REFORMING THE CHINESE STATE-OWNED ENTERPRISE: A LAW AND ECONOMICS PERSPECTIVE

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Abstract

China stands in contrast to the transitional countries of the former Soviet-bloc in its economic reform path that can be characterised as incrementalism instead of 'big bang," and marketisation instead of corporatisation. Despite the extensive reforms in all segments of society, the ownership of state-owned enterprises has been maintained largely under the control of the Chinese authorities as the "crown jewel" of the socialist regime. Yet such a reform path has led China to phenomenal and sustained economic growth far from the dim picture initially envisaged by some commentators. This has given rise to intense disputes concerning a host of questions with profound theoretical and practical implications.

Following the line of theories of the firm in law and economics, this study attempts to analyse the state-owned enterprise reform from two aspects. On the one hand, it examines the Chinese economic reform as institutional changes on the basis of the transaction cost economics and property rights theory. Having established that China's reform is of unambiguous property rights implications, this study continues to demonstrate that enormous transaction costs still exist in the current mixed economy. As the fundamental source of such costs is the incompatibility of state ownership and free market economy, the further reform featured with a privatisation of state-owned enterprises is thus called for.

On the other hand, seeing that the agency problem singles out as the most crucial transaction cost, this study further focuses on the issue of ownership and control in the Chinese state-owned enterprises. Mainly based on the contractual

theory of firm, it analyses two major initiatives of the enterprise reform - the CMRS, and the corporatisation and securitisation of state-owned enterprises. While the former is dismissed as a transitional solution, the latter is deemed to point a right direction for the privatisation of state enterprise and an optimal relationship between state and enterprises. Nevertheless, the share and corporate governance structure provided in the current Chinese corporate laws must undergo immense changes.

This study is at best a preliminary analysis of limited issues. Far more efforts are needed to gauge such a broad and complex topic.

Table of Contents

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Introduction

China's post-Mao economic reform has captured the lasting attention of the whole world, not only because it has generated rapid and sustained economic growth, unprecedented rises in real income and living standards, and has transformed what was one of the world's most insular economies into a major trading nation, but more because China has attained such impressive growth and achievements by taking a strikingly different reform path from those in East Europe and the former Soviet Union.[1] Conventional theory of transitional economy has it that gradual reform and public ownership simply cannot work, not even as a transitional strategy.[2] However, confounding the widely-held theory, China has adopted an incremental reform path featured with a gradual rather than abrupt transition to the market and a protected industry without subject to privatisation. Yet, the profound policy and theoretical implications of such a Chinese path are hard to gauge. Some see China's approach as the antithesis of the "big bang" and "shock therapy" approaches advocated so often in Eastern Europe. Others emphasise to the contrary that China's reforms started with an early "big bang" of privatisation and liberalisation in agriculture, and that in industry the reforms have worked well only in the partial private "non-state" sectors of the economy. Indeed, the Chinese reform experience is just like a "magic bag," from which various theorists seem to be able

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[1] See Andrew G. Walder, "China's Transitional Economy: Interpreting Its Significance" (1995) 144 China Quarterly 963 at 963.

[2] Ibid.

to draw any conclusion suitable to their specific purposes.[3] While the Chinese economic reform is far from complete, and more critical issues have yet to be tackled in the following stages, some authors, mainly basing their analyses on ill-founded presumptions, have made attempts to summarise the so-called "Chinese model" without plunging into its underlying contradictions and disorientation.[4]

In China, despite the mounting pressures, the government keeps shying away from an extensive privatisation of the economy, and shelters the ever-increasing economic problems under such catchwords as the "socialist economy with Chinese characteristics" and the "socialist market economy." However, whether or not China can muddle through its partial reform path and sustain its economic growth is open to question, and demands a comprehensive theoretical analysis beyond the dogmatism of some narrow economic theories.[5]

Drawing upon various theories of the firm in the literature of law and economics, this study ventures to examine the past Chinese reform process and indicate the direction of further economic reform. While always posited in the context of the whole Chinese economic reform, the study however mainly focuses on the state-owned enterprise, more specifically on such issues as its ownership, internal incentive and governance systems,

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[3] For a good description of different views about the Chinese reform path, see Walder, "China's Transitional Economy: Interpreting Its Significance" supra at 964-976.

[4] See Lan Cao, "The Cat that Catches Mice: China's Challenge to the Dominant Privatisation Model" (1995) 21 Brook. J.Int'l.L. 97 at 97-178.

[5] See Thomas G. Rawski, "Implications of China's Reform Experience" (1995) 144 China Quarterly 1150 at 1169-1171. Also see Walder, "China's Transitional Economy: Interpreting Its significance" supra at 977.

because of their critical role in the transitional economy and the significant implications of their reform.[6]

The Introduction presents the basic background of the Chinese economic reform including the state-owned enterprise reform, and the Chinese legal reform so that the further analyses can be carried out in certain context. Also, it interpolates the information about law and economics to illustrate the methodology of the study. Chapter I enunciates various theories of the firm in law and economics to lay a foundation for the theoretical analysis of the major issues in the Chinese state-owned enterprise reform. Chapter II deals with the ownership reform of the state-owned enterprise. Based on the economic theory of institutional change, the study demonstrates that the property rights changes are an integral part of the Chinese economic reform, although the property rights reform is not its pronounced objective; it also argues that China should privatise the state-owned enterprises to complete its transition to a free market economy. Chapter III analyses the Contract Management Responsibility System (CMRS), a centrepiece of the Chinese economic reform in reorienting the relationship of ownership and control of the state-owned enterprise. Following the contractual paradigm of the firm, the study asserts that the CMRS has played a positive role in departing from the hierarchical state-enterprise relation in the planned economy, but it is by no means a valid model for the state-owned enterprise in a market economy. Chapter IV explores another important initiative in the state-owned enterprise reform: the securitisation and corporatisation of the state

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[6] For the importance of the state-owned enterprise in the whole Chinese economic reform, and the issues as the ownership, internal incentive and governance systems of the state enterprises, please see Harry G. Broadman, Meeting the Challenge of Chinese Enterprise Reform (283 World Bank Discussion Papers, 1995).

enterprises. Also examined from the separation of ownership and control perspective, such securitisation and corporatisation are recognized as the right direction for the state-owned enterprise reform. However, to establish an optimal relationship of ownership and control, the share ownership structure and governance mechanisms under the current Chinese law must be transformed and redefined. Finally, the Conclusion highlights the rationality of the further privatisation in China, but takes the notice of the difficulties to propose and carry out the program too. While an extensive privatisation will certainly bring dramatic changes to every segment of society, the legal reform is of utmost importance for a private market economy. On this front, China needs a firmer commitment and much greater efforts to building modern legal institutions, transforming the traditional legal culture, and codifying both legal rules and principles.

I. Chinese Economic Reform

1. The Economy in Transition

Command Economy: The Third Plenum of the Eleventh Central Committee of the Communist Party of China held in December, 1978 marked the beginning of Chinese economic reform. Prior to that, China had operated a command economic system along the model borrowed from the Soviet Union,[7] which, according to Naughton, has two essential features. First, resources allocation decisions are made in response to commands

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[7] Chinese command economy was less strict than other socialist countries because of its poor industrial foundation, and other social and economic condition. See Barry Naughton, Growing Out of the Plan: Chinese Economic Reform, 1978-1993 (New York: Cambridge Univ. Press, 1995) at 26.

from planners rather than in response to prices. The most important signals in the system are commands from the administrative hierarchy, rather than prices from the market. Second, command economies concentrate a large volume of resources in the hands of planners, allowing them to assume command of the economy as a whole. More specifically, command economies evolve as the result of efforts to redistribute resources into the investment program controlled by the planners.[8]

In China, the planning power rested on the central government. At the top of the system of planning institutions was the State Planning Commission (SPC). The SPC set initial rough output targets, which were then sent to various industrial ministries under the State Council and to provincial planning commissions. After several iterations of the process, the SPC came up with a roughly consistent set of output targets, investment projects and supply requirements. The ministries and provinces then disaggregated these targets and added requirements of their own before passing them on to particular enterprises and other units.[9] The various industrial enterprises and rural production units were actually mere agents of the state planning machine. They had no discretion and control over the production input and output, which were pre-set by the state. Conceivably, such a planning process was plagued by the bargaining and power-manoeuvring, and hence more political than economic in nature.

The command economic system may be effective in serving certain short-term economic purposes or dealing with some expedient economic problems. The system itself,

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[8] See Naughton, Growing Out of the Plan: Chinese Economic Reform, 1978-1993, supra at 26-27.

[9] See Donald Clarke, "What 's Law Got to Do With It? Legal Institutions and Economic Reform in China" (1991) 10 UCLA Pac.Bas.L.J. 1 at 5.

however, has systemic failures, and will cause extensive waste, technological retardation, and faulty incentives.[10] In addition, the closeness of Chinese rigid economic system, among other political and ideological obstacles, made it impossible for China to benefit from healthy foreign trade and investment. These chronic economic problems and economic closeness had frustrated the desire and plan of the Chinese authorities to turn China into a world economic power and improve substantially the living standard of the people. It is partly to address these long-existing problems and open the door of China to outside world that Chinese economic reform was initiated.

Incremental Approach: Unlike some former Eastern European Socialist countries, China did not resort to such reform strategies as "shock therapy" and "big bang." Instead, it adopted an incremental approach, which has been vividly described as "groping stones to cross the river." Accordingly, the Chinese economic reform proceeded on an ad hoc, trial-and-error basis. Piecemeal measures were introduced on an experimental basis in a single region or sector and, if successful, were then extended to other regions or sectors of country.

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[10] According to Prybyla, the system fails specifically in four aspects: (1) it fails to provide people with increasing quantities of goods and services that the people want at prices they are prepared to pay; that is, the system is one of chronic shortages of both consumer and producer goods. (2) It fails to supply the goods and services efficiently; that is, the system is statically inefficient and wasteful. (3) It fails to promote economic growth by improvements of factor productivity, such improvements being due primarily to technological and social innovation; that is, the system is dynamically inefficient. (4) It fails to provide an automatic spontaneous mechanism that would reconcile individual and social preferences and transform individual strivings into socially beneficial outcomes. See Jan Prybyla, " A Systemic Analysis of Prospects for China's Economy" in China's Economic Dilemmas in the 1990s: The Problems of Reforms, Modernisation, and Interdependence, v.1 Joint Economic Committee, Congress of the U.S., (1991) at 211-212. Also see Jan Prybyla, Reform in China and Other Socialist Economies (Washington, D.C.: AEI Press, 1990) at 18-21.

Undoubtedly, as an institutional change of enormous magnitude, the Chinese economic reform cannot be fulfilled in a short period of time, and must be pursued step by step and with proper caution. However, what distinguishes China from other former Soviet-bloc countries is the absence of a well-defined economic model to accomplish. Under a policy of a planned economy supplemented by market forces, and later a policy of socialist commodity economy, many partial reform measures such as the dual track policy and soft budget constraint have been taken to cope with various economic problems. It thus follows that a "mixed economic system" has gradually replaced the command economy after a decade of reform.[11] Such a mixed economic system can be described as (1) a system dominated and controlled by the central authorities, (2) an economic system in which both central plans and market coexist, but where the planned allocation of key commodities governs the changing structure and growth of the economy and the market sector activities are carried out on very imperfect markets within serious administrative constraints; and (3) a system in which the central authorities rely very heavily on subsidies and grants to achieve the allocation of resources and goods they desire, overriding the results that would hold from decentralized decisions based on true scarcity prices for the sake of maximising profits.[12]

The incremental process and partial reform measures have been the topics of intense dispute by commentators from both inside and outside China. Nolan, for one, holds that

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[11] See Robert Dernberger, "China's Mixed Economic System: Properties and Consequences" in China's Economic Dilemmas in the 1990s: The Problems of Reforms, Modernisation, and Interdependence, v. 1, Joint Economic Committee, Congress of the U.S., (1991) at 91.

[12] Dernberger,"China's Mixed Economic System: Properties and Consequences" supra at 100.

"the optimal pace of reform is different in different countries. Equally, the model towards which it is desirable that they move is different, given the varied ways in which it is likely that markets will fail in post-communist countries."[13] Perkins also regards Chinese strategy is successful in moving the economy from a Soviet-style command economy to an economy governed in large part by market forces.[14]

More commentators, however, have cast doubt on the path China has taken. In Prybyla's view, system-generated problems have to be addressed by systemic reform. It requires the replacement of the institutions and theories of the system responsible for the problems by a minimum critical mass of internally logical, interacting, compatible, integrated institutions and ideas of another system, not by random transplants. And the present nonsystemic situation in which a partially dismantled plan conflicts with an unfinished market is not viable in the long run.[15]

Frustrated by the numerous problems caused by the partial reform measures, the radical reformists within China have also advocated the "one-knife-cut" strategy[16] since mid-1980s. The dispute and internal struggle over the reform strategies among various factions within the party and government have existed through the whole reform process,

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[13] See Peter Nolan, State and Market in the Chinese Economy (Basingstoke: Macmillan Press, 1993), at 174.

[14] See Dwight Perkins, "Completing China's Move to the Market" (1994) 8 J.Econ.Perspective 23 at 24.

[15] See Jan Prybyla, "A Systemic Analysis of Prospects for China's Economy" supra at 224, 225.

[16] A similar approach with the "shock therapy." It, among other things, calls for totally abandoning planned price and governmental subsidy, and privatisation of state-ownership of most industries.

and surfaced from the underneath now and then. Indeed, it has been a major factor contributing to several power reshuffling.[17]

Through the various partial reform measures China has, albeit gradually and slowly, gone a long way from the command economy. The function of the partial reform measures is however transitional. They have solved some problems of the command economy; in the meantime, they have also created some systemic problems of their own. For example, as a result of decentralization of economic planning power, the former instability in some real macro variables for the economy has been shifted to the financial variables and those variables that affect the daily life of the Chinese. In the past, the traditional Soviet-type economic system internalised the instabilities within the budget by keeping incomes, employment, prices, the balance of payments, and even the budget itself relatively stable. Now the former administrative controls and constraints have been greatly relaxed, if not removed, and considerable instability has shown up in real incomes, the balance of payments, and the budget.[18] Therefore, despite their differences in evaluating the Chinese partial reform and mixed economy, hardly any commentator disputes that: further reform calls for a market economy, and a transition to the market economy needs a sustainable strategy, otherwise the Chinese economic reform is doomed to fail.[19]

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[17] For a detailed description and analysis of the dispute and struggle within the government and party, see Harry Harding, China's Second Revolution: Reform after Mao (Washington, D.C.: Brookings Institution, 1992).

[18] See Dernberger, "China's Mixed Economic System: Properties and Consequences" supra at 92.

[19] See Harry Harding, "The Problematic Future of China's Economic Reforms" in China's Economic Dilemmas in the 1990s: The Problems of Reforms, Modernisation, and Interdependence, v.1 Joint Economic Committee, Congress of the U.S., (1991) at 83.

Socialist Market Economy: Although seemingly it took only the paramount leader Deng Xiaoping's personal tour of South China in 1992 to signal the Chinese government's commitment to a socialist market economy, the establishment of a free market economy requires far more than a mere good-faith commitment on the part of the government. Perkins points out that for any market economy there must be five key elements in place, namely:

(1) Goods must be available for purchase (and sale) on the market. Allocation of intermediate and final products by an administrative body is the antithesis of a market system.

(2) Prices must reflect the relative scarcities in the economy. "Price must be right" or the enterprises will get the wrong signals from the market. With the wrong signals, products will end up in the hands of low priority users.

(3) Enterprises must behave in accordance with the rules of the market, specifically they must maximise profits by cutting their losses, improving product liability and increasing sales. Increasing profits by lobbying the state for higher subsidies, lower taxes, or for monopoly control over one's market will lead to behaviour inconsistent with is required by a well-functioning market. If enterprise behaviour is inconsistent with what market rules require, then goods will end up in low priority uses, even though prices are properly set at their relative scarcity value.

(4) There must be competition between enterprises. It is competition that puts pressure on firms to behave efficiently. Monopolists are notoriously slow about improving product quality and cutting costs.

(5) Inflation, the rate of increase in prices, must be kept to an acceptable level.[20]

Prybyla narrows further the essentials of market system down to two institutional pillars: transactions and property rights.[21] Market transactions are voluntary, competitive, horizontal (symmetrical) legally binding contracts entered into by individual buyers and sellers for utility and profit-maximising purpose, by reference to market prices. Property rights give individuals broad rights to the acquisition and disposal of goods and services (transfer), to the employment of such goods and services (use), and to the fruits of the goods and services (income). When such broad rights are voluntarily delegated by the nominal legal proprietor to the actual user-manager, there is private property. Property rights is a necessary condition for the functioning market economy.[22]

Judging from the above factors, we can assert that the initial Chinese economic reform has set stages for a market economy to build in China. Yet a complete free market economy will not be fulfilled without great effort. Instead it requires systemic changes in legal, political, and economic institutions to complete the transition. In theory, there are still doubts and disputes in China about what the socialist market economy should be. Formidable forces to block further reforms come from various political factions and privileged groups, which have great stakes in maintaining status quo. The ideological gap between the orthodox party theories and the principles underlying a market economy is

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[20] See Dwight Perkins, "Markets versus Plans" in China's Economic Dilemmas in the 1990s: The Problems of Reforms, Modernisation, and Interdependence, v.1, Joint Economic Committee, Congress of the U.S., (1991) at 160-161.

[21] See Prybyla, Reform in China and Other Socialist Economies, supra at 24.

[22] See Prybyla, Reform in China and Other Socialist Economies, supra at 24, 139-140.

hard to bridge. As this study will attempt to identify and analyse some major issues of China's transition towards a market economy later, suffice it here to say that establishing a market economy in China is an inspiring, but difficult and complex cause.

2. State-owned Enterprise Reform

Reforming state-owned enterprise, the cornerstone of Chinese economy,[23] lies at the heart of the ongoing Chinese economic reform. In addition to its important economic function, the state-owned enterprise has also played a pivotal role, both directly and indirectly, in China's political system. They are partially administrative organs subject to the control of both Party and government. Moreover, Chinese state-owned enterprises are, in a sense, "vast kingdoms of welfare management" serving their beneficiaries - workers and their families.[24] While all of these factors underscore the importance of the state-owned enterprise reform, they make it an extremely complex and difficult task. It is thus noted by Jefferson and Rawski that "efforts to revitalise and restructure domestic industry are closely linked to the reform of pricing, banking, public finance, ownership, social welfare, and research and development."[25] Also, the partial reform has allowed certain sectors such as agriculture and private industry benefit from market, whereas left medium-

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[23] Though a poor country, China's state-owned industry accounted for almost one-half of gross material product in the late 1970s (48% in 1978). In addition, large state-owned enterprises occupy the " strategic position in Chinese economy. See Nolan, State and Market in the Chinese Economy, supra at 268, 271.

[24] See Wallace Wang, "Reforming State Enterprises in China: The Case for Redefining Enterprise Operating Rights" (1992) 6 J.Chinese L. 89 at 92-93.

[25] See Jefferson and Rawski, " Enterprise Reform in Chinese Industry" (1994) 8 J.Econ.Perspective 47 at 47.

sized and large state-owned enterprises caught between plan and market. Small wonder that some foreign observers have found some of large Chinese state-owned enterprises virtually unchanged after over a decade's reform.[26] Only an in-depth study will be able to reveal that some profound changes have taken place in China's state-owned enterprises.

