolidated financial statements for the groups. For information on the guidelines for the accounting method of the consolidated financial statements, see the PRC Ministry of Finance, "Guanyu hebing kuaiji baobiao hebing fanwei de fuhuan" (Reply in regard to the scope of consolidation in making consolidated financial statements) (1996).

⁴²Hahn Donghoon, "Joonggook gookyugieopeui nebulatongjewa sayuwha" (Insider control and privatization in Chinese state-owned enterprises), *Gyeonje baljeon yongu* (Journal of Korean Economic Development) (Seoul) 8, no. 2 (2002): 81-102.

this perspective, the burdens on SOEs fall into two categories: strategic and social. The "strategic burden" refers to the deviation of the SOEs' industrial structure from market demand due to the distortion of the industrial structure, which was formed as a result of a heavy industry-oriented development policy. The term "social burden" refers to over-staffing, excessive welfare expenditures, and excessive debts due to the change in fiscal grants for bank loans (撥改貸, *bo gai dai*).

The Chinese government has recently launched a series of policies to alleviate these burdens. The policies are "structural adjustments," and were embodied in the document "Resolution on Some Important Matters Related to SOE Reform and Development" (中共中央關於國有企業改革和發展若干重大問題的決定) which was adopted at the Fourth Plenary Session of the Chinese Communist Party's Fifteenth Central Committee in September 1999. This Resolution emphasizes ownership reform to improve corporate governance, which is to be achieved through diversifying ownership of the SOEs by listing them on stock markets and inviting foreign or private partners.

De Jure Insider Control by Managers: ESOP and MBO

The recent upsurge in takeovers of SOEs by insiders through management buyouts (MBOs) and employee stock ownership plans (ESOPs) can be interpreted in terms of the above-mentioned changes in SOE reform policy. At the heart of the restructuring policies lies activism by the local governments. The recent policy position of the central government towards SOE reform is privatization (國退民進, *guotui minjin*) and diversification of ownership, and these directives are to be initiated by the local governments. The central government has further transferred control rights over SOEs to local governments. The central government is now in charge of only the largest business groups, with the local governments controlling the rest. The local governments are virtually entitled to implement whatever restructuring methods they may like. As a matter of fact, more and more local governments are choosing to privatize SOEs. The central government's reaction has been to turn a blind eye to such behavior.

In principle, compared with the privatization to insiders, privatization to foreign or private enterprises is more advantageous in terms of bringing in additional capital and enhancing management quality. The method that is most frequently adopted by the local governments, however, is privatization to insiders through MBOs and ESOPs. The reasons are as follows.

First, considering the fact that most private enterprises in China are not big enough to merge or acquire large SOEs and the fact that dealing with foreign enterprises are subject to high transaction costs, privatization to private or foreign enterprises is very difficult and will take a long time to complete. Implementing MBOs and ESOPs can thus be an alternative method of accelerating ownership reform.

Second, local governments are concerned more about social stability than efficiency, and want to preserve a certain degree of control over enterprises even after privatization. Local governments are worried about massive layoffs that could result from privatization.

Third, having more information about enterprises than do outside investors, incumbent managers are in a better position to manage the enterprises. Thus, local governments want to turn managers into major shareholders who have incentives to monitor enterprise behavior. In addition, local governments are increasingly realizing the importance of better utilization of scarce managerial talent in China. Moreover, with the intensification of market competition and the emergence of strong managerial autonomy, the importance of managers is being increasingly understood. Actually the September 1999 Resolution stated that the nurturing of capable managers is an important part of SOE reforms, and suggested linking manager income to performance by adopting an annual salary system and/or stock options. This proposal has led local governments to consider managers as the appropriate persons to whom to hand SOE control.