State-owned Enterprise in the Pre-reform Period: In the command economy before the reform, state-owned enterprises were mere passive agents of the state economic bureaucracy. Managers had little authority over research and development, product innovation, investment planning, marketing, or even routine matters as production scheduling, material purchases, wage structures, and employment levels.[27] It operated along the following principles:

- State-owned enterprises were subject to mandatory production plans and were furnished with most of their material inputs through administration supply allocations.
- Product prices were determined by pricing authorities and government agencies controlled the circulation of products from producers to users.
- Wages and salaries followed a national wage scale and were independent of enterprise productivity. Enterprises were responsible for retirement pensions and they had little control over the size and composition of their labour force.

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[26] See James Stepanek, " China's Enduring State Factories: Why Ten Years of Reform Have Left China's Big State Factories Unchanged?" in China's Economic Dilemmas in the 1990s: The Problems of Reforms, Modernisation, and Interdependence, v.1, Joint Economic Committee Congress of the U.S., (1991) at 440-454.

[27] See Jefferson and Rawski, "Enterprise Reform in Chinese Industry" supra at 50.

- Investment and working capital were mostly financed by grants from the government budget or loan from the banking system according to government plans.
- After the payment of commodity taxes state-owned enterprises remitted all their profits, if any, to the state budget and state budget in return covered all losses incurred by enterprises.[28]

State-owned Enterprise Under Reform: Having recognized that the rigid command economy would cause great waste and inefficiency, the Chinese authorities have adopted a wide range of measures to reform the state-owned enterprises since late 1970s. The reforms have proceeded in roughly three stages.[29] The initial stage (1979-83) of enterprise reform emphasised several important initiatives that were intended to enlarge enterprise autonomy and expand the role of financial incentives within the context of the traditional planning system. These include the introduction of profit retention for enterprises and performance-related bonuses for employee and permitting state-owned enterprises to produce outside the state mandatory plan. The reform was reinforced and accelerated in mid-1980s after the agriculture reform had achieved satisfactory results. During the second stage (1984-86) the emphasis of enterprise reform shifted to increase the role of economic instruments and subjecting enterprises increasingly to market influences through the substitution of profit remittance by profit taxes, the rationalisation of indirect taxes and the establishment of double-track system. It is at this stage that market transactions were

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[28] See Qimiao Fan, " State-owned Enterprise Reform in China: Incentives and Environment" in Fan & Nolan, eds., China's Economic Reforms: The Costs and Benefits of Incrementalism (New York: St. Martin's Press, 1994) at 139.

[29] Ibid.

formally introduced alongside the traditional planning system to influence enterprise output decisions. The third period (1987-Present) has witnessed more dramatic changes, the Contract Responsibility has been established in state-owned enterprises; Leasing measures has been experimented and adopted in a limited scale; more and more state-owned enterprises have issued bonds and stocks, and as a result of the establishment of two stock exchanges, some leading state-owned enterprises have gone "public." Some small state enterprises have been "privatised" or "denationalised."[30]

Through the foregoing reform process the state-owned enterprise has undergone dramatic changes. The reforms have already brought alterations in the allocation of industrial products, the procurement of inputs, the character of incentives, and degree of competition. Enterprise managers have gained considerable control of most business decisions. Even the largest state-owned enterprises are deeply enmeshed in markets driven by decentralized forces of demand and supply.[31] However, the state-owned enterprise reform has lagged behind other sectors such as agriculture, foreign trade, and private individual enterprises. Considering the important position of the state-owned enterprise in the Chinese economy, we can assert whether or not a free market economy can be built up in China largely depends on the further reform of its state-owned enterprises.[32]

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[30] See Chao & Yang, "The Reform of the Chinese System of Enterprise Ownership" in Folson & Minan, eds., Law in the People's Republic of China: Commentary, Readings and Materials (London: Nijhoff, 1989) at 452-453.

[31] See Jefferson and Rawski, "Enterprise Reform in Chinese Industry" supra at 50.

[32] See Perkins, "Completing China's Move to the Market" supra at 43.

II. The Role of Law in Chinese Economic Reform

With the policy of economic reforms and opening to the outside world being carried out since the late 1970s, China has attached great importance to building a modern legal system. As a dramatic departure from the legal politicalisation under Mao's reign, law has been used as a primary vehicle to effectuate economic changes. In the wake of the lawless Cultural Revolution, the regime needs law to assume its "legitimacy." Consequently, tremendous changes have taken place in Chinese legal system. The development in legislation, legal institutions, and legal ideologies is unprecedented and unparalleled in any other period of Chinese history.

Foreign Business Law: The area of foreign business law has evidenced the most rapid development in China. As international collaboration, foreign economic exchanges and foreign investment all require legal protection, Chinese authorities have taken great efforts to promulgate a series of laws and regulations: Equity Joint-Venture Law, Foreign Economic Contract Law, Foreign Enterprise Law, Chinese-Foreign Contractual Venture Law, to name only a few. Special Economic Zones were established to provide foreign investors favourable status and special treatment. Over a dozen coastal cities have got the mandate to deal with foreign trade and investment mainly on their own policy initiatives. Thousands of Economic Development Zones have mushroomed all over China to induce foreign investment with various favourable treatment. As a result, China has had a comprehensive legal framework to regulate foreign economic legal relations and provide

protections for foreign business interests, which is an important prerequisite for China's burgeoning foreign economy today.[33]

The foreign business legal system have also had profound influences on domestic legal system. In keeping the Chinese foreign trade and investment law in line with international practice, China must adopt, sometimes reluctantly, foreign legal norms and rules, which are usually inconsistent with the orthodox socialist principles. The accession to some international treaties has required that certain Chinese domestic laws be compatible with the international standards.[34] China's aspiration to join the WTO has also motivated several pieces of legislations and the call for a more market-oriented legal system. More importantly, the rapid growth of economic exchanges with other countries has brought ever-growing challenges to the traditional legal values of the society.

Domestic Legal System: Domestic legal system has also played a critical role in Chinese economic reform. To develop a legal system to regulate the new social and economic relations, China has not only enacted such basic laws as Constitution, Criminal Code, Civil Law, and Criminal and Civil Procedure Laws, but also promulgated large numbers of specific laws, such as Economic Contract Law, Patent Law, and Labour Law. In addition to that, after over a decade's efforts, modern legal institutions begin to take shape in

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[33] China is now in the rank of the countries in the world that absorb the largest amount of foreign investment and by the end of last year, the accumulative total of direct foreign investment in the country has exceeded US $ 100 billion. See " Why Infrastructure Left in Cold" China Economic News, 23, vol.17, (June 24, 1996).

[34] See Wang Guiguo, "Economic Integration in Quest of Globalisation of Law - A Chinese Example" (1995) 5 Australian J.Corp.L. 402 at 407.

China. Built from scratch,[35] the judiciary and legal education have developed very quickly in terms of both quantity and quality.

Remarkable as these developments are, they should not be taken at their face value. Numerous gaps and obstacles still exist between China's current legal system and a modern market-oriented legal system. Any discussion and assessment of China's legal system will not be complete without an analysis of these problems.

First, the Chinese government's approach to law is fundamentally instrumentalist.[36] Theoretically, law is nothing more than an instrument to express and enforce the will of the ruling class against the ruled. Except an abstract limitation of economic condition on the content of the will, the ruling class is free to choose whatever law it likes. The implication of such a theory in practice is that the laws and regulations are intended to be instruments of policy enforcement. Laws and regulations are enacted not because of its underlying normative values, but because they are useful to achieve certain policy objectives. Law is not a limitation on state power. On the contrary it is a mechanism by which state power is exercised.[37]

Second, the authoritarian regime's ambivalence toward the law presents another obstacle to the modernisation of Chinese legal system. Law is a double-edge sword. On the one hand, it is useful for the government to adopt Western rules to regulate the social

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[35] For an understanding of the Chinese legal system in the pre-reform period, please see Victor H. Li, Law Without Lawyers: A Comparative View of Law in China and the United States (Boulder: Westview Press, 1978) and Jerome A. Cohen, The Criminal Process in the People's Republic of China 1949-1963: An Introduction (Cambridge, Mass.: Harvard Univ. Press, 1968).

[36] See Pitman Potter, Foreign Business Law in China: Past Progress and Future Challenges (The 1990 Institute, 1995) at 5.

[37] Ibid.

and economic relations, thus stabilise and strengthen the regime. On the other, the law can also pose procedural and substantive limitations on the government, and the underlying ideologies will cast doubts on the legitimacy of the regime itself. Therefore, more often than not the government writes some ill-defined "principles" or ambiguous provisions into various statutes to leave room for abuse. The legislative body and judiciary are under the constant control of the party. There is no legal procedure to safeguard their impartiality and independence. Moreover, ever since the beginning of economic reform, the party and government have taken several initiatives to wage movements against Western ideologies and values. The collapses of former Eastern European Socialist countries and the Chinese Student Democratic Movement of 1989 have reinforced the regime's belief in the necessity to tight its grip over the issues such as political reform and ideologies. Meanwhile, since it is inevitable that certain ideas and values will exist as the result of economic reform, the Chinese authorities have attempted to accommodate them within the framework of the regime's orthodox ideologies.[38] The persistent propaganda of collectivism and nationalism is a case in point.

Third, traditional legal culture and customs prove to be another stumbling block for the modernisation of Chinese legal system. As known, all legal transplants run the risk of being unacceptable to local people, thus lose their practical legitimacy. In a land like China with a long history of feudalist tradition, the seeds of Western legal rules and ideas may not be able to produce the expected fruits. The reluctance of Chinese people to litigate openly in court, for example, has compromised the effectiveness of some important laws;

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[38] See Chen Feng, Economic Transition and Political Legitimacy in Post-Mao China: Ideology and Reform (Albany, NY: State Univ. of New York Press, 1995).

the habit to rely on connections instead of legal channels to make deals has nurtured a special subculture,[39] which hinders the establishment of the rule of law in China.

The foregoing major obstacles, albeit powerful, are by no means insurmountable. Borrowing the distinction made famous by Toennies, Tay locates the Chinese legal culture and system as a Gemeinschaft and bureaucratic-administrative model, not a Gesellschaft, the Western legal tradition model. It is based on the primacy of traditional social relationships and not on the primacy of the right-and-duty-bearing individual, on social ties rather than contractual obligations. Yet, the Gesellschaft strain keeps re-emerging and, at the formal level, the Chinese government is moving to increased emphasis on aspects of the Gesellschaft conception of law and its role in modern society.[40] As the legal traditions and legal systems are not neutral and colourless tools available for any social purpose, carrying no ideology of their own,[41] it can be asserted that the increasing adoption of Western legal rules and norms will have great impact on transforming the Chinese legal culture and legal system. The organic interplay between economy and law indicates that a free market economy will finally bring China a modern legal system equipped with principles such as rule of law, equal protection, and individual freedom. In the meantime, law will continue to play an important role in China's transition to the market economy.

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[39] See Potter, Foreign Business Law in China: Past Progress and Future Challenge, supra at 5.

[40] See Alice Erh-Soon Tay, "Legal Culture and Legal Pluralism in Common Law, Customary Law, and Chinese Law" (1996) 26 Hong Kong L.J. 194 at 202-204.

[41] Ibid. at 209.

III. Methodology: Law and Economics

Prior to 1960, most of law and economics studies centred only on limited subjects such as anti-trust, public utility regulation, and tax policy. They are referred to as the "old" law and economics. However, beginning in the early 1960s with pioneering articles by Guido Calabresi[42] on tort law and Ronald Coase[43] on property rights, followed by prolific writing and a comprehensive text by Richard Posner[44] on a vast range of legal issues, the "new" law and economics have explored the economic implications of almost every aspect of the legal system. In a contrast to the "old" law and economics, the "new" law and economics deals with non-market behaviour as well as market one. With such economic theories as Public Choice Theory and Transaction Cost Economics applied to the analysis of law, the "new" law and economics has also provoked intense controversy and disputes.[45]

The central preoccupation of economics is the question of choice under conditions of scarcity. Because of scarcity, economics assume that individuals and communities will (or should) attempt to maximise their ends by doing the best they can with the limited resources (means) at their disposal. If the resources can be made relatively less scarce, the individuals and communities will realise more ends or goals. The legal system, in important

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[42] Guido Calabresi, " Some Thoughts on Risk Distribution and the Law of Torts" (1961) 70 Yale L.J. 499.

[43] Ronald Coase, "The Problem of Social Costs" (1960) 3 J.L.& Econ. 1.

[44] Richard Posner, Economic Analysis of Law, 3rd ed. (Boston: Little, Brown, 1986).

[45] See Michael Trebilcock, "Law and Economics" (1993) 16 Dalhousie L.J.360.

ways, structures the choices available to individuals and groups in a whole range of settings. Law and economics scholarship analyses the issues of choice under the conditions of scarcity and the impact of legal system on such choices, and it employs two conceptually different kinds of analysis: positive and normative.[46]

Positive Analysis: With respect to positive economic analysis of legal issues, the analyst tends to predict the likely economic impacts, allocative and distributive, of the legal policy, given the ways in which people are likely to respond to the particular incentives or disincentives created by the policy. In predicting these behavioural responses, the positive analyst will assume that most individuals are motivated by rational self-interest, in the sense of maximising their individual utilities subject to whatever constraints are imposed on the choices open to them.

Positive economic analysis is individualistic and subjective in its behavioural premises. The fundamental presumption of neo-classical economics is that economic agents, in their various activities, respond to incentives. The legal system, to the neo-classical economist, is simply an institutional arrangement for prescribing, and setting implicit prices for, certain activities, within some over-arching consequentialist objective. It then follows that a crucial aspect of law and economics scholar's enterprise is the empirical testing of the presumption that agents do indeed respond to the implicit prices specified by the legal system. In the opinion of many law and economics scholars, while

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[46] See Trebilcock, "Law and Economics" supra at 362. Also see Posner, Economic Analysis of Law, supra at 20-22.

law and economics is powerful in its own right as an organizing and sorting tool, it will ultimately be judged on the empirical validity of its propositions.[47]

Normative Analysis: With respect to normative economic analysis, the analyst tends to ask the question: Is it likely that this particular transaction or this particular proposed policy or legal change will make individual affected by it better off in terms of how they perceive their own welfare (not as some external party might judge that individual's welfare). Two concepts of efficiency are of central importance in the context of normative analysis: *Pareto efficiency* and *Kaldor-Hicks efficiency. Pareto efficiency* is achieved when the transaction or change makes somebody better off while making no one worse off. *Kaldor-Hicks efficiency* refers to the state when the collective decision (e.g., a change in legal rules) generate sufficient gains to the beneficiaries of the change that they could, *hypothetically*, compensate the losers from the change so as to render the latter fully indifferent to it but still have gains left over for themselves. It is effectively a form of cost-benefit analysis.[48]

In contexts where private exchange and private ordering is feasible, many economists prefer notions of Pareto efficiency to Kaldor-Hicks efficiency. They in general attach strong normative values to regimes of private exchange and ordering. To them, if two parties enter into a voluntary private exchange, the presumption is that they both feel that the exchange is likely to make them better off, otherwise they would not have entered into it. This presumption is rebuttable in the case of market failure or contractual failure.

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[47] See Trebilcock, "Law and Economics" supra at 362-363.

[48] Ibid., at 364.

With respect to collective decisions which are not the result of voluntary agreement among all affected parties, such decisions will typically generate both winners and losers. The question then becomes whether the net effect of these decisions is to increase social welfare as judged by all affected individuals in terms of the impact of such decisions on their levels of present or prospective utility. The central difficulty here is that the effects on individuals' utility functions are not directly observable by collective decision-makers and there is no ready way of ensuring accurate revelation by individuals of their evaluation of these impacts, thus rendering the utilities and disutilities associated with such a decision largely incommensurable. Similar questions arise as to changes in legal regimes which make some individuals better off and others worse off. One persistent issue in law and economics then is: how does one determines whether the gains in utility to one group exceed to the losses in utility to other.

Both positive and normative analyses have aroused considerable antagonism.[49] The most frequent criticism is that the normative underpinnings of the economic approach are so repulsive that it is inconceivable that the legal system would (or should) embrace them. Law and economics is also criticised for ignoring "justice." A conventional external critique of the concept of Pareto efficiency is that it takes existing preferences, of whatever kind, as given and provides no ethical criteria for disqualifying morally monstrous or self-destructive preferences as unworthy of recognition. Furthermore, it is also argued that Pareto efficiency is wholly insensitive to the justice or injustice of the prior distribution of endowments that parties bring to an exchange, but rather takes these

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[49] See Posner, Economic Analysis of Law, supra at 22-26.

endowments as given in evaluating the welfare implications of a given exchange. Some of these objections are also directed against the concept of Kaldor-Hicks efficiency; it accepts all existing preferences as equally valid; and to the extent that cost-benefit analysis reflects only willingness-to-pay measures of value (rather than underlying utility functions), disparities in endowments will bias cost-benefit judgments in distributively unjust ways.[50] In addition, the positive analysis is criticised for its limitations in explaining the important principles, institutions, and outcomes of the legal system.

While some criticisms are misplaced, most of them have substantial force. Yet they cannot constitute valid challenges to the law and economics as a whole. The law and economics movement, as West sees it, is grounded in the postmodern sceptical conviction that neither general legal norms themselves nor philosophical verities can be usefully employed as the basis for the rational criticism of law, and hence strives to provide "objectively knowable standards" from economics.[51] Although it is doubtful that these economic standards are capable of totally replacing the traditional legal rationales and excluding other approaches, they do, however, promise a way of thinking that will shed new light on evaluating particular laws. Indeed, with the flourishing of "new" law and economics scholarship, the economic analysis approach has been extended to more and more areas of law. The theories of the firm in the literature of law and economics are the basis of the analysis and reasoning of the Chinese state-owned enterprise reform in this study.

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[50] See Trebilcock, "Law and Economics" supra at 365-366.

[51] See Robin West, "Disciplines, Subjectivity, and Law" in Sarat and Kearns, eds., The Fate of Law (Ann Arbor: University of Michigan Press, 1991) at 127, 149.

Chapter One

The Nature of the Firm

One of most active areas in law and economics scholarship is the corporate law. As the focal point of the interplay between law and economics, the business firm is the natural topic for the economic analysis. Ever since Professor Coase's The Nature of the Firm (1937)[52] there have been various theories presenting different paradigms to analyse the firm: transaction cost economics, agency-principal theory, nexus-of-contracts theory, and property rights theory. All these theories, albeit different, are clearly connected with each other.[53] Indeed, considering the breadth and complexity of the economic and legal relationships within the firm, no single theory can present answers to all the questions concerning it, and one promising sign is that the different approaches appear to be converging. It is thus hoped that a comprehensive and realistic theory of the firm may be developed drawing on the best aspects of each of these approaches. Another development in the area is that the various theories have been used to analyse the systemic institutional changes such as the privatisation of state-owned enterprises of former socialist countries, where alternative models of the privatisation process clearly have very different efficiency and distributional implications.

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[52] 4 Economica (n.s.), (1937) at 386-405.

[53] See Thomas S. Ulen, "The Coasen Firm in Law and Economics" (1993) 18 J.Corp.L. 301 at 303-304.