With regard to the rapid spread of MBOs and ESOPs, the will of local governments plays the most important role. Lacking any formal guidance from the central government, as of 2002 more than thirty provinces and municipalities promulgated their own rules on the implementation of MBOs and ESOPs. Some local governments have even stipulated the

minimum equity share to be held by managers and core engineers.⁴³

ESOPs originated from the shareholding cooperative system (股份制, *gufen hezuozhi*) that had been implemented in the early 1980s in the township and village enterprises (TVEs).⁴⁴ The purpose of the issuance of employee stocks was to solve a shortage of capital. However, the central government has launched a series of regulations on employee stocks, in response to certain problems (such as excessive rent-seeking). Despite the various regulations, however, ESOPs are being widely implemented at a rapid pace, and in many cases under the support of local governments. Most local governments are legislating rules on ESOPs. The ESOP in the SOEs takes various forms, the most prevalent of which is to set up an "employee stock-holding board" as an organization to collectively exercise control rights for employee stocks.⁴⁵

In contrast to ESOP, MBO is a relatively new phenomenon that first emerged in the late 1990s in China. Being adopted very rapidly, MBO is becoming the dominant form of insider share ownership. As of May 2001, about 6 percent of the listed companies had already implemented certain forms of MBOs.⁴⁶ As of June 2003, out of about nine hundred listed firms in which the state held shares, about two hundred firms had plans to conduct MBOs.⁴⁷

Typical MBOs in developed market economies can be characterized as follows. First, an incumbent manager (either the top manager alone or managers as a group), who knows the company's potential better than

⁴³Examples are provided in Li Keming, "Qiye gaige: gaidao shenchu shi chanquan" (Enterprise reform: the essence is the property right), *Zhongguo jingji daobao* (China Economic News), January 15, 2002; and Zhu Jinfu, "Nanjing guozi MBO diaocha" (Survey on MBO of state assets in Nanjing), *Zhongguo jingying bao* (China Management Daily), March 25, 2004.

⁴⁴Wang Wei, *Zhongguo binggou baogao* (China M&A report) (Beijing: Huaxia chubanshe, 2002), 341.

⁴⁵In the city of Beijing, for instance, employee stock-holding boards were set up in as many as fifty-eight companies, with boards holding as high as 20 percent of the total stocks issued.

⁴⁶Wang, *Zhongguo binggou baogao*, 352.

⁴⁷Wang Zihui, "Guozi liushi shi MBO zuida de yinhuan" (State property dissipation is the biggest threat of MBO), *Zhongguo jingji shibao* (China Economic Times), June 30, 2003.

others, would buy a majority shares of the company with a view to claiming a share of future profits, the increased value of the firm, and the subsequent resale of the shares. Another motivation for incumbent managers to purchase the shares is to use them as an anti-takeover device. Thus, the top managers, not including employees, are usually the ones to initiate MBOs. Second, given that funding for MBOs relies heavily on secured loans, MBOs are thus usually leveraged buyouts. Moreover, the target firms of MBOs are usually listed companies or big firms. Also, typical MBOs tend to entail massive restructuring.

The MBOs recently in fashion in China are somewhat different from the description given above. First, the main purpose is ownership reform (i.e., privatization). In line with this feature, the MBOs in China are not confined to managers, but include core engineers, and in many cases are implemented in parallel with ESOPs. Second, target shares are state shares or legal person shares that are not circulated in the market. Third, because of the ban on stock-secured bank loans, many illegal funding activities for MBOs are prevalent, including self-funding, installment payments, private equity funds, and trust funds. Fourth, MBOs are not accompanied by massive restructuring.⁴⁸

Firms that conduct MBOs in China have the following characteristics.⁴⁹ In terms of industry characteristics, most are leading firms with a strong competitive edge and a high value of intangible assets, and are engaged in very competitive or traditional industries. In terms of financial performance, they feature relatively high and steady profit rates and rapid expansions of business. In terms of manager characteristics, the managers have long job tenures and have been with the firm for a long time. They tend to have high intra-firm prestige due to both their managerial knowledge and contributions that they have made to firm performance. In terms of share distribution, the portion of state and legal person shares tends to

⁴⁸Ibid.

⁴⁹As described in Mao Daowei, Cai Lei, and Ren Peiyu, "1999-2002 shangshi gongsi MBO yanjiu" (Study on MBO of listed companies in 1999-2002), *Zhongguo gongye jingji* (Chinese Industrial Economy), October 2003, no. 10:74-81.

be relatively high and the shares tend to be concentrated.

Rent-seeking Through MBO

However, the MBO, especially the MBO led by local governments, has some negative aspects; these include illegitimacy in implementation and rent-seeking through undervaluation of enterprise assets and the resultant expropriation of state assets. Because the MBO is a relatively new phenomenon in China, however, there is no law regulating MBO activities. Nevertheless, the fact that MBOs are very much in fashion indicates that they are being conducted illegally or in an irregular manner. Some of the main obstacles to the MBO are the legitimacy of the MBO "shell company"⁵⁰ and difficulties in financing. In developed market economies, the usual way to conduct an MBO is for the managers of the target companies to establish a shell company and then obtain a loan for the acquired shares of the target companies.

The first obstacle to the MBO in China is the legitimacy of the shell company. Because a group of people collectively purchases the shares, the usual way to conduct an MBO in China is to establish the employee shareholding boards or shell companies. Lacking the status of legal persons, however, the employee shareholding boards are not entitled to be shareholders of the target firms. For this reason, the government suspended the approval of employee shareholding boards in 1999. Moreover, according to the Corporate Law (公司法) of China, except for investment companies or holding companies approved by the State Council, corporations are prohibited from making investments for limited liability companies or shareholding corporations exceeding 50 percent of their net assets. The second obstacle to the MBO in China is a ban on MBO loans. The Corporate Law and Regulations on Administering M&A of Listed Companies (上市公司收購管理辦法) prohibit loans on the merged firm's assets, and the General Guidelines on Bank Loans (貸款通則) prohibits investment in stocks on borrowed money. Considering the limited financial capabilities

⁵⁰A shell company is a kind of holding company for the shares transferred to the managers or employees.

of the managers, we can easily surmise that financing would be the biggest obstacle to the MBO.

Recently, trust funds have often been used in MBO processes in order to avoid the above-mentioned legal obstacles. Trust funds play the role of proxy shareholders by buying out the shares of the target companies on behalf of the incumbent managers of the target companies. Later, the managers buy back these shares in a prearranged period of time. Since personal loans for MBOs are not allowed, trust funds play the role of financial intermediaries by attracting strategic investors, including private MBO funds.

Aside from the above legal restrictions, a more essential problem that hinders the spread of the MBO is the issue of fairness. The unfairness revealed in recent implementations of MBOs can be discussed in terms of share pricing, sources of funds, and transparency. The first and most serious problem is share pricing. The target companies for MBOs are usually local enterprises controlled by local governments. The shares sold by local governments to managers are state shares and/or legal person shares (usually the latter). According to the Regulations on Administering M&A of Listed Companies promulgated in 2002, the transfer of state shares for listed companies requires the approval of the Ministry of Finance, whereas the transfer of legal person shares does not. That is why in most MBO cases the shares traded are legal person shares. The local governments hold state shares, whereas legal person shares are held by the SOEs. However, local governments hold control of legal person shares in most cases. Thus, local governments get involved in the negotiations to determine the selling prices of state shares and/or legal person shares. The transfer prices of the stocks are determined by negotiations between local governments and managers. Local governments tend not to play a sufficient role as effective shareowners in negotiations, however, due to such reasons as collusion with insiders, lack of incentives, and information asymmetry. In actuality, the MBO process is virtually "self-selling and self-buying" (自賣自買, *zimai zimai*). As a result, in most cases the shares are sold to insiders at prices lower than the net asset value of the firm (see table 3).