1.1 The Neo-Classical Theory of the Firm

The conventional theory of the firm is the approach of the neo-classical economics.[54] Basically it views the firm as a set of feasible production plans presided over by a selfless and compliant manager.[55] The manager buys and sells inputs and outputs in a spot market and chooses the plan that maximises owners' welfare. Under the neo-classical economics theory business enterprises exist to take advantage of three closely related economies.[56]

The first is that the relatively large number of employees allows for the tasks of production to be broken down into their constituent steps, and for groups of the employees to specialise in each of those tasks. Put briefly, it is the economies of specialisation. Secondly, the business firms allow a wider use of capital goods. As we know, there are significant limitations on the individual producer's ability to acquire capital, whereas the business firm, due to its special legal and economic features, can raise and accumulate much larger quantities of capital at a lower cost. The third reason that neo-classical economics hold for the existence of the firm is the economies of scale, which, to a large extent, interrelates with and overlaps the above two economies. Economies of scale exist when the average (or unit) cost of production falls continually for large volumes of output. Mainly due to the specialisation of task and the accumulation of large funds, the business firm is effective in realising such economies of scale.

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[54] See Oliver Hart, " An Economist's Perspective on the Theory of the Firm" (1989) 89 Colum.L.Rev. 1757 at 1757.

[55] See Oliver Hart, "An Economist's View of the Fiduciary Duty" (1993) 43 U.T.L.J. 299 at 299.

[56] See Ulen, "The Coasen Firm in Law and Economics" supra at 304-305.

While the neo-classical theory, often mathematically elaborated, is useful for analysing a firm's production choice and the consequences of strategic interaction between firms under conditions of imperfect competition, there are however some intrinsic weakness in this conventional theory. It disregards what goes on within the firm, and more specifically, it does not explain how production is organised within the firm, what is the structure inside the firm, how conflicts of interests between the firm's various constituencies - its owners, managers, workers, and consumers - are resolved, and how the goal of profit-maximisation is achieved.[57] Therefore, the firm of neo-classical theory is actually a "black box."[58] Another shortcoming of the neo-classical theory is that it begs the question of what defines a given firm or what determines its boundaries. It fails to address the issue of the size and extent of the firm, and not capable of explaining why some functions are done within the firm and others are contracted out, and why some firms merge.

1.2 The Transaction Cost Economics

Coase's Theory: The deficiencies of the neo-classical firm theory was first noticed by Coase over half a century ago. And in order to address these shortcomings Coase wrote the seminal paper The Nature of the Firm, which introduced a very novel approach to the theory of the firm developed under the heading of transaction cost economics. According

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[57] See Hart, "An Economist's Perspective on the Theory of the Firm" supra at 1758.

[58] See Ronald Coase, "The Institutional Structure of Production" (1992) 82 Am.Econ.Rev. 713 at 713-714.

to Coase, the main reason why it is profitable to establish a firm is simply that there is a cost of using the price mechanism. The most obvious cost of "organising" production through the price mechanism is that of discovering what the relevant prices are. Therefore, the firm is best understood as a nonmarket institution embedded within the market economy. Affairs within the firm are organised not by the continual haggling of the market place, but rather by hierarchical direction. He states:

> Outside the firm, price movements direct production, which is co-ordinated through a series of exchange transactions on the market. Within a firm these market transactions are eliminated, and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator, who directs production. It is clear that there are alternative methods of coordinating production. Yet, having regard to the fact that, if production is regulated by price movements, production could be carried on without any organisation at all, well might we ask, why is there any organisation?[59]

Although Coase's explanation about why the discovery and negotiation of prices are costly is not complete,[60] his thesis that firms come into existence to save the costs of bargaining has significant implications in revealing the nature of the firm. In fact, a firm could be foregone, the theory suggests, when it is possible to arrange all the steps of production and marketing by market transactions at no higher cost than by hierarchical order within an organisation.

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[59] See R. Coase, "The Nature of the Firm" in Posner & Scott, eds., Economics of Corporation Law & Securities Regulation (Boston: Little, Brown ,1980) at 4.

[60] See Steven N.S. Cheung, "The Contractual Nature of the Firm" (1983) 26 J.L.& Econ. 1 at 6-8. In this article, Cheung notes that Coase's "explanation seems incomplete" in the reasons he gave as to why the discovery and negotiation of prices are costly. And Cheung offers further explanations partly as the derivatives of Coase's reasoning. Accordingly, there are four general reasons. The first is that significantly more transactions are required, each calling for a separate price. A second factor is the information cost of knowing a product. A third cost of discovering price is that of measurement. Finally, the problem of separating contributions generate cost in reaching price agreement.

In a similar vein, Coase's theory also tries to offer the explanations about the boundaries of the firm and reasons why firms merge. In Coase's view the boundaries of the firm occur at the point where the marginal cost savings from transacting within the firm equal the additional error and rigidity cost.

Firstly, as a firm gets larger, there may be decreasing returns to the entrepreneur function, that is, the costs of organising additional transactions within the firm may rise. Naturally, a point must be reached where the costs of organising an extra transaction within the firm are equal to the costs in carrying out the transaction in the open market, or to the costs of organising by another entrepreneur.

Secondly, it may be that as the transactions which are organised increase, the entrepreneur fails to place the factors of production in the uses where their value is greatest, that is, fails to make the best use of the factors of production. Again, a point must be reached where the loss through the waste of resources is equal to the marketing costs of the exchange transaction in the open market or to the loss if the transaction was organised by another entrepreneur.

Finally, the supply price of one or more of the factors of production may rise, because the "other advantages" of a small firm are greater than those of a large firm. Of course, the actual point where the expansion of the firm ceases might be determined by a combination of the factors mentioned above.[61]

Coase's theories that transaction costs determine the existence and the limits of the firm lay a foundation for the theory of the nature of the firm, and has gained, though

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[61] See Coase, "The Nature of the Firm" supra at 6.

gradually and slowly,[62] its popularity, in particular, in law and economics.[63] However, as the following study will show, Coase's characterisation of the firm as a hierarchic nonmarket institution is superficial, and his analysis of the transaction costs is incomplete and unclear.[64]

Alchian-Demsetz's Critique: While Coase noted the difference between the firm and market, there is a conceptual weakness, pointed out by Alchian and Demsetz,[65] in the theory's dichotomy between the role of authority within the firm and the role of consensual trade within the market. To Alchian and Demsetz, it is not clear that an employer can tell an employee what to do, any more than a consumer can tell the grocer what to do; in either case, a refusal will likely lead to a termination of the relationship. Therefore, Coase's view that firms are characterised by hierarchical authority relations does not really stand up.[66]

Finding Coase's characterisation of the firm wanting, Alchain and Demsetz thus develop their own theory based on joint production and monitoring. They argue that the essence of firm should be understood as lying on the market exchange, but the market

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[62] As Coase described, they were "much cited and little used" (until the 1970s). See Coase, "The Nature of the Firm: Influence" (1988) 4, J.L.Econ.& Organ. 33 at 33.

[63] See Posner, Economic Analysis of Law, supra at 367- 368. Also see Hart, "An Economist's Perspective on the Theory of the Firm" supra at 1761.

[64] See Cheung, "The Contractual Nature of the Firm" supra at 6-8.

[65] See Armen Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organisation" in Posner & Scott, eds., Economics of Corporation Law & Securities Regulation (Boston: Little, Brown., 1980) at 12-20.

[66] See Hart, "An Economist's Perspective on the Theory of the Firm" supra at 1761.

exchanges characterising the firm's internal affairs are different from the market exchanges characterising the firm's external affairs. The principal aspect of this difference arises from the nature of team production and how that influences the optimal structure of contracts within the firm. On the one hand, there are some outputs for which the most efficient method of production is by teams of workers. In a well-functioning team, the output is greater or of better quality than would be the case if the members of the team worked by themselves. On the other, team production requires careful monitoring due to the problem of shirking. Indeed, two key demands are placed on any organisation-metering input productivity and metering rewards.[67]

According to Alchian and Demsetz, in a team production, if detecting such behaviour were costless, neither party would have an incentive to shirk, because neither could impose the cost of shirking on the other (if the co-operation was agreed to voluntarily). But since the costs must be increased to monitor each other, each input owner will have more incentive to shirk when he works as a part of a team, than if his performance could be monitored easily or if he did not work as a team. If there is net increase in productivity available by team production, net of the metering cost associated with disciplining the team, then team production will be relied upon rather than a multitude of bilateral exchange of separable individual outputs.[68]

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[67] See Alchian and Demsetz, "Production, Information Costs, and Economic Organisation" supra at 13.

[68] Ibid. at 14.

Establishing that completely effective control cannot be expected from individualised market-competition,[69] Alchian and Demsetz point out that the specialist who receives the residual rewards will be the monitor of the members of the team, and therefore, the best way to provide the monitor with appropriate incentives is to give him a bundle of rights, which effectively defines ownership of the firm, namely: (1) to be a residual claimant; (2) to observe input behaviour; (3) to be the central party common to all contracts with inputs; (4) to alter membership of the team; and (5) to sell the above rights.[70]

In the meantime, Alchian and Demsetz realise that such a residual-claimant-monitoring cannot function very well in Berle-Means corporations.[71] In such a corporation, if every stockowner participated in each decision, not only would large bureaucratic costs be incurred, but many would shirk the task of becoming well informed on the issue to be decided, since the losses associated with unexpectedly bad decisions will be borne in large part by the many other corporate shareholders. More effective control of corporate activity is achieved for most purposes by transferring decision authority to a smaller group, whose main function is to negotiate with and manage (renegotiate with) the

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[69] According to Alchian and Demsetz, market competition, in principle, could monitor some team production, but its effectiveness is very limited. First, for this competition to be completely effective, new challengers for team memberships must know where, and to what extent, shirking is a serious problem. But the detection of shirking by observing team output is costly for team production. Secondly, assume the presence of detection costs, and assume that in order to secure a place on the team a new input owner must accept a smaller share of rewards (or a promise to produce more). Then his incentive to shirk wound still be at least as great as the incentives of the inputs replaced, because he still bears less than the entire reduction in team output for which he is responsible. See ibid. at 15.

[70] Ibid. at 16.

[71] Berle and Means distinguish five types of corporations though no sharp dividing line separates type from type. These include (1) control through almost complete ownership, (2) majority control, (3) control through a legal device without majority ownership, (4) minority control, and (5) management control. Berle-Means corporation is mainly referred to the fifth type: management control corporation.

other inputs of the team. The corporate stockholders retain the authority to remove the membership of the management groups and over major decisions that affect the structure of the corporation or its dissolution.[72]

Undoubtedly, Alchian and Demsetz's characterisation of the firm as a production team and their analysis of the monitoring function in the structure of the firm not only shed new light on our understanding of the nature of the firm in a contractual perspective, but also underscore the importance of monitoring in the structure of the firm, which, as I will discuss later, has profound influences on other theories of the firm.

Williamson's Theory: As noted above, except the costs of price-discovering and contract-negotiating, Coase did not elaborate on the nature of the transaction costs and what constitutes these costs. Williamson has offered the deepest and most far-reaching analysis on this regard.[73] In Williamson's view, transaction cost economics poses the problem of economic organisation as a problem of contracting.[74] More specifically, the so-called transaction costs can be usefully distinguished as two types: ex ante and ex post. The first are the costs of drafting, negotiating, and safeguarding an agreement. This can be done with a great deal of care, in which case a complex documents are drafted in which numerous contingencies are recognised, and appropriate adaptations by the parties are stipulated and agreed to in advance. Or the document can be very incomplete, the gaps to

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[72] See Alchian and Demsetz, "Production, Information Costs, and Economic Organisation" supra at 17.

[73] See Hart, "An Economist's Perspective on the Theory of the Firm" supra at 1762.

[74] See Oliver Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting (New York: Free Press, 1985) at 20.

be filled in by the parties as the contingencies arise. Rather, therefore, than contemplate all conceivable bridge crossings in advance, which is a very ambitious undertaking, only actual bridge-crossing choices are addressed as events unfold.

On the other hand, there are ex post costs. Ex post costs of contracting take several forms as follows: (1) the maladaption costs incurred when transactions drift out alignment in relation to the "shifting contract curve," (2) the haggling costs increased if bilateral efforts are made to correct ex post misalignments, (3) the set up and running costs associated with the governance structures (often not the courts) to which disputes are referred, and (4) the bonding costs of effecting secure commitments.[75]

Thus suppose that the contract stipulates X but, with the benefits of hindsight (or in the fullness of knowledge), the parties discover that they should have done Y. Getting from X to Y, however, may not be easy. The manner in which the associated benefits are divided is apt to give rise to intensive, self-interested bargaining. Complex, strategic behaviour may be elicited. Referring the dispute to another forum may help, but that will vary with the circumstances. An incomplete adaptation will be realised if, as a consequence of efforts of both kinds, the parties move not to Y but to Y'. To make things more complicated, the ex ante and ex post costs of contract are interdependent. Thus, they must be addressed simultaneously rather than sequentially.

Williamson also recognises that transaction costs may assume particular importance in situations when economic actors make relationship-specific investments-investments to some extent specific to a particular set of individuals or assets. Accordingly, transaction

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[75] Ibid.

cost economics assumes that human agents are subject to bounded rationality, when behaviour is "intendedly rational, but only limited so," and are given to opportunism, which is a condition of self-interest seeking with guile. Transaction cost economics further maintains that the most critical dimension for describing transactions is the condition of asset specificity. Parties engaged in a trade that is supported by nontrivial investments in transaction-specific assets are effectively operating in a bilateral trading relation with one another. Harmonising the contractual interface that joins the parties, thereby to effect adaptability and promote continuity, becomes the sources of real economic value.[76]

For example, once an employee is hired he or she can either make investments in the development of his or her talents that are specific to the organisation that hired him or her, or that are more generally applicable and might, therefore, be valuable to other employers, as well as to his or her current employer, and his or her employability has been greatly improved.[77] Such an opportunism problem also arises in the relationship between a firm and its input supplier. In situations like these, there may be plenty of competition before the investments are made. But once the parties sink their investments, they are to some extent locked into each other. As a result, external markets will not provide a guide to the parties' opportunity costs once the relationship is underway. This lack of information takes on great significance, since, in view of the size and degree of the specific investment, one would expect relationships like these to be long lasting.[78]

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[76] Ibid. at 30.

[77] See Ulen, "The Coasen Firm in Law and Economics" supra at 314.

[78] See Hart, "An Economist's Perspective on the Theory of the Firm" supra at 1762. Also see Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting, supra at 61.

In the line of the foregoing reasoning, Williamson analyses the attributes of the contractual process based on the behavioural assumption (see Table 1.1). Thus, according to Williamson, when bounded rationality, opportunism, and asset specificity are joined, each of the three devices (planning, promise, and competition) fails. Planning is necessarily incomplete (because of bounded rationality), promise predictably breakdown (because of opportunism), and the mutual identity of the parities now assumes significance (because of asset specificity). This is the world of governance. Since the efficacy of court ordering is problematic, contract execution falls heavily on the institutions of private ordering. This is what transaction cost economics is concerned.

Table 1.1 Attributes of the Contracting Process: Behavioural Assumption[79]

Bounded Rationality	Opportunism	Asset Specificity	Implied Contracting Process
O	+	+	Planning
+	O	+	Promise
+	+	O	Competitiion
+	+	+	Governance

In an ideal world, the lack of ex post market signals would pose no problem, since the parties could write a long-term contract in advance of the investment, spelling out each agent's obligations and the terms of the trade in every conceivable situation. In practice,

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[79] See Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting, supra at 31-32.

however, thinking, negotiating and enforcement cost will usually make such a contract prohibitively expensive. As a result, parties must negotiate many of the terms of the relationship as they go along. Williamson argues that this leads to two sorts of costs. First, there will be costs associated with ex post negotiation itself - the parties may engage in collectively wasteful activities to try to increase their own share of the ex post surplus; also asymmetries of information may make some gains from trade difficult to realise. Second, and perhaps more fundamental, since a party's bargaining power and resulting share of ex post surplus may bear little relation to his ex ante investment, parties will have the wrong investment incentives at ex ante stage.[80] In particular, a far-sighted agent will choose his or her investment inefficiently from the point of view of his or her contracting partners, given that he or she realises that these partners could expropriate part of his or her investment at the ex post stage.[81] Therefore, bring a transaction from the market into the firm - the phenomenon of integration - mitigates this opportunistic behaviour and improve investment incentives.

Transaction cost economics, as a comparative institutional approach to the study of economic organisation in which the transaction is made the basic unit of analysis, has important implications in Law and Economics. As Williamson argues, virtually any relations, economic or otherwise that takes the form of or can be designed as a contracting

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[80] See Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting, supra at 88-89.

[81] See Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting, supra at 30-32.

problem can be evaluated to advantage in transaction cost economics terms. Most explicit contracting relations qualify; many implicit contracting relations also do.[82]

1.3 Principal-Agent Theory and Nexus-of-Contracts Theory

Principal-Agent Theory: As mentioned earlier, the Alchian-Demsetz paradigm may explain the monitoring problem in conventional closely held firms, it does not however function well in the large modern corporations. The residual claimants in the modern corporation are common shareholders, and it is almost impossible for all the common shareholders to perform the "monitoring" role as elaborated in Alchian-Demestz's theory. Rather, they will hire managers to run the firm; and there arises the problem of separation of ownership and control.

Although Berle and Means have brought extensive attention to the problem of separation and control in modern corporation since the early 1930s, only recently has there been the Principal-Agent theory addressing the weakness of neo-classical economic theory.[83] Principal-Agent theory recognises conflicts of interest between different economic actors. Because of such divergence and conflicts of interests between residual claimants and managers, there is likely to be some efficiency loss unless there are some compelling means of causing the managers to act solely in the interests of owners. The efficiency losses that arise in the principal-agent relationships are referred to as "agency costs."

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[82] See Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting, supra at 387.

[83] See Hart, "An Economist's Perspective on the Theory of the Firm" supra at 1758.

According to Jensen and Meckling, the agency costs can be defined as the sum of (1) the monitoring expenditures of the principal, (2) the bonding expenditures by the agent, and (3) the residual loss.[84] In order to limit the divergence from his interest, the principal can establish appropriate incentives for the agent and incur monitoring costs designed to the aberrant activities of the agent. In addition in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decision from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (nonpecuniary as well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions which would maximise the welfare of the principal. The reduction in welfare of the principal due to the divergence is the "residual loss" in the agency relationship.

While the agency costs are hardly avoidable, it is important to control the problem when the decision managers who initiate and implement important decisions are not the major residual claimants and therefore do not bear a major share of the wealth effects of their decisions. Without the effective control procedures, such decision managers are more likely to take actions that deviate from the interests of residual claimants. One basic approach to the normative aspect of agency relationships is to bring the interests of the

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[84] See Michael Jensen and William Meckling, "Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure" in Posner & Scott, eds., Economics of Corporation Law and Securities Regulation (Boston: Little, Brown, 1980) at 40.

managers and owners into line. That is, by creating the incentive scheme to join the interests of owners and managers together, the divergence between them can be minimised. Such incentive schemes include making the managers part-owners of the firm, having the managers' compensation depend in part on the profit performance of the firm, or giving the managers stock options and warrants whose value depends on the share price of the firm.[85] However, another view holds that the agency costs are not really so great as one might expect, because they are minimised by the competitive market for managerial compensation; the divergence will be constrained by the market for the firm itself; it will also be limited by the competition from other potential managers.[86]

An effective system for decision control also implies that the control (ratification and monitoring) of decisions is to some extent separate from the management (initiation and implementation) of decisions. Individual decision agents can be involved in the management of some decisions and the control of others, but separation means that an individual agent does not exercise exclusive management and control rights over the same decisions.[87] Agency cost and the control system function differently in various organisations.

In Fama and Jensen's view an organisational form survives in an activity when the costs and benefits of its residual claims and the approaches it provides to controlling agency problems confine with available production technology to allow the organisation to

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[85] See Ulen, "The Coasen Firm in Law and Economics" supra at 313.

[86] See Jensen and Meckling, " Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure" supra at 44; also see E. Fama, " Agency Problems and the Theory of the Firm" (1988) 88 J.Pol.Econ. 288 at 288.

[87] See Fama and Jensen, "Separation of Ownership and Control" (1983) 26. J.L.& Econ. 301 at 304.

deliver products at lower prices than other organisational forms.[88] The restricted residual claims of proprietorships, partnerships, and closed corporations are more likely to dominate when technology does not involve important economies of scale that lead to large demands for specialised decision skills, special risk bearing, and wealth from residual claimants. In these circumstances, the agency costs saved by restricting residual claims to decision agents outweigh the benefits that would be obtained from separation and specialisation of decision and risk-bearing functions. On the other hand, unrestricted common stock residual claims are more likely to dominate when there are important economies of scale in production that (i) can be realised only with a complex decision hierarchy that makes use of specialised decision skill throughout the organisation, (ii) generate large aggregate risks to be borne by residual claimants, and (iii) demand large amounts of wealth from residual claimants to purchase risky assets and to bond the payoffs promised to a wide range of agents in the organisation. In such complex organisations the benefits of unrestricted common residual claims are likely to outweigh the costs of controlling the agency problems inherent in the separation and specialisation of decision and risk-bearing functions.

The principle-agent theory's exploration on the organisational form is not broad enough, but its emphasis on the agency costs and optimal incentive schemes are essential to our understanding and analysis of the separation of ownership and control in modern corporations.

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[88] See Fama and Jensen, "Agency Problems and Residual Claims" (1983) 26. J.L.& Econ. 327 at 333.

Nexus-of-Contracts Theory: A well-received theoretical model in the law and economics is the theory of the firm as a nexus of contracts. Remember Alchian and Demsetz hold that contract governs both the internal and the external affairs of the firm, and this thesis constitutes the basis for nexus-of-contracts view of the firm. Thus, according to Jensen and Meckling, the firm is not an individual. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals (some of them may "represent" other organisations) are brought into equilibrium within a framework of contractual relations. In this sense the "behaviour" of the firm is like the behaviour of a market; i.e., the outcome of a complex equilibrium process.[89]

While the contractual perspective of the firm can be seen in nearly all the literature regarding the firm in law and economics, a more coherent expositions of the nexus-of-contracts view was done by Easterbrook and Fischel in their book The Economic Structure of Corporate Law. They assert that the corporation is a set of implicit and explicit contracts.[90] The arrangements among the actors (production employees, managers, equity investors, debt investors, holders of warranty, and so on) usually depend on contracts and on positive law, not on corporate law or the status of the corporation as an entity.

Nevertheless, they also make it clear that the corporate contract, like the social contract, is no more than a rhetorical device. Investors do not sit down and haggle among

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[89] See Jensen and Meckling, "Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure" supra at 41.

[90] See Easterbrook and Fischel, the Economic Structure of Corporate Law (Cambridge, Mass.: Harvard University Press, 1991) at 12.

themselves about the terms. Instead, they usually buy stocks in the market and many know little more than its price. The terms were established by entrepreneurs, investment bankers, and managers. Changes in the rule are accomplished by voting rather than unanimous consent. Even so, the corporation is still viewed as a set of contracts.[91]

To be sure, there are many real contracts in the corporate venture. The terms present in the articles of incorporation at the time the firm is established or issues stock are real agreements. Everything to do with the relation between the firm and suppliers of labour (employees), goods and services (suppliers and contractors) is contractual. Many changes in the rules are approved by large investors after negotiation with management. And the rules that govern how rules change are also real contracts. The articles of incorporation typically allow changes to be made by bylaw or majority vote; they could as easily prevent changes, or call for supermajority vote, or allow change freely but require nonconsenting investors to be bought out. And many remaining terms of the corporate arrangement are contractual in the sense that they are "presets" or fallback terms specified by law and not varied by the corporation. These contracts usually negotiated by representatives. For example, indenture trustees negotiate on behalf of bondholders, unions on behalf of employees, and investment banks on behalf of equity investors.

Sometimes terms are not negotiated directly but are simply promulgated. They are also contractual because their value is reflected in price. For instance, the price of the corporation's choice of corporate governance mechanisms will be reflected in the stock price.[92] So, all the terms (including obscure ones) in corporate governance are contractual

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[91] Ibid. at 15-16.

[92] Ibid. at 17-20.

in the sense that they are fully priced in transactions among the interested parties. They are thereafter tested for desirable properties; the firm that picks the wrong terms will fail in competition with other firms competing for capital. It is unimportant that they may not be "negotiated;" the pricing and testing mechanisms are all that matters, as long as there are no effects on third parties.

According to Easterbrook and Fischel, mandatory rules and even court decisions can be viewed in the contractual light. If the terms chosen by firms are both unpriced and systematically perverse from investors' standpoints, then it might be possible to justify the prescription of a mandatory terms by law. This makes sense, however, only when one is sure that the selected term will increase the joint wealth of the participants, that is, the term that the parties would have selected with full information and costless contracting. Courts are known to use this formula to fill the gaps in explicit contracts that inevitably arise because it is impossible to cover every contingency.

In accordance with the nature of the corporation as nexus of contracts, the function of corporate law is to provide "free" terms to the firm so that participants in corporate ventures can save the cost of contracting. Such rules as voting and quorums will be adoptable to all the firms. In addition, even when the parties work through all the issues they expect to arise, they are apt to miss something. All sorts of complexities will arise later. Corporate law fills the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance. The law completes open-ended contracts.[93]

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[93] Ibid. at 35.

The view of the firm as a nexus of contracts has had great impact, both theoretically and practically, on the theory of the firm.[94] The implications of its systematic approach to such important corporate issues as corporate governance, monitoring, fiduciary duties, and corporate control, etc. are far more clear than other theories. And nexus-of-contracts theory fuelled directly the ALI Corporate Governance Project and the debates on insider-trading regulations in 1980s.[95]

However appealing as the nexus-of-contracts theory is, it is still criticised for its shortcomings. The first is that, it fails to provide ample explanation for the limits and size of the firm.[96] Another strain of criticism of the nexus-of-contracts theory is that the web of contracts that the theory takes as characteristic of the firm may be extremely costly to conclude, leaving important gaps in the relationships among the parties to the nexus-of-contracts. Also the imperfect information may mean the terms of the standard contracts are themselves imperfect and in need of correction from outside the contracting process. Finally, there may be high costs of monitoring and enforcing the terms of the contracts that comprise the corporation. As a result, the contracts may be imperfectly enforced, leading to a separate source of inefficiencies.

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[94] See L. Kornhauser, "The Nexus of Contracts Approach to Corporations; A Comment on Easterbrook and Fischel" (1989) 89 Colum L. Rev. 1449 at 1449. He commented that critics and advocates agreed that a revolution, under the banner "nexus of contracts," has in the last decade swept the legal theory of the corporation.

[95] See Ulen, "The Coasen Firm in Law and Economics" supra at 323-328.

[96] See Ulen, "The Coasen Firm in Law and Economics" supra at 321, also see Hart, "An Economist's Perspective on the Theory of the Firm" supra at 1764.

1.4 The Property Rights Theory of the Firm

Another approach, known as property rights theory, is very much in the spirit of the transaction cost literature of Coase and Williamson, but differs by focusing attention on the role of physical, that is, nonhuman, assets in contractual relationship. As Demsetz points out, when a transaction is concluded in the marketplace, two bundles of property rights are exchanged. A bundle of rights often attaches to a physical commodity or service, but it is the value of that rights determines the value of what is changed. Property rights convey the right to benefit or harm oneself or others except in the world of Robinson Crusoe where property rights play no role.[97] Thus, a primary function of property rights is that of guiding incentives to achieve a greater internalisation of externalities. Every cost and benefit associated with social interdependencies is a potential externality. One condition is necessary to make costs and benefits externalities. The cost of a transaction in the rights between the parties (internalisation) must exceed the gains from internalisation. In general, transacting cost can be large relative to gains because of "natural" difficulties in trading or they can be large because of legal reasons. Also, when change in knowledge result in changes in production functions, market values, and aspirations, the emergence of new property rights takes place in response to the desires of the interacting persons for adjustment to new benefit-cost possibilities; or in other words, property rights develop to internalise externalities when the gains of internalisation become larger than the cost of internalisation. Increased internalisation, in the main, results from changes in economic

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[97] See H. Demsetz, "Toward a Theory of Property Rights" (1967) 57 Am.Econ.Rev (Papers and Proceedings) 347 at 347.

values, changes which stem from the development of new technology and the opening of new markets, changes to which old property rights are poorly attuned.[98] The theory that property rights arise when it becomes economic for those affected by externalities to internalise benefits and costs has great implications in the nature, ownership and integration of the firm.

Consider an economic relationship of the type analysed by transaction economics, where relation-specific investments are important and transaction costs make it impossible to write a comprehensive long-term contract to govern the terms of the relationship. Given the initial contract has gaps, missing provisions, or ambiguities, situations will typically occur in which some aspects of the use of these assets are not specified. Take the position that the right to choose these missing aspects of usage resides with the owner of the asset. That is, ownership of an asset goes together with the possession of residual rights of control over that asset; the owner has the right to use the asset in any way not inconsistent with prior contract, custom, or any law.

In a world of transaction costs and incomplete contracts, ex post residual rights of control will be important because, through their influence on asset usage, they will affect ex post bargaining power and the division of ex post surplus in a relationship. This division in turn will affect the incentives of actors to invest in that relationship. Hence, when contracts are incomplete, the boundaries of firms matter in that these boundaries determine who owns and controls which assets. In particular, a merger of two firms does not yield unambiguous benefits: to the extent that the (owner-)manager of the acquired

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[98] Ibid. at 348, 350.

firm loses control rights, his incentive to invest in the relationship will decrease. In addition, the shift in control may lower the investment incentives of workers in the acquired firm. In some case these reductions in investment will be sufficiently great so that the nonintegration is preferable to integration.

Consequently, when assessing the effects of integration, one must know not only the characteristics of the merging firms, but also who will own the merged company. If firms A and B integrate and A becomes the owner of the merged company, then A will presumably control the residual rights in the new firm. A can then use those rights to hold up the managers and workers firm B. Should the situation be reversed, a different set of control relations would result in B exercising control over A, and A's workers and managers would be liable to hold-ups by B.[99]

The property rights approach has features in common with the neo-classical economics on maximising behaviour, the principal-agent approach on incentive issues, the transaction costs economics on contracting costs, and the nexus-of-contracts theory on a "standard form" contract. However, its advantage over these other approaches is its ability to explain both the costs and benefits of integration; in particular, it shows how incentives change when one firm buys up another one.[100]

Furthermore, as the property rights theory attempts to answer the question of how the structure of property rights evolves in response to individual incentives and behaviour patterns, it has significant implications to the theory of institutional changes. Demsetz used

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[99] See Hart, "An Economist's Perspective on the Theory of the Firm" supra at 1766-1767.

[100] See Hart, "An Economist's Perspective on the Theory of the Firm" supra at 1771.

the property rights theory to illustrate rather convincingly the close relationship between the development of private rights in land and the development of the commercial fur trade of aboriginals.[101] North further theorises the reasoning about the institutional changes.[102] He concludes that institutions provide the structure for exchange that (together with the technology employed) determines the cost of transacting and the cost of transformation. How well institutions solve the problem of coordination and production is determined by the motivation of the players (their utility function), the complexity of the environment, and the ability of the players to decipher and order the environment (measurement and enforcement). The greater the specialisation and the number and variability of valuable attributes, the more weight must be put on reliable institutions that allow individuals to engage in complex contracting with a minimum of uncertainty about whether the terms of the contract can be realized. While the former socialist transition economies commands intensive academic interest, the theory of institutional changes proves to be especially illuminating.

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[101] See Demesetz, "Toward a Theory of Property Rights" supra at 351-353.

[102] See D.C. North, Institutions, Institutional Change and Economic Performance (Cambridge and New York: Cambridge Univ. Press, 1990).

Chapter Two

The Ownership Reform of the Chinese State-owned Enterprise

2.1 Introduction

The state-ownership of enterprises is the base of China's socialist economic system. It has been hailed as a superiority of socialism over capitalism in China's Political Economics.[103] When it started the economic reform to solve the long-existing economic inefficiency and stagnation in late 1970s, China did not have the change of public ownership in its plan. On the contrary, the economic reform was adopted to strengthen the socialist public ownership.[104] The socialist public ownership and its leading position in China's socialist economy were written into its Constitution as general principles in 1982.[105] When the urban reform was officially carried out in 1984, it was also made clear

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[103] For example, the socialist public ownership is regarded as advantageous by comparing it with the drawbacks of capitalist private ownership. (a) Socialist public ownership eliminates the departure of labour from the means of production which is the sources of class oppression and enslavement. It also eliminates private ownership which hinders the initiatives of workers. (b) Socialist public ownership overcomes the contradictions between the socialisation of production and private ownership of production means; and between unplanned and anarchic production of society and the planned production of individual enterprises under capitalism. It also eliminates the source of economic crises characterised by relative overproduction. It ensures that the social production develops in a planned and proportional way. (c) Socialist public ownership changes the aim of production from surplus value and profit to "meeting the material and cultural needs of the people." (d) Socialist public ownership overcomes the ruthless competition, fraudulence and excessive secrecy of the results of scientific research under capitalism, which are detrimental to the development, thus it promises great possibility for developing science and productivity. So advantageous is the socialist public ownership that China takes it as unshakeable principle to adhere to. See Xia Baisan, China's Economic Policies, Theories and Reforms Since 1949 (Fudan University Press, 1991) at 395.

[104] Ibid.

[105] The Constitution of the PRC (1982): Art. 6: The basis of the socialist economic system of the People's Republic of China is socialist public ownership of the means of production, namely, ownership by the whole people and collectively ownership by the working people.... And Art. 7: The state economy is the

that the socialist economy was a planned commodity economy based on public ownership in "Chinese Communist Party Central Committee's Decision on Economic System Reform."[106] A decade later, despite the government's commitment to a socialist market economy, the public ownership is still maintained as the mainstay of the Chinese economy. It is generally held that the market economy is the result of the development of the commodity economy at a certain stage; the essence of the socialist market economy is the public ownership forms its basis, and the market economy does not equate with capitalism any more than the planned economy with socialism. While the public ownership is not the sole component of the socialist market economy, it ought to play a dominant role.[107] Some economists have noted the necessity of the ownership reform. But they maintain that the objective of such a reform is to develop a multi-form ownership structure dominated by public ownership, which is essential to the reform of the economic operating mechanism.[108] In a recent governmental guideline for the restructuring of state-owned enterprises, the first and foremost one is that, "state-owned enterprises must continue to uphold the system of public ownership.... State-owned economies must control and lead the national economy, and state-owned enterprises must not be privatised."[109]

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sector of socialist economy under ownership by the whole people; it is the leading force in the national economy. The state ensures the consolidation and growth of the state economy. See "The Constitution of the People's Republic of China" (adopted on Dec. 4, 1982) (Beijing: Foreign Languages Press, 1983).

[106] See Shangquan Gao, China's Economic Reform (New York: St. Martin's Press, 1996), at 6.

[107] Ibid. at 6-7.

[108] See Fureng Dong, "Reform of the Economic Operating Mechanism and Reform of Ownership" in Nolan & Fureng, eds., The Chinese Economy and its Future (Cambridge, UK: Polity Press, 1990) at 71.

[109] See "Guidelines for State Enterprise Restructuring" Daily Report China, FBIS-CHI-96-002 (Jan. 3, 1996) at 40.

Thus, the question is whether or not a socialist market economy can be established successfully in China with the public ownership as its leading force. The radical reformists in China and some foreign economists have argued for long that dominant private property rights are essential to a market economy. And these rights, vested in individuals and freely formed associations of individuals, must be comprehensive and cover transfer, use, and income. They must be legally protected and introduced with decent haste on a grand scale.[110] In other words, China must privatise its state economy to realise its plan to develop a socialist market economy. While these reformists and economists, to some extent, aptly pinpoint the problems of the public economy, they have yet to come up with a theoretic framework to make a satisfactory case for the institutional changes they advocate. To accomplish that, the theory must be capable of evaluating the performance of alternative institutional arrangements and uncovering the reasons for the institutional transformations.

The economics of property rights and transaction costs shed light on the analysis of institutional changes. By identifying the transaction costs and incentive effects of different property rights arrangement it can expand the scope of the ability of economic analysis to explain a wide range of institutional structures. This study attempts to apply the theories to analyse the ownership reform of the Chinese state-owned enterprises. Following a delineation of the analytical framework, I will further argue (1) China's experience proves that redefining property rights is actually the most important part of its economic reform after over a decade's reform; the landscape of its public ownership has been greatly

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[110] See Prybyla, "A Systemic Analysis of Prospects for China's Economy" supra at 217.

changed; (2) future reform calls for the privatisation of the Chinese state-owned enterprise and the transformation of its mixed economy into a free market economy.

2.2 An Economic Theory of Institutional Change: Property Rights and Transaction Costs

Efficiency and Economic Institutions: Fundamental to the analysis of economic institutions is an understanding of the "Pareto condition."[111] In the context of resource allocation, or the use of scarce resources, the Pareto condition describes that point of equilibrium at which the well-being of one individual cannot be improved without hurting another. In other words, no re-allocation of resources can result in an overall benefit to the group. Conversely, when the Pareto condition is not met, a re-allocation of resources can benefit at least one individual without hurting another.

Satisfaction of the Pareto condition defines economic efficiency in a society. The standard economic postulate, "constrained maximisation," asserts as a universal truth that each individual will constantly seek to benefit himself as much as possible subject to the constraints and limitations he faces. Combined with this postulate of human behaviour, the Pareto condition becomes an equilibrium one: that is, if the constraints permit, people will not interact to harm themselves; if they can accomplish something of benefit at sufficiently low cost, they will work towards the end. It follows that, when the constraints or limitations facing them change, individuals will make adjustments until no further

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[111] See Steven N. S. Cheung, Will China Go 'Capitalist'? An Economic Analysis of Property Rights and Institutional Changes (Hobart Paper 94) (London: Institute of Economic Affairs, 1982) at 30.

improvements are possible. Their behaviour therefore becomes predictable once the changes in the relevant constraints have been identified.[112] Now the question is: What constitutes and determines all the constraints of various institutions? Once it is decided, we can not only understand, but even predict the institutional changes.