As a reaction to this situation, in April 2003 the Ministry of Finance stopped receiving applications for MBOs from both listed and non-listed companies. In December 2003, the newly established State-Owned Assets Supervision and Administration Commission promulgated "Opinions on Regulating SOE Transformation" (關於規範國有企業改制工作的意見, *Guanyu guifan guoyou qiye gaizhi gongzuo de yijian*). The "Opinions" prohibits "self-selling and self-buying," and stipulates that share transfer prices should be determined through such methods as auctions or negotiations and that the transfer price of state shares of listed companies should not be lower than the net asset value per share.

Table 3 shows that in many firms the transfer prices are lower than the net asset value. In the case of Huaqiang Corporation (華強公司), which is not included in table 3, the transfer prices were fixed at 34 percent of the net asset value.⁵¹ In most cases, share transfer prices are settled without any revaluation of assets, resulting in the stripping of state property and infringement on minority shareholder rights. Considering the fact that the figures for net asset value per share were calculated according to their book value, and that in China land values are not reflected in the accounting books, we can surmise that the transfer prices are very much discounted. In many cases, the land is the real objective of acquiring a firm in China. Managers tended to take advantage of information asymmetry for rent-seeking purposes in MBO processes. Cases were reported in the media that managers wrote up financial statements that concealed profits and instead claimed false losses, and then purchased state shares and/or legal person shares at very low prices by threatening the local governments that the firm performance would deteriorate even further.⁵² Then, after the MBOs were completed, the managers added the concealed profits back to the financial statements in order to get paid a high rate of dividends, and used

⁵¹Wu Ming, "Gongsi yanjiu: Shenzhen Huaqiang—Huaqiang jituan zhengti gaizhi taiqian muhou" (Enterprise research: Shenzhen Huaqiang—a behind-the-scenes story of the whole restructuring of Huaqiang Group), *Zhongguo zhengquan bao*, October 14, 2003, <http://www.cs.com.cn>.

⁵²He Xiaoqing, "MBO weihe zong zao goubing" (Why is MBO always blamed), *Zhongguo jingji shibao*, November 26, 2002, <http://www.cet.com.cn>.

Table 3
Transfer Prices of Shares for MBO in Eight Listed Companies in China

Firms	Takeover share ratio (%)	Transfer price (yuan)	Net asset value per share (yuan)	Pricing rule
Shengli	17.65	2.27 2.27	2.24 2.27	Net asset value
Tebian Diangong	27.64	1.24 2.5 3.1	3.1 3.28 3.28	Not announced
Fosu	29.48	2.95	3.3	Not announced
Yutong Bus Manufacturing	100	Not announced	7.0	Not announced
Fangda Group	36.1	3.08 3.28 3.55	3.43 3.43 3.45	Not announced
Guangdong Meide	30.59	Not announced Not announced Not announced 2.95 3.0	2.99 3.31 3.56 3.99 3.99	Not announced
Dongting	22.9	5.75	5.84	Net asset value
Ordos	43.8	1.77 1.77	5.64 5.79	Not announced

Source: Annual and mid-term reports (1999-2002) of listed companies.

the dividends to pay off personal debts incurred in purchasing the shares.

The second problem is the source of the MBO funds. In China, there are many restrictions regarding the funding for MBOs. The General Guidelines on Bank Loans prohibits investment in stock on borrowed money, the Corporate Law prohibits loans on the assets of the merged firms, and Regulations on Administering M&A of Listed Companies forbids the merged firms from providing financial assistance. Under these circumstances, the funding for an MBO in most cases is done in an illegal or irregular manner—such as loans on securities, private equity funds, or trust funds. In most cases, the source of MBO funds is not made public.

The amount of the merging firm's equity capital is often smaller than the amount to be paid in exchange for the transferred shares.⁵³ A close look at the accounting books of Chinese group firms reveals that there are accounting items named "related transaction," "internal transaction," etc.—transactions often used as sources of funding for MBOs.

The last problem is non-transparency in the MBO process. Although the China Securities Regulatory Commission (中國證券監督管理委員會) stipulated the public announcement procedure for MBOs of listed companies in December 2002, many firms disobeyed the regulations. Many did not even announce the occurrence of MBOs, let alone the share transfer prices or the pricing principle. In response, the central government suspended acceptance of MBO proposals in April 2003. Many firms have conducted the MBOs in an illegal or irregular manner with implicit or explicit help from the local governments, however. A typical example is the case of Yutong Bus Manufacturing (宇通客車製造).⁵⁴

Next we turn to the relations between the MBO and the ESOP. For some firms, the MBO involves the managers alone, who obtain *de jure* insider control; for other firms, the MBO is conducted in combination with an ESOP. Even in the latter case, however, the participation of the employees in the management of the enterprise is blocked. In most cases, the employee stock management boards administer the employee stocks collectively, yet are under the influence of the manager(s). In addition, there are various restrictions imposed on the exercise of shareholder rights. As a result, ESOPs are used as devices to strengthen the controlling power of the manager(s)—i.e., in the enterprises that recently conducted MBOs or ESOPs, the managers hold *de jure* control. We can thus infer that control rights have been grasped by the insiders (i.e., the managers).

A good example is the case of Huaqiang Corporation. In September 2003, the Guangdong (廣東) provincial government made an agreement

⁵³Mao, Lei, and Ren, "1999-2002 shangshi gongsi MBO yanjiu," 77.

⁵⁴For details see Zhang Lidong and Yang Kairan, "Yutong keche jie paimai wancheng MBO" (Yutong Bus Manufacturing realized MBO by relying on auction), *Jinghua shibao* (Jinghua Daily), January 5, 2004, B26.

to transfer not only 46 percent of the state shares to the ten top managers but also 45 percent to Huaqiang Hefeng Investment Corporation (華強合豐投資公司), a shell company to hold the employee shares, while keeping the remaining 9 percent.⁵⁵ Through this measure, the formerly wholly state-owned Huaqiang Corporation became a mixed-ownership corporation. *De jure* control of the firm, however, was transferred to the managers, because the ten top managers collectively became the majority shareholder, with their share ratio slightly higher than that of the employees.

Some International Comparisons

Radical privatization of SOEs in Eastern Europe tended to result in an insider control problem.⁵⁶ Table 4 shows that in the case of Russia, the shares held by insiders can comprise as much as 60 percent of the total. In other words, while the former control by state bureaucrats under central planning has now gone, no substitutive monitoring mechanism has been set in place.

Although Mongolia is often regarded as having opted for shock therapy, the actual privatization was somewhat different from that in Eastern Europe. In Mongolia, the state was in charge of accomplishing a well-planned privatization program in a remarkably short period of time, yet wanted to retain a certain minimum amount of shares after privatization.⁵⁷ The state guideline on the size of the state's residual ownership was flexible, and the state retained stakes ranging from 15 to 80 percent in 41 percent of privatized enterprises.⁵⁸ Table 4 shows that in Mongolian firms, the share of outsiders is as high as 44.9 percent, and that of the insiders (the

⁵⁵Chen Dong, "San da yuanzui kaowen quxian MBO" (Three original sins are torturing roundabout MBO), *Shichang bao* (Market News), January 6, 2004, 21.

⁵⁶Masahiko Aoki and Hyung-Ki Kim, "Overview," in Aoki and Kim, *Corporate Governance in Transitional Economies*, 8.

⁵⁷Georges Korson and Peter Murrell, "The Politics and Economics of Mongolia's Privatization Program," *Asian Survey* 35, no. 5 (1995): 472-86.

⁵⁸*Ibid.*

Table 4
International Comparison of Insiders' and Outsiders' Shares

Average Percentage of the Enterprise Shares Owned by: (%)										
	No's	State	Outsiders				Insiders			
			sub-total	A	B	C	sub-total	directors	employees	
Mongolia	249	(1994)	20.4	44.9				34.8	11.0	23.8
					Legal person	29.7	General public	28.0	Foreigner	6.9
China	171	(1994)	34.6	64.6				0.8		
					Large investors	16.0	Small investors	11.0		
Russia		(1994)	13.0	27.0				60.0	11.0	49.0
					Other <i>keiretsu</i>	19.0	Independent	27.2		
Japan	6	(1973)		46.2				53.8	owners & relatives	member firms
Korea	5	(1996)		52.15				47.85	8.2	39.65
	30			55.86				44.14	10.32	33.82

Notes: "No's" means the number of the firms used for the calculations of the figures.