Property Rights and Transaction Costs: Economic historian North defines institutions as a "set of rules, compliance procedures, and moral and ethical behaviour norms designed to constrain the behaviour of individuals in the intent of maximising the wealth or utility of principals."[113] The property rights economics holds that, what actually determines these rules and procedures is the structure of property rights. According to Demsetz:

> [P]roperty rights derive their significance from the fact that they help a man from those expectations which he can reasonably hold in dealing with others. An owner or holder of property rights is that of guiding incentives to achieve a greater internalisation of externalities.[114]

The system of property rights adopted within a community provides a mechanism for assigning to particular individuals the authority to select how specific resources will be used. In particular, it specifies the nature of the rights which an individual may hold to the use of resources, and to the transferability of those resources to other individuals. The system of property rights thus determines, via actual or imputed prices, how the benefits and the harms resulting from a decision will be allocated between the decision maker and other individuals, thereby specifying the expectations which an individual can hold in his or

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[112] Ibid.

[113] See Douglass North, Structure and Change in Economic History (New York: Norton, 1981) at 201-202.

[114] See Demsetz, "Toward a Theory of Property Rights" supra at 347-348.

her dealings with other members of society. If different systems of property rights present decision makers with different structure of costs and rewards (different opportunity sets), they will affect choices systematically.[115] Private property rights generally bring closer the relationship between the welfare of an individual owner and the economic (social) consequences of his decision. As a result, the greater is the incentive to take account of the benefits and harms that his decisions visit on other individuals. Indeed, in the limit there are no external effects: an individual must take account of all the harms and benefits flowing from his actions, including future consequences which are fully capitalised. Accordingly, resources rights are priced at their opportunity cost and flow to their highest-valued use. However, we can hardly make the conclusion here that, under any condition is the private rights structure superior to the public rights structure. As witnessed by the actual world, private rights are far from the single choice even in a capitalist economy. There must be something determining the selection of alternative property rights.

The determinant is the transaction costs. In The Problem of Social Cost, Coase pointed out that, in the absence of transaction costs, a clear delineation of private property rights would lead to the identical allocation of resources regardless of how the rights were assigned or distributed. His analysis gave birth to the well-known "Coase Theorem" which states, in essence, that if all scarce resources are viewed from the standpoint of rights, and if all rights are costlessly delineated or defined as private or exclusive, then in the absence of transaction costs the standard theorem of exchange will operate to bring about the most

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[115] See Louis De Alessi, "The Economics of Property Rights: A Review of the Evidence" (1980) 2 Research in Law and Economics 1 at 3.

valuable use of resources.[116] In a similar vein, Coase Theorem can also be applied to non-private property rights system. In the absence of transaction costs the allocation of resources would be same regardless of the nature of property rights or regardless of the nature of the operative economic institution. Thus, at one end of the spectrum, with private property rights, maximisation of the resource value in the absence of transaction costs would lead to the state of resource use described by Coase. Yet, at the other end of the spectrum - a state of "common" property rights where no individual can exclude another from the use of a productive resource, maximisation behaviour would produce the same effect.[117]

Nevertheless, the transaction costs loom large in any institutional arrangements. In Coase's analysis of the nature of the firm half a century ago, he explained that, it was because of significant transaction costs attached to the determination of market prices that an alternative institution - the firm - would emerge to reduce the use of them.[118] It is indeed the transaction costs economics that contribute significantly to understanding the institutional changes.

Transaction Costs in the Institutional Changes: Subject to existing constraints, society will always choose that institution which imposes the lowest transaction costs; that is assured by the "postulate of constrained maximisation" explained earlier. For example, North and Thomas argued that when common property rights over arable land became

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[116] See Cheung, Will China Go 'Capitalist'? supra at 36.

[117] See Chueng, Will China Go 'Capitalist'? supra at 37.

[118] See supra text at 28-31.

privatised some 10,000 years ago, the new resources owners were able to reap the gains of specialisation and trade in agriculture, making possible the first economic revolution in mankind's history, whereby communities centred around agriculture and commerce began to develop.[119] Later, improvements in commercial law and clarification of property rights also made possible the rise of trading companies and the corporations, whereby agents and these organisations developed new economies of scale and more efficient production and distribution.[120] Williamson tried to show that American corporations developed complex, hierarchical and multi-functional operations that substituted for a range of market activity that normally provided those same services. The corporation produced those services more cheaply than relying on the market to purchase them. The emergence of internal enterprise hierarchy represented a partial substitution for the market system, but a type of substitution that made more productive use of resources.[121]

Moreover, the transaction costs analysis has been applied to socialist-planned economies to determine why economic slowdown and poor technological innovation characterised the former Soviet Union since the 1960s and 1970s.[122] Recently, some scholars have gone a step further to analyse the systemic changes in former socialist

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[119] See Douglass North and Robert Thomas, "The First Economic Revolution" (1977) 30 Econ.History Rev. 2 at 229-241.

[120] See Douglass North and Robert Thomas, The Rise of the Western World: A New Economic History (Cambridge, UK: Cambridge University Press, 1973) at 146-156.

[121] See Oliver Williamson, "The Modern Corporation: Origins, Evolution, Attributes" (1981) 9 J.Econ.Literature 1537 at 1537-1568.

[122] See John Moore, "Agency Costs, Technological Change, and Soviet Central Planning" (1981) 24 J. L.& Econ. 189 at 189-214.

countries.[123] Some even compare the socialist system with Coase's firm, and find out that they are remarkably similar.[124]

Therefore, with transaction costs as the parameters, the choice of an institutional change can be explained if we can show that, in the light of all the relevant constraints, it is the least costly option. In turn, institutional change can be predicted in an identifiable direction.

In the context of an institutional change, the transaction costs consist of two broad categories: (a) those incurred in the operation of an institutional arrangement; (b) those incurred in adopting or changing an institution.[125] The former refers to those transaction costs existing in a certain set of institutional arrangement. In the cases of private economy and public economy, though there are different types of transaction costs within them, each can be efficient through intra-institutional changes in terms of the Pareto condition. The latter includes those costs incurred in the process of both intra-institutional and inter-institutional changes. If the institutional changes were costless, the institution chosen would be always be that which incurred the lowest operating costs in the use of resources. If the costs of changes are prohibitively high, the chosen institution may not have the lowest operating costs among the available options. Only if some institutional option is available which would operate at lower cost, it will be chosen if the adopting or changing costs are less than the potential saving on operation.[126]

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[123] e.g., Svetozar Pejovich, The Economics of Property Rights: Toward a Theory of Comparative Systems (Dordrecht; Boston: Kluwer Academic Publishers, 1990.)

[124] See Cheung, Will China Go 'Capitalist'? supra at 39-40.

[125] See Cheung, Will China Go "Capitalist'? supra at 38.

[126] Ibid.

Transaction Costs and the Socialist Economic Reform: In line of reasoning described above, which links transaction costs, property rights, and institutional changes, we can make following observations:

(1) The socialist economic reform is basically a process of transforming the property rights, which defines the institutional norms and rules for the behaviour of individuals and other members of the society. Inasmuch as the economic efficiency is the basic goal, state-ownership, the dominant system of property rights of socialist economy, must be the locus of the economic reform.

(2) The operating transaction costs of the Soviet-type command economy are huge and hence render it dysfunctional. The central planning and control of resources limit the individual choices and competitions, which, in Cheung's view, are the major determinants of transaction costs in an institutional arrangement.[127] There are insurmountable problems for planners in trying to obtain accurate information and equally large problems in trying to process the information into a complete operational plan.[128] Not only is it extremely costly to make such a plan, but its execution will cause inefficient use and waste of scarce resources as well. Naughton observes that "the ability of planners to obtain compliance with specific detailed directives had always been limited" by the "extraordinary weak

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[127] Steven Cheung asserts that the transaction costs of operating institutions must be higher when institutional choices are fewer and when there is no right of transfer to encourage cost-reducing competition. And private property rights are unique in that (a) permit the largest range of institutional choices, and (b)competition to reduce transaction costs is enhanced by the right to transfer or sell. See Cheung, Will China Go 'Capitalist'? supra at 40-43.

[128] See Peter Nolan, " China's New Development Path: Towards Capitalist Markets, Market Socialism or Bureaucratic Market Muddle?" in Nolan and Fureng, eds., The Chinese Economy and Future (Cambridge, UK: Polity Press, 1990) at 118.

planning apparatus."[129] In a Soviet-type economy, the owners of "public property" are actually bureaucratic officials. More often than not they are incompetent economic decision-makers. Such a quandary is further aggravated by the highly centralised one-party political structure, which poses the risk for one or a few individuals to have a major influence on economic development with detrimental consequences.[130] For example, China's notorious "Great Leap Forward Movement" and "Cultural Revolution," which inflicted unimaginable pain upon the nation and people, were largely the results of the late Mao's bad personal judgments and insatiable hunger for power. Monitoring the execution of the economic plan is too difficult to be effective. Without a market there is not a workable mechanism to check the production results. The cheating and lying are commonplaces in a planned economy. Pejovich summarises that the transaction costs specific to the Soviet-type economy are (a) prepare economic plan, (b) monitor their execution, (c) maintain and protect the rules of the game, and (d) cheat and lie to bureaucratic superiors. Those costs limit the expansion of the social opportunity set in response to a technical change and even contribute to a contraction in the social opportunity set.[131]

(3) The transaction costs in the economic reforms are also high. The first set of costs is the gathering of information about alternative institutional arrangements. As discussed earlier, the economic reform is a complex and difficult project, which requires a

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[129] See Naughton, Growing out of the Plan, supra at 26.

[130] See Naughton, Growing out of the Plan, supra at 119.

[131] See Pejovich, The Economics of Property Rights: Toward a Theory of Comparative Systems, supra at 110. For Pejovich's detailed analyses of those costs, see pp 109-113.

comprehensive blueprint to guide each step. But making such a blueprint sometimes is prohibitively costly. China has dealt with the problem by opting for piecemeal reforms which have however caused some chronic economic disorders in the economic reforms. Another set of costs is the resistance of various "privileged groups." As the economic reforms necessarily result in a redistribution of benefits, the originally privileged group, usually the one of considerable decision-making power, will attempt to resist these changes, distort information, and shape the rules of the game (property rights arrangements) to their own competitive advantage.[132] Of course, these two sets of transaction costs take different forms in different countries, and vary in different contexts of social, political and economic conditions. In addition, compared to other social systems, the establishment and development of the socialist system are unusually driven by such exogenous elements[133] as ideologies, and top bureaucrats' personal believes. These elements must also be taken into consideration in the transaction-costs-analysis of the institutional changes.

2.3 Redefining the Property Rights: China's Reform of the State-owned Enterprise

It goes without saying that the property rights changes have dominated China's agricultural reforms and the reforms in the areas of private enterprises, Sino-foreign joint ventures, foreign enterprises, and collective enterprises. Cheung concludes that " the end

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[132] See Cheung, Will China Go 'Capitalist'? supra 43-47.

[133] See Pejovich, The Economics of Property Rights: Toward a Theory of Comparative Systems, supra at 4.

result of the agricultural reforms is, for all practical purposes, a system of private property rights....[A]s it turns out, the so-called responsibility contract, with all its modifications and refinements, is a Chinese version of the deed of trust."[134] To Cheung, the responsibility contracts system as applied in agriculture comes very close to what in the Western world is nothing but a grant of private property in land in the form of leasehold rather than fee simple.[135] Moreover, in order to attract foreign investment and technology, China has gone a great length in making laws and regulations to recognise and protect the foreign investors' interests and rights in the equity joint ventures, foreign-owned enterprises, Sino-foreign contractual-ventures, and other businesses.[136] Further, under such a slogan as "to be rich is glamorous," a great number of private enterprises have grown up in China, with their property rights protected by the law. Reforms have also brought dramatic changes in the property rights of township and village enterprises and small- and medium-scale collective enterprises.[137] Facing hard budget constraints and hard competitions, they are acting more like private enterprises in the market.

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[134] See Steven Cheung, "Privatisation vs. Special Interests" in James Dorn & Wang Xi, eds., Economic Reform in China: Problems and Prospects (Chicago: Univ. of Chicago Press, 1990) at 22.

[135] Ibid., at 23. Also see Perkins, "Completing China's Move to the Market" supra at 26-29. In Perkins' analysis, although by the end of 1983, the system of people's communes and production teams of 20-30 families that had operated as a collective unit had ceased to exist in most of the country, the property rights established through the reform is incomplete in nature, and has had a negative impacts on agriculture's performance and farmers' behaviours. That is exactly a proof of the property rights theory stated earlier in the study.

[136] See Equity Joint-Venture Law of the PRC (1979), etc. "Law of the People's Republic of China on Chinese-Foreign Equity Joint Venture" (adopted on July 1, 1979) in Laws and Regulations of the People's Republic of China Governing Foreign Related Matters (compiled by the Bureau of Legislative Affairs of the State Council of the PRC) v.1 (Beijing: Chinese Legal System Publishing House, 1991) at 513-516.

[137] See Perkins, "Completing China's Move to the Market" supra at 37.

Nevertheless, when it comes to the state-owned enterprises, the assessment of the role of property rights changes in the reforms is controversial.[138] Such a controversy is not simply a conceptual dispute, but of significant political and economic implications as well. According to Putterman:

> What role property rights have played in the success and problems of China's reforming economy is similarly debatable. The view that property rights have remained largely "social" leaves open interpretative possibilities ranging from the conclusion that China offers evidence of the viability of a market socialist option, to arguments that the transformation of property rights remains a major hurdle on the road to an economy that can support sustained growth.[139]

Thus it is the function of property rights changes in the process of the state-owned enterprise reform the following sections turn to.

1. Major Reform Measures and the Property Rights

As stated earlier, at the outset of reform, China's state-owned enterprises functioned as passive agents of the state economic bureaucracy.[140] Consequently, the dominant force in the state-owned enterprises' relationships with the state and individual workers was not property rights, but the state economic plans and administrative orders.[141] After over a decade's efforts, the state-owned enterprises have been given a lot of decision-making

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[138] See Loius Putterman, "The Role of Ownership and Property Rights in China's Economic Transition" (1995) 144 China Quarterly 1047 at 1047.

[139] Ibid.

[140] For a detailed description of the characteristics of the state-owned enterprise before reform, see supra text at 13-14.

[141] It was a bureaucratic "cliché" to stress the relationships among State, collective units, and individuals, in particular, in the Mao's era, but such relationships were based upon administrative orders rather than legal rights and duties.

powers through various reform measures in several fronts. Examined in depth, these measures are nothing but reallocations of property rights between the state and enterprises.

Price Reform: One of the important measures in China's reform package is the price reform. Right from the beginning of the economic reform, it was realized that "if expanded decision-making on the part of enterprises was not coordinated with overall change in the pricing system, it could achieve little," and price reform deserved special attention.[142] Thus as early as 1980, the government put forth a price reform programme following the similar measures of Czechoslovakia in 1967-1968, and set up the Structure Reform Office under the State Council to execute the programme. According to this programme, the price reform would be carried out in two steps: adjusting the current factory prices throughout industry at first, and then abolishing "price-fixing by directive" (except for a few items) and introducing a market-determined price system.[143] Unfortunately, this plan for price reform aborted due to the debate on the relationship between the planned economy and the function of market. Considering the importance of the price control in China's planned economy, the price reform programme, if put into effect, would have set the "bird" (market) out of the "cage" (plan).[144]

The issue about the relationship between the plan and market was not settled until May 1984, when the decision of the State Council, the Interim Provisions for Further

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[142] See Wu Jianlian and Zhao Renwei, "The Dual Pricing System in China's Industry" in Bruce Reynolds, ed., Chinese Economic Reform (Boston: Academic Press, 1988) at 21.

[143] Ibid.

[144] The relationship between the plan and market ought to be like "a bird in the cage" was a comment made by the late economic hardliner Chen Yun, and frequently quoted by foreign and Chinese economists to highlight the socialist economic system the conservative reformists envisaged.

Expansion of Decision-making Power of State-owned Industrial Enterprises,[145] stipulated that there are two components of production, namely, planned economy and non-planned economy; that there are two types of material supplies for the enterprises: state allocation and free purchase by individual enterprises. Accordingly, the prices of the goods produced in the state quota system will be fixed by the state, and the prices of the goods produced outside the state quota system can be fluctuated within a range of 20% higher or lower than state prices.[146] In February 1985, the State Price Administration and the State Material Administration jointly cancelled the 20% limit. At that point, the dual-price system was formally in place.

Despite the constant changes towards more market prices and more types of market-priced goods, and some reformists' challenges in the late 1980s, the dual-price system has been kept in tact. Under the dual-price system, the state-owned enterprises transact marginal sales and purchases on markets where prices response increasingly to the forces of supply and demand. As a result, the market forces, with various limitations, have more and more impact on the state-owned enterprise.

Needless to say, pricing products has significant property rights implications. By allowing the state enterprises to fix the prices of their products and purchase the supplies from the market, the state basically reallocates certain property rights (rights of disposal and benefit) back to the enterprises.

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[145] " *Guanyu Jinyibu Kuoda Guoying Gongye Qiye Zizhuquan de Zanxing Guiding* [Interim Provisions for Further Expansion of Decision-making Power of State-owned Industrial Enterprises]" in *Guowuyuan Bangongting Fazhiju* [The Bureau of Legislative Affairs of the State Council], ed., *Zhonghua Renmin Gongheguo Fagui Huibian* [The Collection of Laws and Regulations of the PRC] (January - December 1984) (Beijing: *Falu Chubanshe* [Law Press], 1986) at 479-482.

[146] See Wu and Zhao, "The Dual Pricing System in China's Industry" supra at 22.

Tax Reform: More germane to the property rights is the reform of the tax system. Before reform, almost all of the profits had simply been turned over to the state and the state then reallocated those funds to investment projects determined by the central plan. The first reform adopted allowed state-owned enterprises to retain a small portion of their profits in the form of a special purpose enterprise fund. The qualification to retain such a fund, as well as the size and uses of the fund, was very strict and limited. By 1980, a more comprehensive "Profit Sharing System" had substantially replaced the enterprise fund system. Profit sharing allowed state-owned enterprises to retain a larger share of their profits. Accordingly, the funds otherwise directly allocated to such enterprises were reduced. The system, however, was not universally applied to all the state-owned enterprises. Certain conditions based on annual output, product quality, annual profits, and contract fulfillment must be met to qualify for participating the system. In the early 1980s, China adopted the reform programme known as "the conversion of profits into taxes" (*li gai shui*). This system allowed the state-owned enterprises to retain all of its profits after paying income taxes and other assessments. The conversion sought to increase the legal and financial autonomy of state-owned enterprises and leave the room for their own investment initiatives.[147]

Recently, more attempts have been made to streamline the tax collection and administration system and make the Chinese business tax system compatible with international practices.[148] As a result, a relatively comprehensive tax system including the

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[147] See Yang Xiaoping, "Progress and Problems in the Development of a New Income Tax System for State-Owned Enterprises in China" (1989) 3 J.Chinese L. 95 at 95-115.

[148] e.g. The newly promulgated the Taxation Administration Act and other tax laws have drawn on extensively the experience of Western tax legislation and practice. See "*Zhonghua Renmin Gonghoguo*

business tax, value-added tax, and turnover tax has been established. Under such a system, the state-owned enterprises are afforded more freedom to utilise a substantial amount of fund according to their own plan.

Wage and Employment Reform: Insofar as human assets as a special kind of property are concerned, the reform of wage and employment systems warrants our attention. In addition to the recognition of the property rights of the state-owned enterprises over their workers, one of the essential production factors, it is also necessary to ensure the workers the right to dispose and benefit from their own human assets.