Sources:

- Figures for Mongolia are from James Anderson, Georges Korson, and Peter Murrell, "Ownership, Exit, and Voice after Mass Privatization: Evidence from Mongolia," *Economics of Transition* (1999).
- Figures for China are from Xiaonian Xu and Yan Wang, "Ownership Structure, Corporate Governance, and Corporate Performance: The Case of Chinese Stock Companies" (mimeo, 1997).
- Figures for Russia are from Mizobata Satoshi, *A Study on the Economic and Management Systems in Russia* (in Japanese) (Tokyo: Law and Culture Publishing House, 1996).
- Figures for Japan are from the original table reported in Chalmers Johnson, Laura D'Andrea Tyson, and John Zysman, *Politics and Productivity: How Japan's Strategy Works* (New York: Harper Business, 1989), 159.
- Figures for Korea are from Korea Fair Trade Commission.

sum of the shares held by the management and the workers) is about 35 percent. Such a distribution of shares should be viewed as an improvement over the East European cases where insider shares might be as high as 60 percent.

Both in Mongolia and in Eastern Europe, the large portion of insider shares is due to the compromise given to insiders as incentives for rapid implementation of privatization. To a certain extent, however, this portion is a price to be paid since without it the program itself would have been delayed or even stalled due to political conflict and/or the emergence of organized opposition to the program. In the case of the Chinese companies listed, the outsider's shares reached as high as 64.6 percent, whereas those of the insiders were less than 1 percent in 1994. Even if we put together the shares of the insiders (managers and workers) and the state, the total is less than 40 percent. This difference between China and Mongolia can be explained by the difference in their methods of privatization: in China, only newly issued stocks were gradually sold to the public, while Mongolia used comprehensive voucher schemes.

Thus, in China, in cases where new shares of the shareholding corporations are sold to the public, a balance has been struck between the state agencies holding original state shares and inside managers and new outsiders holding newly issued shares. In Vietnam, too, where many foreign companies participated as shareholders or partners in the existing SOEs, a similar balance has been struck among state agencies, inside managers, and foreign partners. The above discussion indicates that China—unlike Russia and other East European countries—has not experienced insider privatization, as seen by the very low level of shares held by insiders. This implies that the insider control problem has not been that serious.

Nevertheless, taking into account the recent spread of privatization to the insiders through MBOs and/or ESOPs, we observe that insider control of Chinese SOEs is continuing to intensify. Despite this new progress toward *de jure* insider control, however, we still infer that the degree of insider control in Chinese SOEs will not be as high as in the Russian and East European cases. There are grounds to support this prediction. First, MBOs and ESOPs are not the only methods considered by the Chinese

government for privatization and improvement of corporate governance. The Chinese government recently legalized M&A of SOEs by foreigners, allowing local governments to sell their state shares and legal person shares to foreigners. In support of this move, the government promulgated the "Provisional Rules on the SOE Restructuring by Making Use of Foreign Capital" (利用外資改組國有企業暫行規定) and a "Notification on the Transference of State Shares and Legal Person Shares of Listed Companies to Foreigners" (關於向外商轉讓上市公司國有股和法人股的通知) in November 2002.

Second, the government is not considering any massive and radical privatization in the near future, preferring instead to continue with the gradualist approach of listing and selling shares on stock markets. In 2001, the Chinese government did decide to sell both state and legal person shares on stock markets, but because stock prices plummeted due to investor fear of a possible downfall of stock prices, the Chinese government suspended the plan. The Chinese government will pursue this policy again, however, as stock market conditions allow.