For a long period of time the wages of workers were directly controlled by the state. All the workers were paid almost equally in accordance with a rigid "wage categories," which has been known as a system of "eating from the same big rice pot." Since the introduction of reform, the enterprises' right to allocate wages and bonuses has been greatly extended. In July 1979, some enterprises began to link the bonuses with the profits. A proportion of profits retained by enterprises was extracted to use as bonuses and awards. Beginning from late 1980, many enterprises have adopted the "floating wage system." Part of the workers' wages became floating, so that the gains of workers would be partly linked to the profits of the enterprises. In May 1984, the aforesaid Interim Provisions for Further Extending the Self-Decision Power of State-owned Industrial Enterprise stipulated, among other things, as long as enterprises complied with the state-fixed unitary wage standards, they could choose the wage forms as they decided, and the

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Shuishou Guanlifa [The PRC Taxation Administration Law]" (adopted in Sept. 4, 1992) in *Cuanguo Lushi Zige Kaosi Bidu Falu Fagui Hueibian* [Laws and Regulations for National Bar Examination] v.2 (Beijing: *Zhongguo Zhengfa Daxue Cubans* [China Politics and Law University Press], 1994) at 838-850.

enterprise directors had the discretion to raise the wages within a 3% limit. In January 1985, the State Council promulgated the Circular on the Wage Reform in State-owned Enterprise,[149] setting the basic rules for the further reform of the wage system in the medium-sized and large state-owned enterprises.[150] Currently, the state only stipulates the range of increase permissible for annual wage rises, and determines the scope for promotion within the enterprises. The enterprises link wages and bonuses directly to quotas and profits, and adopt various forms of wages, bonuses, and penalties they see fit.

Corresponding to the wage reform, the employment system of the state-owned enterprises has also been dramatically transformed. In the past, the state labour departments directly allocated the labourers to enterprises. Once allocated, an employee would hold an "iron rice-bowl," that is, a life-time job, for the state-owned enterprises had scarcely the discretion to fire any unqualified employee. As a result of the labour recruitment system reform, the state-owned enterprises now have the right to employ their own workers and set the level of skill or qualification for a particular line of work. Most of the state-owned enterprises have adopted the labour contract system, whereby the enterprises can discipline and fire any employee for his or her poor performance, and the employees who are unfairly treated can resort to such mechanism as labour arbitration and law suit to protect their legal rights.[151]

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[149] "*Guanyu Guoying Qiye Gongzi Gaige Wenti de Guiting* [Circular on the Wage Reform in State-owned Enterprise]" in *Laodong Renshibu Laodong Kexue Yanjiaosuo* [Labour Personnel Research Institute], ed., *Zhonghua Renmin Gongheguo Laodong Fagui Xuanbian* [The Select Collection of Labour Laws and Regulations] (Beijing: *Laodong Renshi Cubanse* [Labour Personnel Press], 1988) at 121-125.

[150] See Xia, China's Economic Policies, Theories and Reforms since 1949, supra at 70-74.

[151] To meet the need of the changes in the labour relations, China has enacted its first Labour Code, among other things, to protect the rights and interests of the employees. See "The Labour Law of the

The employment reform is by no means only limited to ordinary workers. The managers of the state-owned enterprises used to be appointed by the responsible government department. Now with the exception of the large-scale enterprises, most of the managers of the small and medium-sized state-owned enterprises are either elected by the workers, or selected through a public bidding process.[152]

The reform of wage and employment systems proves to be a difficult and painstaking undertaking. In early 1990s, the central government's propagandising machine still called for the smashing of the "three irons" - the iron rice bowl, ironclad wages, and the iron armchair(life-tenure for managers).[153] One major factor contributing to the situation is the Chinese worker welfare system.

Social Welfare Reform: In China, both before reform and into the early 1990s, the state-owned enterprises were responsible for the housing, health services, day care, and much else for their workers. In fact, they function more as welfare societies than as production sets.[154] Getting rid of the many surplus workers, however desirable from an efficiency point of view, may mean depriving people laid off of their homes and health care. As the Chinese economic reform continues, it is becoming more and more evident that a

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PRC" (promulgated on July 5 1994 and effective from January 1 1995) (1994) 29 China Law & Practice 21 at 21-36.

[152] See Gao, China's Economic Reform, supra at 72-73.

[153] See Wallace Wang, "Reforming State Enterprises in China: The Case for Redefining Enterprise Operating Rights" supra at 101-102.

[154] See Stepanek, "China's Enduring State Factories: Why Ten Years of Reform Have Left China's Big State Factories Unchanged?" supra at 440-454. Stepanek specifically mentions some of his observations regarding the welfare function of the Chinese state-owned enterprise.

comprehensive social insurance and welfare system must replace the old arrangements so that the state-owned enterprises can be the profit-maximising production units. By the early 1990s, the commercialisation and marketisation of housing had been underway. The Central Committee directive of November 1993 also called for further steps to separate the dependence of the unemployment insurance and the pension system on individual enterprises.[155] While the result of these measures remains to be seen, the transfer of the welfare function of the state-owned enterprises to the state is undoubtedly of significant property rights implications.

The Contractual Responsibility Systems and Share Ownership: More direct reforms in the property rights of the state-owned enterprises are, however, witnessed by the establishment of the contractual responsibility systems and share ownership. The contractual responsibility systems, which include Leasing, the Contract Management Responsibility System (CMRS), and the Asset Management Responsibility System (AMRS) came to the fore in the state-owned enterprises in the mid-1980s. The basic idea of the systems is to form a kind of contractual relationship between the government and the state-owned enterprises so as to solve the ownership and control problem of the state-owned enterprises.

The experiments with share ownership caused more controversies. In 1984 and 1985, faced with a shortage of funds and tightening of bank credits, some of the Chinese collective enterprises started to issue stocks to their own staff and workers.[156] The practice

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[155] See Perkins, "Completing China's Move to the Markets" supra at 39.

[156] See Xu Jing'an, "The Stock Share System: A New Avenue for China's Economic Reform," in Reynolds ed. Chinese Economic Reform: Haw Far, How Fast? (Boston: Academic Press, 1988) at 219.

to issue shares within the enterprises was recognized by the Chinese authorities. In the State Council's circular of March 1985, Article 2 of the circular provides that "[i]n experimental cities a few large [state] enterprises may solicit investments from their employees, but appropriate rules must be issued regarding dividends."[157] However, despite advocacy of some influential economists and government officials, issuing the shares of the state-owned enterprises to the public was not allowed then.

Not until the late 1980s did the Chinese government start to change its attitude towards the public issuing of the state-owned enterprises' stock. In September 1988, the Third Plenum of the Thirteenth CPC Congress called for experimentation with ownership of shares by the public.[158] With two securities exchanges established respectively in Shanghai and Shenzhen in early 1990s, the share ownership of the state-owned enterprises begins to develop in China.

As the contractual responsibility systems and share ownership will be further examined in later chapters, it suffices here to say that they represent the direct attempts on the part of the Chinese government to redefine the property rights of the state-owned enterprises, and indicate to us how far China has gone, sometimes inadvertently, in its departure from its orthodox standing on a socialist economy dominated by the public ownership.

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[157] See Chao and Yang, "The Reform of the Chinese System of Enterprise Ownership" supra at 454.

[158] See Pitman B. Potter, "The Legal Framework for Securities Markets in China: The Challenge of Maintaining State Control and Inducing Investor Confidence" (1992) 7 China Law Reporter 61 at 64.

2. Conceptual Bases: Legal Person and Operating Rights

In the process of the foregoing reforms to redefine the property rights of the stated-owned enterprises, two legal concepts, legal person and operating rights, have been developed to support and reflect their new status in the Chinese economic system. Though the Western legal theories have clearly some bearing on the two concepts, attempts have been made to accommodate the socialist characteristics of the state-owned enterprises.

Legal Person: To reflect the newly attained status of the enterprises as separate economic units under the reforms, the concept of "legal person" (*faren*) was put forward at the beginning of the economic reform. The Economic Contract Law promulgated in 1981 officially used the term "legal person" for the first time without providing a definition.[159] The discussion of the concept itself was however mainly carried out in the academic circles, which shared a consensus as to the basic features of legal persons similar to that of the Civil Law countries. Accordingly, a legal person must (1) be legally formed, (2) possess the necessary property or funds, (3) be an organisational entity with a clear business scope, and (4) be capable of assuming civil liability independently. [160]

As known, China had hardly a legal system when it started the economic reform, not to mention the rules to govern the business relations under the commodity economy. Therefore, the concept of legal person played an important gap-filling role in providing protection to the enterprises and other business organisations and regulating the market

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[159] See Henry Zheng, China's Civil and Commercial Law (Singapore; London: Butterworths, 1988) at 310.

[160] Ibid. at 311.

transactions which were stimulated by the reforms. Such corporate law issues as "undercapitalisaion," "lack of appropriate corporate structure," and "piercing the corporate veil," were all covered by the concept. Indeed, it has became "a key element in the Chinese law of business organisations."[161] When the General Principles of Civil Law was adopted in 1986, it not only absorbed the basic elements of legal person, but also elaborated at length on the stipulations of enterprises as legal persons including approval, registration, civil liabilities, and dissolvement and liquidation.[162]

Inasmuch as recognized as legal persons, the state-owned enterprises had a fairly different status from the pre-reform period even though they were not equal to the "legal persons" under the Western corporate laws. Some Chinese scholars did try to put the concept of legal person into the Chinese socialist economic context. For example, Chen Qizhong stated that the state-owned enterprises as legal persons were relatively independent economic organisations with certain operating rights and limited liabilities, but they were different from the capitalist corporations in nature.[163] Differences aside, the ownership of certain property rights is commonly regarded as essential to any legal person. In the case of the Chinese state-owned enterprises, it posed a sensitive issue, in particular, at the beginning of the economic reform, that is, how to define such a property rights without jeopardising the fundamental principle of the state ownership?

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[161] Ibid. at 310.

[162] See arts. 39, 41-49 in " General Principles of the Civil Law of the PRC" in Laws and Regulations of the People's Republic of China Governing Foreign Related Matters (compiled by the Bureau of Legislative Affairs of the State Council of the PRC) v.1 (Beijing: Chinese Legal System Publishing House, 1991) at 331-348.

[163] See Chen Qizhong, "*Sangpin jingji he qiye faren* [Commodity economy and enterprise legal persons]" (1985) 17 *Zhengzi yu Falu* [Politics and Law] 7 at 7-9.

Operating Rights: Again, heavily borrowed from the principle of the separation of ownership and control in the Western modern corporations, the principle of separating the state ownership from the operating rights has been established in China. While the state-owned enterprises have no ownership over the assets of the enterprises, they have the right to operate the assets.

With the so-called operating rights, the state-owned enterprises have gradually increased the control of their assets. Before reform, the state could reassign (*diaobao*) assets from one state enterprise to another without any compensation. In 1979, the Ministry of Finance issued regulations requiring that the reassignment of fixed assets must be for reasonable compensation, except in certain special cases. In 1983, the State council promulgated the State Industrial Enterprise Regulations,[164] which permitted state-owned enterprises to dispose of, rent or transfer their surplus fixed assets. In the following two years, the State Council issued two other important documents, the Interim Provisions for Further Expansion of Decision-making Power of State-owned Industrial Enterprise and the Interim Provisions on Problems in Invigorating State Enterprises,[165] which further enlarged the autonomous power of the state-owned enterprises. These two sets of regulations authorise the state-owned enterprises to sell or lease their fixed assets to other enterprises

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[164] "*Guoying Gongyi Qiyi Zanxing Tiaolu* [Interim Regulations of the State industrial Enterprise]" in *Guowuyuan Bangongting Fazhiju* [The Bureau of Legislative Affairs of the State Council], ed., *Zhonghua Renmin Gongheguo Fagui Huibian* [the Collection of Laws and Regulations of the PRC] (January-December, 1983) (Beijing: *Falu Chubanshe* [Law Press], 1986) at 383-399.

[165] "*Guanyu Zengqian Dazhongxing Qiyi Huali Ruogan Wenti de Zanxing Guiding* [Interim Provisions on Problems in Invigorating State Enterprises]" in *Guojia Jiwei Tigai Faguisi* [The Structural Reform Legal Office of the SPC], ed., *Qiyi Jingying Guanli Sheyong Wenjian Jicheng* [The Collection of Regulations and Documents for Enterprise Management] (Beijing: *Zhongguo Fazhi Cuobanshe* [Chinese Legal Systems Publishing House], 1991) at 1706-1708.

without the approval of their superior organisation if the assets are redundant and idle.[166] Of course, the operating rights are not simply limited to the disposal of assets. Rather, the concept of operating rights constitutes a theoretic base for the reforms of the state-owned enterprises. In the Regulations on Transforming the Mechanisms of State-Owned Industrial Enterprises promulgated by the State Council in 1992,[167] a comprehensive enterprises' management authority package provides that enterprises have the authority to occupy, use, and dispose according to law the property entrusted to them by the state for management and business purposes.[168] More specifically, the state-owned enterprises have production and management decision-making powers,[169] the right to decide the prices of products and labour services,[170] the right of selling their products and purchasing goods and materials.[171] They also enjoy import and export rights,[172] the right to make investment decisions,[173] the right to dispose of their assets,[174] and the right to hire workers and decide their wages and cash awards.[175] In addition to that, the state-owned enterprises can decide

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[166] See Chao and Yang, "The Reform of the Chinese System of Enterprise Ownership" supra at 451.

[167] "The Regulations on Transforming the Management Mechanisms of State-Owned Industrial Enterprises" Daily Report China, FBIS-CHI-92-145 (July 28, 1992) at 27-39.

[168] Ibid. art. 6.

[169] Ibid. art. 8.

[170] Ibid. art 9.

[171] Ibid. arts. 10 and 11.

[172] Ibid. art 12.

[173] Ibid. art 13.

[174] Ibid. 15.

[175] Ibid. arts. 17 and 19.

on the organisation of internal structures and refuse proration of manpower, materials, and financing from any government department.[176]

At first glance, these operating rights seem to be so impressive and comprehensive that they may be regarded as quite close to the management power of the modern corporations in the Western countries. Nevertheless, due to limitation of the Chinese economic reform, the ownership of the assets of the state-owned enterprises still belongs to the state. Hence the issue of how to balance the relationship between state's ownership rights and enterprise's operating rights is yet to be solved. For example, the aforesaid 1992 State Council's Regulation proposes to limit the power of the government to macro economic regulation and control instead of interfering with the production and management of the state-owned enterprises, but it still maintains the government's proprietary rights of enterprise assets and its power to decide the allocation of profits, approve production-related construction projects, and award and penalty for the enterprises' directors.[177]

As a reflection of the confusions and complexities of "separating two rights" there are also a lot of controversies in theory regarding the nature of the operating rights in China. Most representative among all the theories are the agency relation, contractual rights, rights in things (*wuquan*), and rights *sui generis*.[178]

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[176] Ibid., arts 20 and 21. For more detailed rules, see "Chapter II. Enterprises' Management Authority," The Regulations on Transforming the Management Mechanisms of State-Owned Industrial Enterprises, supra at 28-32.

[177] Ibid. "Chapter V. Relations Between Enterprises and the Government," at 35-37.

[178] See Wallace Wang, "Reforming State Enterprises in China: The Case for Redefining Enterprise Operating Rights" supra at 107-122.

(1) Agency Relationship

Pursuant to agency theory, a state-owned enterprise is merely an agent authorized by the state to manage specific properties. The operating rights contemplate some kind of agency relationship.[179] For instance, Li Zhuguo takes note of the fact that the state has the control over the profits of the state-owned enterprises, and the latter must follow the former's instruction on major issues. Therefore, he concludes that the state-enterprise relationship should be considered as one of agency. Moreover, considering the uniqueness of such a relation, Li further categorises it as a quasi-agency relationship, and the enterprise managers (as members of society) assume some capacities as co-owners, for theoretically the state-owned property is owned by the "whole people."[180]

(2) Contractual Rights

This theory holds that management rights are contractual in nature. According to this theory, although the state is the owner of property, it cannot directly manage all state property. Based on its own interests and needs, the state gives specific property to state-owned enterprises to manage and operate. This type of relationship can be regarded as either a trust arrangement[181] or a contractual arrangement such as responsibility-based contract system. Under a responsibility-based contract system, the state contracts with the

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[179] See Li Zhuguo, *"Quanming qiye jingying quan xingshi qiantan* [A preliminary inquiry on the nature of state enterprise operating rights]" (1989) 2 *Zhongguo Faxue* [China Jurisprudence] 63 at 63.

[180] Ibid. at 64-65.

[181] See Jin Ping and Zhao Yongshan, "*Guojia caichan quan yu weituo jingying quan* [The state's property rights and the right to entrust operating rights]" (1985) 4 *Zhongguo Faxue* [China Jurisprudence] 32 at 32.

state-owned enterprises to undertake a series of economic and technical goals such as profit targets and equipmentalisation rates.[182]

(3) Rights in Things

Tong Ruo, one of the co-drafters of China's General Principles of Civil Law, takes the position that operating rights are a type of independent real rights or rights over things.[183] As such, the holder of the rights can, based on law, resist any person, including the owner (i.e., the state). Tong also refutes such ideas that the operating rights are a single attribute of ownership and a form of relative ownership. Instead, they are rights in things which give enterprises exclusive control over the property they operate.[184]

(4) Rights *Sui Generis*

There are also scholars trying to develop some new theories to explain the essence of the operating rights of the state-owned enterprises. Zhang Ling, for example, argues that operating rights are rights *sui generis* granted to the state-owned enterprises by the state.[185] Adopting Marxist analysis, she concludes that operating rights, like other rights, are a "natural outcome" of historical development. However, she fails to define what exactly constitutes the content of such rights *sui generis*.[186]

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[182] See Wang Liming and Liu Zhaonian, "On the Property Rights System of the State Enterprises in China" (1989) 52 L.& Contemp. Probs. 19 at 37-41.

[183] See Tong Rou, "The General Principles of Civil Law of the PRC: Its Birth, Characteristics, and Role" (1989) 52 L. & Contemp. Probs. 151 at 151-172.

[184] Ibid.

[185] See Zhang Ling, "*Jingying quan chanshen genju xingtan* [A new inquiry into the basis of management rights]"(1988) 6 *Faxue Yanjiu* [Legal Studies] 47 at 47.

[186] See Wallace Wang, "Reforming State Enterprises in China: The Case for Redefining Enterprise Operating Rights" supra at 112.

All these theories should not be dismissed lightly. While none of them can satisfactorily explain the nature and extent of the operating rights as a whole,[187] each theory, taking references to some foreign legal ideas, has shed some light on certain specific dimensions of the operating rights. As discussed earlier, the nature of the Western firm is multi-dimensional (including its property rights), and various theories have been developed to approach it from different perspectives.[188] As well, the operating rights of the Chinese state-owned enterprises are by no means of a single dimension. Besides, compared to the ownership and control issue in the Western corporate law, the line between the state-ownership and the enterprises' operating rights is far more blurred and confused, and in a constant state of changing. Thus, the foregoing theories, although deficient one way or another, have had positive effects on redefining the property rights of the state-owned enterprise. Indeed, the theory of operating rights, together with the concept of legal person, has been the theoretic foundation of the Chinese state-owned enterprise reform.

3. Legal Framework

Along with the development of the concepts of legal person and operating rights, China has established a legal framework to codify and protect the property rights of the state-owned enterprises. In an effort to grant some management powers to the state-owned enterprises, the 1982 Constitution provides that "[s]tate-owned enterprises have decision-making power in operations and management within the limits prescribed by law,

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[187] Ibid.

[188] See supra text at 26-50 for a general introduction of the theories of the firm.

on the condition that they submit to unified leadership of the state and fulfil all their obligations under state plan."[189] As further enterprise reforms are carried out in a larger scale and higher level, more detailed legal norms and rules have been proffered in a series of laws and regulations.

Civil Law: The General Principles of Civil Law of the People's Republic of China (hereinafter Civil Law) promulgated in 1986 establishes a systematic and comprehensive legal system. As a fundamental law regulating property relations, the Civil law has played an important role in defining the framework of property rights for the state-owned enterprises.

Article 36 of the Civil Law defines a legal person as an "organisation that possesses capacity to acquire civil rights and competence to perform civil acts, and that, according to the law, may independently assume civil rights and bear civil liability." The state-owned enterprises can enjoy a bundle of underlying rights as legal persons. Furthermore, Article 48 provides the state-owned enterprises with limited liability.[190]

Under article 71, ownership rights over property are defined as the rights of possession, use, profit and disposition, reflecting the Roman law tradition. However, to accommodate the newly-formed concept of operating rights, the Civil Law enumerates five "property rights related to ownership."[191] Chief among them are the "operating rights"

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[189] See art. 16, the Constitution of the PRC (1982).

[190] Art. 48 provides: A State-owned enterprise legal person bears civil liability to the extent of the property the State has given it to operate and manage. See The Constitution of the PRC (1982).

[191] See arts. 80-83 of the Civil Law supra.

enjoyed by a state-owned enterprise. Pursuant to article 82, operating rights are defined as "[t]he rights enjoyed by state-owned enterprise to operate according to law state property that has been given to it to operate and manage."

More importantly, the promulgation of the Civil Law, at least nominally, put an end to the dispute between the "economic law school" and "civil law school." The major controversies between the two schools mainly locate on their perceptions of the position of the state-owned enterprises in "the socialist economic relations." Three major theories have arisen since 1980.[192] The first is the comprehensive economic law theory. The theory holds that all the legal relationships in a socialist country ought to be subject to the regulation of the economic law, which governs civil, administrative, and labour relations according to the principles of the planned economy. In other words, there is no such legal relation as equivalent to the "equality" of the Western capitalist countries based on pure market exchanges. Socialist economic relation should be regulated according to socialist principles. The second one is the vertical and horizontal relations theory. This theory notes the differences between the economic relations among state enterprises and relations among private individuals. Accordingly, it argues that the economic law should only regulate the former, be it horizontal or vertical; while the latter falls into the jurisdiction of the civil law, which regulate the equal relations among the legal entities. This theory admits the existence of the equal exchanges among the enterprises, but refuses to regard them as private relations. Finally, the vertical relations theory. To the proponents of this theory,

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[192] See Tong Rou ed., *Zhongguo Minfaxue: Minfa Chongzhe* [Chinese Civil Laws: the General Principles of the Civil Law] (Beijing: *Zhongguo Renmin Gongan Daxue Cubanshe* [Chinese People's Public Security University Press], 1990) at 24.

economic law deals only with vertical relations in the socialist economy, and other horizontal relations including such relations among the state-owned enterprises are regulated by the civil law.[193] Apparently, the Civil Law adopts the vertical relations theory.[194] To affirm the independent legal status of the state-owned enterprises in market transactions, the Civil Law regulates the civil relations of citizens and legal persons (including the state-owned enterprises) in accordance with the principles of voluntariness, fairness, exchange of equivalent values, honesty and good faith, the staples of a Western-style civil code.[195]

Nevertheless, there are still some problems in the vertical relations theory. While affording the civil law protection to the state-owned enterprises in their horizontal relationships, it also makes quite clear that the vertical relations concerning the state-owned enterprises will be in the jurisdiction of the economic law, the main characteristics of which are the dominance of the state bureaucratic orders and inequality of the legal entities. Yet, the demarcation line between the vertical and horizontal relations is hard to draw, and thus it is difficult to define the scope of the operating rights provided in the Civil Law.

The State-owned Enterprise Law: A major shift in the relationship between the state and its enterprises came when the Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People (hereinafter the State-owned Enterprise Law)

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[193] Ibid.

[194] Ibid., at 24-25.

[195] See supra Civil Law, arts. 1, 2, 3, and 4.

was enacted in April 1988. The major theme of the 69-article law is the principle of the separation of enterprise management from state ownership.[196] Under the principle, the law sets forth the rights and obligations of the state-owned enterprise. It promises an enterprise the right to arrange its production; the right to request adjustment of the mandatory plan and to reject additional assignment outside the mandatory plan; the right to sell on its own, outside the mandatory plan quotas; the right to choose suppliers; and the right to set its own prices, except for those under price controls set by the State Council provisions, budgetary control over retained funds (retained earnings), control over fixed assets and their disposal, power to fix wages and bonuses, and the power to hire, fire and redeploy personnel.[197] As a significant addition to enterprise autonomy, Article 33 provides that the state-owned enterprise can "reject the exaction of manpower, materials and financial resources" by any state organ or unit.

The state-owned enterprise law deals with the management of the operating rights of the state-owned enterprise by giving more power to enterprise directors, which echoes the policy for less control of the party in the day-to-day business of the production. The factory director is made the legal representative of the state-owned enterprise. The director has the power to decide on the enterprise plan, the administrative setup of the enterprise, the middle-level administrative personnel, as well as the power to reward or punish the staff or workers.[198]

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[196] See art. 2, "The PRC Industrial Enterprises Owned by the Whole People Law" (passed on April 13, 1988 and effective as of August 1, 1988) (1988) 2 China Law & Practice 35 at 35-55.

[197] Ibid. arts. 22-32. Also see James Feinerman, "The Evolving Chinese Enterprises" (1989) 15 Syr.J.Int'l.L. & Com. 203 at 209-210.

[198] See Feinerman, "The Evolving Chinese Enterprises" supra at 211.

The law marks China's further efforts to reform the state-owned enterprise, in particular, to define its operating rights, which the Civil Law fails to do. By enunciating the contents of the operating rights and delegating the rights mainly to the directors, the State-owned Enterprise Law, if enforced strictly, will undoubtedly narrow the gap between the Chinese state-owned enterprises and the modern corporations of the Western countries, and greatly improve their autonomy and efficiency. However, the role of the Communist party and of government agencies in controlling business operations, although less powerful than before, is still clearly maintained.[199] Under the state plan, the government is to provide enterprises what they need to fulfil their quotas.[200] The ideological barrier in granting the managers the operating power looms large, which is evidenced by the provisions concerning the powers of "Workers' Representatives."[201] Staff and workers are promised the right to participate in the enterprise's "democratic management," that is, through the Workers' Representative Assembly, they are entitled to evaluate the administrative leaders of an enterprise; to make suggestions regarding the leaders' rewards, penalties, appointment and removal; to elect and remove the enterprise director subject to government approval; to discuss and decide on plans regarding workers; and to discuss and offer suggestions on the enterprise's plan.

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[199] See Robert C. Art and Mingkang Gu, "China Incorporated: The First Corporation Law of the People's Republic of China" (1995) 20 Yale J.Int'l.L.273 at 279.

[200] See State Enterprise Law supra art. 55.

[201] See State Enterprise Law supra arts. 49-54. The contentious issue of limiting the authority of the enterprise directors through the "workers' assembly" was disputed in the drafting process, but strongly argued for by the workers' representatives who took part in drafting. See Feinerman, "The Evolving Chinese Enterprises" supra at 213.

Company Law: The most recent legislation concerning the reforms of the state-owned enterprise is the Company Law of the People's Republic of China (hereinafter the Company Law) promulgated on December 29, 1993. Unlike the State-owned Enterprise Law, the Company Law applies to all kinds of enterprises in China, the state-owned and nonstate-owned alike.

To modernise the state-owned enterprises is the core of the Company Law.[202] Accordingly, the Company Law provides rules for the setup and powers of the board of directors and supervisory committee. The board selects managers and makes other key business decisions.[203] The supervisory committee oversees the board of directors and assures that it pursues the policies fixed by the shareholders. Its members attend meetings of the board in a non-voting capacity and inspect the company's financial affairs.[204]

Another driving force for the enactment of the Company Law is to meet the needs of regulating the newly-born "public companies." With the public listing of some state-owned enterprises both at home and abroad, China needs legal rules to protect the interests of the public shareholders as well as to guide the operation of these companies. Therefore, the Company Law provides different rules for limited liability companies and companies limited by shares.[205] The shareholders of the latter are given extensive rights similar to that of their counterpart in the Western public companies, which range from the vote in the shareholders' meeting to the pay of dividend.

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[202] Art. 1, "Company Law of the People's Republic of China" (adopted on Dec. 29, 1993 and effective from July 1, 1994) (1994) 4 China Current Laws 5 at 5-43.

[203] Ibid. art. 46.

[204] Ibid. arts. 54 and 126.

[205] Ibid. art. 3.

Despite some seemingly similarities, China's Company Law is no equivalent to its Western counterparts. There remains some fundamental differences between them. For one thing, the Company Law is designed mainly to restructure the state-owned enterprise, rather than to totally redefine its ownership and property rights. Partly due to this, some commentators suspect that the Company Law will have large effects on the state-owned enterprises. For example, in Art and Gu's view, "[r]epackaging the state-owned enterprises in the garb of Western capitalism will have merely cosmetic consequences if the underlying incentives remain unchanged. Success of the central goal of promoting efficiency and productivity depends on resolve and policies beyond the Company Law."[206] Nevertheless, as my further study shows, the Company Law, albeit limited in its scope and principles, has codified the Chinese share ownership system, and is essential to building a modern enterprise system in China.

4. An Evaluation of the Results of the Changes in the Property Rights of the State-owned Enterprises

The economic achievements of the Chinese economic reform have caught the attention of the whole world. China's rate of growth of GDP per capita rose from around 4 per cent during 1952-78 to over 7 per cent during 1978-92, with estimated per capita consumption more than doubling during the latter period.[207] But how far such a growth

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[206] See Art and Gu, " China Incorporated: The First Corporation Law of the People's Republic of China" supra at 308.

[207] See Putterman, " The Role of Ownership and Property Rights in China's Economic Transition" supra at 1053.

has been directly related to the property rights changes is a debatable question, and demands our further examination.

Agriculture scored the first major success in China's economic reforms. While the acceleration of the growth rate of crop output value from the 2.5 per cent rate of 1952-78 to 5.9 per cent in 1978-84 proved somewhat impermanent, rural reform freed residents to shift to higher value activities, thus helping to account for growth rates of 4.7, 11.1, 6.4, ad 18.9 per cent respectively for forestry, animal husbandry, sidelines and fishery output during 1984-92 (2.7, 10.9, 1.0 and 17.9 per cent respectively for 1978-92 as a whole).[208] The relationship between such an economic success and the property rights arrangements in agricultural sector is relatively straightforward. Supported by econometric studies, most authors have contributed the single most important cause of China's improved agricultural performance to the change in the locus of day-to-day management and of the claim on net output, the result of the adoption of the household responsibility system.[209]

The impact of the changes in the property rights on the performance of the state-owned enterprises is much harder to evaluate. To be sure, the overall industrial performance of China has been greatly improved, and total factor productivity has also risen dramatically.[210] Most authors, however, concur that the increasing importance of the "non-state" sector and foreign investment have been major contributors to growth.[211] The

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[208] Ibid.

[209] See e.g., Peter Nolan, The Political Economy of Collective Farms: An Analysis of China's Post-Mao Rural Reforms (Boulder: Westview, 1988).

[210] See Jefferson and Rawski, "Enterprise Reform in Chinese Industry" supra at 55-57, in particular, Table 4: Estimated Rates of Annual Productivity Growth in Chinese Industry, at 56.

[211] See Putterman, "The Role of Ownership and Property Rights in China's Economic Transition" supra at 1055-1056.

reason for that lies on the fact that the non-state sector and foreign enterprises have relatively reasonable property rights arrangements, which get them to behave according to the rules of the market.[212]

On the one hand, due to its partial and incomplete nature the Chinese economic reform has not brought the state-owned enterprise well-defined property rights. On the other hand, various measures described above have unequivocally reshaped the property relationship between the state and the enterprises, and dramatic changes have taken place in the structure and conduct of the state-owned enterprise.

Autonomy: As the scope of mandatory planning declines, the managers of the stated-owned enterprises have acquired growing authority over decisions about the production and product marketing. A host of market-supporting institutional developments have enhanced enterprise autonomy by increasing choice and reducing transaction costs, thereby expanding the capacity of the state-owned enterprise managers to restructure business management. In sum, the state-owned enterprises have got substantial autonomous powers under the heading of the "operating rights."

Incentives: The property rights play the function to reducing transaction costs with their underlying incentive mechanisms. The reform measures have reconfigured the relations between effort, financial outcomes, individual reward, and enterprise control over resources. Despite continuing support of loss-making enterprises and their employees from direct budgetary subsidies, flexible tax rates, and "soft" bank lending, new incentive

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[212] See Perkins, "Completing China's Move to the Market" supra at 37.

arrangements have begun to generate penalties as well as rewards.[213] The incentive schemes, albeit flawed, have largely connected the profits of the state-owned enterprise with its financial rewards, and performance of the managers and workers with their wages and bonuses.

Competition: Reform has meant an expansion not only of markets, but also of competition. With the demise of regional and industrial sector monopolies, the state-owned enterprises take part in increasingly heated business competition for the share of markets, material supplies, and customers. For example. a price "war" was waged among three major TV producers in China. When the war was started by Sichuan Chang Hong TV Co., the other two companies tried to request responsible government ministries to interfere, which was reportedly denied.[214]

Conduct: The structural changes have, in turn, induced changes in conduct. There is little doubt that profit has become the dominant objective of managers in China's state-owned enterprises. In a sharp contrast to the conduct in the planned economy, the state-owned enterprise now arranges production plans according to market conditions with the objective of increasing profit. The "profit-seeking" and "profit-maximising" have been on the top agenda of almost all state-owned enterprises. The new incentive mechanisms have

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[213] Jefferson and Rawski, "Enterprise Reform in Chinese Industry" supra at 52.

[214] "Demon Behind the Price War," v.17 China Economic News, No. 31 (August 19th, 1996) at 1-2. Also, "China's TV Price War," Newsbytes News Network (June 27th, 1996), (On-line information kept in author's personal file).

also spurred both managers and workers to adapt their behaviour for more benefits and profits.

However impressive as these changes are in comparison to the enterprises in the former planned economy, the functioning of the state-owned enterprise in the present mixed economy is still riddled with various problems. Without a well-defined property rights, the improvements in both the structure and conduct of the state-owned enterprises are greatly compromised.[215] Among the major problems facing the Chinese state-owned enterprise are hyperinvestment, ratchet effect, financial undiscipline and corruption, and the confusion over the ownership and control.

Hyperinvestment: Hyperinvestment or "investment hunger" is a familiar problem in many socialist economies, where each locality has a stake in developing as wide a range of industrial enterprises and social facilities as possible.[216] These tendencies have been exacerbated in the China's mixed economic system as a consequence of granting enterprises and local governments greater autonomy over investment decisions without subjecting them to rational prices and hard budget constraint. These excessive levels of investment greatly fuel the inflation, which has already been economic concerns as the result of price reform. The increasing inflation from time to time prompts the government to adopt expedient measures to control the money supply and bank loans, hindering the healthy development of the whole economy. Thus the chronic hyperinvestment has caused

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[215] Jefferson and Rawski, "Enterprise Reform in Chinese Industry" supra at 58.

[216] See Harding, China's Second Revolution: Reform after Mao, supra at 279.

a serious problem known as a "vicious cycle" (hyperinvestment-inflation-economic control) in the Chinese economy.

Ratchet Effect: Although the systematic ratchet effect of the planned economy has been greatly contracted, there are some dysfunctional systems in the mixed economy creating disincentives by penalising successful enterprises. The target benefits in the Contract Responsibility System, for example, are usually set according to the profits of the previous years. And once the central or local governments are in the budget difficulty, they will try to arbitrarily improve the target at the expense of profits of these enterprises. On the other hand, the soft budget constraint keeps the state banks to pump funds into money-losing firms. More often than not these money-losing firms have no plan and hope to improve their performance at all.

Financial Undiscipline and Corruption: The partial economic reform has generally improved the workers' individual productivity as indicated early, but the managers of the state-owned enterprise often raise their wages, bonuses, and other benefits at far greater rates, and hence incur the profit loss of the enterprises.[217] The dual-price system not only distorts the rationale allocation of resources, but also constitutes the source for irregular economic dealings and corruption. In addition to the notorious "official profiteering" by some state firms, most of the state-owned enterprises set up their auxiliary trading companies known as "the third production industry" in China to channel the redundant

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[217] This phenomenon was also observed to exist in Hungary years before in its economic reform. See Walder, "China's Transitional Economy: Interpreting Its Significance" supra at 967.

employees. In order to make profits, these trading companies often engage in such businesses as reselling the planned material at market price. Furthermore, without proper regulation, monitoring and adequate accountability, the managers of the state-owned enterprises can easily abuse their newly-attained autonomy by making sweetheart deals at the expense of the enterprises or engaging in other corruptive practices. Indeed, the corruption is so serious that Harding lists it as the most immediate problem to plague the reforms.[218]

Ownership and Control: The core problem of the Chinese state-owned enterprise in the mixed economy is the increasing confusion over the ownership and control as a result of its ill-defined property rights. In its 1990 report on the Chinese economy, the World Bank laments the confused position in respect to property rights in the state-owned sector:

> [T]he ownership of Chinese "state owned" enterprises is becoming increasingly ill-defined. Ten years ago, all industrial assets in the state run economy were clearly controlled, and effectively "owned" by various levels of governments, which exercised both ultimate managerial authority and claims on residual income. Today, managerial authority and claims on income split between government and the enterprise itself, as well as, to a lesser extent, the banking system. The uncertainty attending on the ownership system is putting serious obstacles in the way of improved performance.[219]

Needless to say, the confused relationship between the state and enterprises has incurred enormous costs. With a small number of official bodies charged with the supervision of 93,700 state enterprises, monitoring costs are high and information channels clogged.[220]

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[218] See Harding, China's Second Revolution: Reform after Mao, supra at 281.

[219] World Bank (1990), China: Macroeconomic Stability and Industrial Growth under Decentralized Socialism (Washington, DC: World Bank).

[220] See Jefferson and Rawski, "Enterprise Reform in Chinese Industry" supra at 64.

On the other hand, the discretionary bureaucratic interference with the management continues to exist, causing the waste of resources and inefficiency of the state-owned enterprise.

Overall, the economic reform has brought about great changes to the state-owned enterprise, but there are still huge transaction costs in running a mixed economy. These costs, together with the other related problems, have not only plagued the Chinese state-owned enterprise, but also impeded the growth of China's whole economy and even jeopardised the prospects of future economic reform. Because of the incompatibility of the market economy with the extensive state ownership, further economic reform must be based on a well-defined property rights. For this purpose, an across-the-board privatisation is called for in China.