Third, the Chinese government is stepping up efforts to improve the governance structure of firms. One of the many measures is the provision for independent directors. According to a new regulation, listed companies should have a certain minimum number of independent directors on the board. Another step in this direction is the government's recognition of the monitoring role of institutional investors. One might think that legal person shareholders might not really be independent in the Chinese context. An empirical analysis using data of the listed companies has found, however, that there is a significantly positive relationship between the shares by legal persons and firm performance.⁵⁹ This finding implies that these shareholders provide a positive check-and-balance function. Thus, one could say that one of the merits of "state-led transition" in China, Vietnam, and Mongolia—when compared to the changes in Russia and

⁵⁹Xiaonian Xu and Yan Wang, "Ownership Structure, Corporate Governance, and Corporate Performance: The Case of Chinese Stock Companies" (Mimeo, 1997).

Eastern Europe—is that the state agency is able to play a role as an outside monitor until the full-fledged market mechanism is set in place, although there remains, of course, a collusion problem between state bureaucrats and managers.

Insider control is a problem only when an insiders' interest is strongly reflected in the strategic decision-making of the enterprises. Even in the firms in mature market economies with a low rate of insider shares (including the United States), such problems exist to a certain extent, albeit in different forms. In Japanese or Korean firms, mostly large-sized *keiretsus* or *chaebols* that are known for very high rates of insider shares, the checking mechanism has been either the state (as in Korea up to the 1980s) or the main bank (in Japan). On top of this, there has also been discipline from the markets, mostly world markets, since domestic markets have been quite oligopolistic.

Thus, we argue that the very high level of market competition in Chinese domestic markets is another factor which checks the tendency of insider control. As is well known now, the Chinese market is one of the most competitive markets among developing countries, if not in the world. There are three reasons for the increasing market competition in China. First, market-oriented reform since 1978 transformed the planned economy into a decent market economy featuring excess supply rather than the supply shortages of the past. Second, market-driven integration of the domestic economy weakened the notorious provincial protectionism. Third, the strong new entry of private and FDI-backed firms contributed to increasing market competition. The mounting pressure from the market has been pushing enterprises and their employees to become more efficient.

Concluding Remarks

The reform of state-owned enterprises has been at the heart of all economic changes in China during the last decades. In this process, the personal interests of agents at various levels of the hierarchy have emerged

as one of the most important sources of interference with economic outcomes. This paper has focused on the three levels of agents relating to enterprise matters: the outsiders consisting of supervisory state and party organs at the top, and two insiders consisting of managers at the middle level and workers at the bottom. In such a hierarchical principal-agent model, the key issue is who controls the system, with or without collusion with other agents. Based on the above framework, the paper has analyzed the evolution of the enterprise system over the reform decades in China, identifying four distinct stages.

The first stage is the pre-reform period characterized by a strong top and a weak middle and bottom, that is, a period of outsider control. The second stage, which took place mostly in the 1980s, was characterized by a weak middle and a strong top and bottom; during this stage there were two tiers of collusion involving both insiders and an outsider with the upper hand held by the outsider. The third stage, during most of the 1990s, was characterized by a strong middle and a weak top and bottom, and it is this period that saw the insider control problem—although the insider (i.e., the manager) still had to collude with the outsider to a certain extent. The fourth stage, which began at the end of the 1990s and continues today, is characterized by the shift from *de facto* insider control toward *de jure* insider control. This paper finds that while the dual collusion had led to the expropriation of state income (enterprise profits), the insider control problem has led to asset dissipation and diversion by insider agents. The paper also finds that the insider control problem has recently been aggravated by the fact that insiders are turning into majority shareholders through management buyouts and employee stock ownership plans.

While also existing in mature market economies, the insider control problem can be especially serious in China since there is no check-and-balance mechanism (such as well-functioning capital markets or active monitoring by banks) as in other mature market economies. However, in comparison with other transition economies such as Russia, the insider control problem can be said to be less serious in China: no substantial amount of shares—and hence no *de jure* control—is held by insiders in SOEs.

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