2.4 A Step Further: China Goes Private?

No issue is more contentious and sensitive than the privatisation of the state-owned enterprise in any discussion concerning the Chinese economic reform. In the context of analysing the "Chinese Model" of evolutionary system reform, three broad views have been voiced. The first argues that privatisation is central to economic reform and efficiency, that failure to embark on a thorough privatisation programme retards economic progress, and that little additional progress is therefore possible for China without such a programme. The second sees marketisation but not privatisation as desirable for an economy, so that consolidating and further adjusting the institutions of China's emerging socialist market economy is desirable, but increasing private ownership of enterprises and

resources is not. The third contends that comprehensive privatisation will ultimately bring gains but it is not necessary in the early stages of reform, and that China can continue to dispense with full privatisation for some time to come.[221] Apparently, the three views are of tremendous implications to the Chinese economic reform, for each indicates a particular reform path, upon which depends not only China's economic efficiency and viability, but also the ultimate fate of its economic reform programme as a whole.

As the earlier study indicates, the property rights theory and transaction costs economics hold that, everything being equal, the private ownership brings more incentives to private property owners, and hence incurs fewer transaction costs than the public ownership. The private ownership system is, therefore, generally superior to the public ownership system. But it in no way means that the public ownership should and will be replaced by the private ownership, for the institutional change is quite costly itself. Therefore, to decide which reform path for China to take, an examination of all the three views in the context of transaction costs economics analysis is in order.

To begin with, let us shift the eyes of history back to the late 1970s to see whether or not China could possibly adopt a private ownership system then, as urged by the proponents of the first view. These proponents mainly base their analysis on the experience of the reform of East European socialist countries, and take the crackdown of the 1989 student democratic movement as an evidence for the failure of China's incremental reform approach. What they have neglected, however, is China's socioeconomic conditions in the late 1970s, the eve of the Chinese economic reform. It is

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[221] See Putterman, " The Role of Ownership and Property Rights in China's Economic Transition" supra at 1058.

thus my argument that the underlying transaction costs would be too great for China to embark on the course of privatising its whole economy at that time.

The first and foremost of all was the ideological barrier. When the economic reform began in the late 1970s, the dominant ideology still was the so-called Marxism, Leninism and Mao Zedong Thoughts, which maintained the socialism and its economic foundation public ownership as the doctrines of utmost importance. Although the reformists came to power after outmanoeuvring the faction in control which adhered to the doctrine of "two whatevers,"[222] they did not, and indeed could not, abandon the orthodox ideology. Rather, they held themselves out to the Chinese people as the real Marx-Leninists, and claimed the reform was the restoration of the Marxism, Leninism and Mao Zedong Thoughts, whose meaning had somehow been lost in the Cultural Revolution. They even wrote it as one of Four Cardinal Principles into the 1982 Constitution. Indeed, seeing that the orthodox Marx-Leninist ideology had the appeal to the public, and the disillusionment with such an ideology was only limited to a handful of intellectuals at that time, we can safely assert that, had the reformists taken such a line as to denounce and abandon the socialism and the principle of public ownership, it would have been fatally unwise and doomed to a disastrous end.

Secondly, as a socialist country China had been closed to the outside world for more than three decades. All the information about a private economy was nothing but bad

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[222] The doctrine of "two whatevers" were maintained by the restorationist faction, whose leading figure was Hua Guofeng, then the Chairman of the party and Premier of the government. For a detailed description of the power struggle in the aftermath of the death of Chairman Mao, see Harding, China's Second Revolution: Reform after Mao, supra, in particular, "Chapter 3: The Rise of the Reformers," at 40-69.

memories of the economic chaos in China before 1949 and the distorted depiction of the Western countries by the propaganda machine of the Chinese authorities. Against that background, the proposal of a Western-style free market economy as an alternative to the planned economy was simply out of the question. In terms of transaction costs, it would be extremely costly to get the necessary information for a private economy, and equally costly to overcome the collective psychological hostility toward the private ownership system. It is rather telling that China turned to such socialist countries as Hungary and former Yugoslavia instead of the modern Western economic powers for the reform experience in the first stage of the economic reform.

Thirdly, although China's economic reform began in the agriculture sector, and its reform is actually a de facto privatisation as illustrated above, the seeds of such a policy to decollectivise the farmers was planted in the late 1950s and the early 1960s. In fact, one of the pronounced reasons to purge the leading reformist Deng Xiaoping in the Cultural Revolution was his role in making and promoting the agricultural decollectivisation. With Deng regaining his power, it goes without saying that the legitimacy of the policy might not be questioned. But the idea of reforming the industry as a whole was otherwise premature, for the plausibility of a planned industry as the foundation of the socialist country had seldom been challenged openly. Not incidentally, the comprehensive plan to reform the industry, not to mention the privatisation of the industry, was not fully explored until the mid-1980s when the agriculture reform had achieved satisfactory results.

Finally, the economic conditions would not allow the rapid privatisation, and at the same time, there was the possibility of improving the economic performance without the

privatisation.[223] Compared to other socialist countries, the position of agriculture in China's economic structure and its less centralised planned economy made it possible to adopt an incremental approach to maintain the economic improvement by growing out of the plan. Therefore, the incremental reform without privatisation proved a viable alternative to the planned economy, not the rapid privatisation.

However, after more than a decade's reform efforts, the conditions seem to be ripe for China's transition to a private economy. With the development and broadening of the operating rights of the state-owned enterprise, the rigid state ownership under the planned economy has been attenuated. First of all, despite the differences in the legal forms of the ownership between the common law and civil law, the right of ownership must contain such four elements as: (1) the right to use asset (*usus*), (2) the right to capture benefits from the assets (*usus fructus*), (3) the right to change its form and substance (*abusus*), and (4) the right to transfer all or some of the above rights.[224] In the Chinese Civil Law, ownership rights are also defined as rights to "possess, use, benefit from, and dispose of" one's property.[225] Judging from the Chinese reform process, it is fair to say that the state-owned enterprises have got significant rights in all the aspects, which undoubtedly has laid a foundation for the complete transfer of the ownership from the state to enterprises.

Then, the "open door" policy has brought China closer to, if not gradually integrated with, the outside world. Although the Chinese authorities are always vigilant about the

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[223] See Nolan, State and Market in the Chinese Economy, supra at 182-185.

[224] See Pejovich, The Economics of Property Rights: Toward a Theory of Comparative Systems, supra at 27-28.

[225] See Civil Law supra art. 71.

influence from the Western countries, and have indeed initiated several movements against the "bourgeois liberalisation" and "peaceful offensive," the Western values and ideas have crept into the minds of the Chinese people. The disillusionment with the orthodox communist ideology is so pervasive that the Chinese authorities have bemoaned the "faith crisis." Hence, the orthodox ideology which I have identified as the biggest obstacle for a private economy in the late 1970s poses much less problems. When Deng Xiaoping promoted his plan for openly embracing the market economy in 1992, he pointedly denounced the practice to take the ideology as the foremost consideration in the economic field.[226] Once the Chinese government decided to grant the land lease to both domestic and foreign property developers in the late 1980s, it just amended the relevant constitutional provisions to legalise the transferability of land. Few ideological considerations were raised or aired.

Furthermore, the rapid growth of foreign enterprises and domestic private businesses has provided the Chinese people with ample knowledge and information about running and managing a private economy. Unlike its attitude toward the Western values, the Chinese government encourages the learning and adoption of Western business practices and management techniques in China's enterprises. In addition, the booming Chinese economy mainly fuelled by the non-state sector industries provides economic resources to undertake the cause to privatise the state-owned enterprises. The huge funds in the hands of private enterprises and individuals, which have been accumulated during the past

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[226] Deng put his idea as " not to ask what name the technology or equipment is: capitalism or socialism; the only concern is to improve the productivity," which was also consistent with his famous " two cats theory."

economic reform, can almost surely "buy out" the state-owned enterprises if they are given the chance to do so.[227] Whereas the former Soviet Union and the Eastern European countries have resorted to voucher system and other measures to privatise their industries, which have caused concerns over official favouritism, corruption, and even collusion with organized criminals.[228]

As stated earlier, the theory of institutional changes indicates that the property rights will be rearranged to cut the transaction costs if the changing process is cost-free or costs less than the final benefits. Now that the conditions for a private economy are ready in China, why do the Chinese authorities still keep tiptoeing around the issue of privatisation of the state-owned enterprise, and insist the state ownership as an unbreakable principle? What are the major obstacles of the Chinese economic privatisation? Are these obstacles surmountable? These questions warrant careful analysis.

Having kept a close watch of the developments of China's property rights throughout the whole economic reform, Cheung asserts the major hurdle of the economic privatisation is the opposition from the privileged interests.[229] Some authors have used both the "welfare hypothesis" and the "cartel hypothesis" to analyse the Soviet-style

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[227] According to Jefferson and Rawski, there is no financial obstacle to selling large numbers of state firms. The bank deposits of China's households, which have grown faster than the fixed assets of state industry in recent years, amounted to about RMB 1.3 trillion at the end of 1992, while year-end 1992 net fixed assets of state industry amounted to RMB 1.1 trillion. Seventy firms with assets in excess of RMB 1 billion each accounted for RMB 225 billion of this total. See Jefferson and Rawski, "Enterprise Reform in Chinese Industry" supra at 65.

[228] e.g. Andrei A. Baev, "The transformation of the Role of the State in Monitoring Large Firms in Russia: From the State's Supervision to the State's Fiduciary Duties" (1995) 8 Transnat'l.Law. 274 at 274-275.

[229] See Cheung, "Privatisation vs. Special Interests" supra at 26.

economies and their economic reforms, and drawn the conclusion that the rent-seeking for the welfare of the ruling groups is the driving force and ultimate motivation of the Soviet-type regime.[230] The reform in Soviet-type societies were not motivated primarily by the welfare consideration for the people. And as long as the privileged groups can reap the benefits and their fundamental interests are not threatened, they will resist any changes at the expense of the general welfare.

In the current mixed economic system the privileged groups are much more diversified than in the former planned economy. As the economy moves towards a free market, both the political and economic interests tend to be less polarised as before. The Chinese Communist Party itself may be viewed as an interest group as far as the political power is concerned. In order to maintain its uni-party regime, the party, especially the conservative faction within it, is always suspicious of any dramatic changes. No major reform policy has come out without the disputes in the party over its influence and impact upon the authoritarian regime. Since a total privatisation of the Chinese economy will undoubtedly cause turbulent political transformation and challenge the communist regime's legitimacy, the party is persistently antagonistic against the privatisation of the state-owned enterprise.

Another privileged group is the core bureaucrats within both the party and the government, who exert formidable force in blocking the privatisation in China. These bureaucrats have both their political and economic privileges at stake in maintaining the status quo. Their behaviour patterns are so saturated with bureaucracy of a public

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[230] See Paul B. Stephan III, "Toward a Positive Theory of Privatisation-Lessons from Soviet-type Economies" (1996) 16 Int'l.Rev.L.& Econ. 173 at 173-181.

economic system that they will not be able to adapt to a private economy. Moreover, in the mixed economy, many of them, or their relatives and associates, have engaged directly in business activities, benefiting from the state ownership system. The notorious "princeling," for example, has wielded not only enormous economic power, but also awesome political influence in China.

Another major problem with the privatisation of the state-owned enterprise is to ensure the macroeconomic stability. Although the welfare and concerns of the people in a socialist system are not the major consideration and motivation of its policies, the regime must be careful to keep the macroeconomic instability within the collective psychological limits of the people. Unlike a democratic system, the authoritarian regime provides no formal channel for people to voice their opinions and discontents about the government policies, instead it furnishes the public with no or false information to keep them at bay. Conventional political theories maintain that such uninformed people, albeit easily manipulated, may stand up against the regime once their expectation is seriously frustrated or the economic instability and uncertainty are over their psychological limits.

The Chinese economic reform has raised people's expectation for their well-being. Thus the Chinese authorities would not be able to reverse its policy to the former planned economic system. That is the reason why even the most conservative reformists promised to continue the economic reform after they had purged the radical reformists and changed their policies in the late 1980s. On the other hand, the public reaction over the inflation, increasing economic inequality, and social disorder has forestalled some dramatic reform measures in the past. Several setbacks of the radical reformists in the 1980s were closely related to the macroeconomic difficulties, and more conservative measures were adopted

under the appeal to the public for stability. To establish a private economy, the Chinese government must gradually change its price, money supply and other fiscal policies, which will certainly result in the macroeconmic instability. The process of privatising the state enterprises is also very costly, plagued with corruption, social disorder, and economic uncertainty as witnessed in the Eastern European countries and Russia. Whether or not the Chinese public can bear such a pain is hard to say, and must be calculated by the decision-makers.

Nonetheless, since there is no other viable alternatives to the mixed economy, in which the Chinese communist regime cannot muddle through primarily due to the inherent costs to run the state-owned enterprise, it will finally come to terms with the private economic policy. The huge burden on the whole Chinese economy imposed by the money-losing state-owned enterprises has been a great source of anxiety for the authorities and people alike, and may prompt China to embark on the path leading to a private economy once the current economy is stretched out of its limits. Meanwhile, the obstacles posed by the various privileged groups and the public at large can be overcome or avoided if the privatisation proceeds in an orderly manner and flexible fashion. Because of that, the rapid privatisation advocated by "fast privatisers"[231] should not be adopted. Instead, a step-by-step blueprint with privatisation as the ultimate goal should be adopted.

All in all, the mixed economy, the product of the incremental reform, is hardly a satisfactory goal of the Chinese economic reform. In order to improve economic efficiency

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[231] See Wallace Wang, "Reforming State Enterprises in china: The Case for Redefining Enterprise Operating Rights" supra at 133.

and productivity, further institutional changes characterised by the privatisation of the state-owned enterprise are called for. Despite the huge odds to overcome and the current regime's hesitancy, China is well on the threshold to a private economy after more than a decade's economic reform and opening to the outside world. The time will finally come for China to "go private."

Chapter Three

Ownership and Control (1): Contract Management Responsibility System

One of the centrepieces of the Chinese state-owned enterprise reform is the Contract Management Responsibility System (CMRS). As the principle that the state-owned enterprises should have much greater autonomy than in the past is upheld as a way to improve the economic productivity and efficiency, a critical issue has arisen ever since the beginning of the Chinese economic reform, in particular the urban reform in the mid-1980s, that is, how to properly deal with the relationship of the state's ownership rights and the enterprise's operating rights.[232] To depart from the former hierarchical bureaucratic control of the enterprises by the state without giving up its ownership rights, China has mainly used the Contract Responsibility Systems (CRS) to set up the contractual relationship to clarify the responsibilities, rights and benefits between the state and the enterprises.[233]

Over the course of the economic reform, the forms of CRS that were implemented have undergone significant changes as complementary policy reforms were carried out.[234]

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[232] See World Bank, China: Long-term Development Issues and Options (Baltimore: Johns Hopkins Univ. Press, 1985) at 165.

[233] Art. 2, "The Provisional Regulation of the Contract Management Responsibility System for the State-owned Industrial Enterprise" (issued on 27 February 1988 by the State Council) in Delong Chen, Chinese Firms between Hierarchy and Market (New York: St. Martin's Press, 1995) Appendix 1 at 177-181.

[234] See Koo, Li, and Peng, " State-Owned Enterprise in Transition" in Galenson, ed., China's Economic Reform (The 1990 Institute, 1993) at 42.

The dominant form is CMRS, however. In late 1987, it was chosen by the central government for rapid popularisation to the bulk of state-owned industrial enterprises.[235] While enterprises already implementing other types of CRS appeared not to have changed over directly to it, CMRS has tended to take on "umbrella" connotations, covering all of the different CRS.[236] Indeed, the use of CMRS was so pervasive that nearly 90 percent of all state-owned industrial enterprises had reportedly adopted it by 1988.[237]

By and large, CMRS is a special institutional arrangement aimed to accommodate the "dual rights" of the Chinese state-owned enterprise. However, whether it is a transitional device or a suitable final model for China's further economic reform is far from settled.[238] Based on an examination of its history and contents, this Chapter ventures to analyse the CMRS from a contractual perspective.

3.1 The Origin and Development of CMRS

CRS in Rural Enterprise: The idea of CRS originated from the Household Contract (*chengbao*) Responsibility System (HCRS) adopted in the Chinese agricultural reform in

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[235] See William A. Byrd, "Contractual Responsibility System in Chinese State-Owned Industry," in Campell et al. ed. Advances in Chinese Industrial Studies, v.2 (Greenwich, Conn.: JAI Press, 1991) at 18.

[236] Ibid.

[237] See Koo, Li and Peng, "State-Owned Enterprise in Transition" supra at 44. Some studies, however, indicate that CMRS covered about 70% of all SOEs in 1988, see Fan "State-owned Enterprise Reform in China: Incentives and Environment" supra at 149.

[238] See Zhou Shulian, "Enterprise Reform and the Two-Power Separation Theory" in Totten & Zhou, eds., China's Economic Reform: Administering the Introduction of the Market Mechanism (Boulder: Westview, 1992) at 138-141.

the late 1970s, and was first practised in rural enterprises.[239] As early as 1978, some rural enterprises (i.e., township and village enterprises) carried out a primary responsibility system to reward the workers according to their fulfillment of job quotations. Soon the contract system was used to the rural enterprises themselves, and they were contracted out like the land in HCRS. As a result, the productivity and profit of these enterprises were greatly improved. For example, Yanqiao Town of Wuxi County, Jiangsu Province carried out a series of policies in the early 1982 as to the management system of rural and township enterprises, the kernel of which was the contract responsibility scheme. Only a year later, the total output value of rural and township industrial enterprises rose by 55.3 percent, the profit 72.8 percent, and average income over 100 percent.[240] From 1983 to the end of 1984, more than 96 percent of the rural enterprises in China had adopted some types of management contract system.

Quota Responsibility System (QRS): Drawing experience of the rural HCRS and CRS in the rural enterprises, the state-owned enterprises adopted the QRS, also known as "economic responsibility system." Coming to fore in 1981-1982, it involved fixing targets for profits to be turned over by enterprises to the government, with very high enterprise retention rates (often 60-80%, sometimes 100%) from the above-quota profits to be turned over by the enterprises to the government supervisory agencies and could be adjusted year by year and even within each year.[241] The essential features of the system

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[239] See Xia Baisan, China's Economic Policies, Theories and Reforms since 1949, supra at 408.

[240] Ibid., at 408-409.

[241] See Byrd, "Contractual Responsibility System in Chinese State-Owned Industry" supra at 10.

were its flexibility and the high marginal profit incentives supposedly provided to enterprises. But the QRS led to frequent, pervasive bargaining, since targets were set every year, and changes in "objective conditions" could be grounds for renegotiation. Given the annual determination of targets, ratchet effects were very likely to occur. What is more, the QRS itself did not delineate any decision-making authorities within the enterprises.

CMRS: The CMRS directly links to the QRS. It was experimented with in some state-owned enterprises in the mid-1980s, and formalised and widely implemented in late 1987. Under CMRS, the contractual arrangement relates to the amount of profits an enterprise is required to turn over to the government supervisory agency. In the early versions of CMRS the existing director virtually automatically became the contractor, for most of them were relatively smaller enterprises. In more cases what occurred was "collective" contracting by a management team or even by the entire workforce of the enterprise. Under these circumstances, the director was signing the contract much more as a representative of either management team or all enterprise employees.

Galvanised by the preliminary successful results of the experiments of the CMRS in some enterprises, the Chinese government promoted the CMRS to all the state-owned industrial enterprises in 1987. For this purpose, the State Council issued the Provisional Regulation of the Contract Management Responsibility System for the State-owned Industrial Enterprise on 27 February 1988 to regulate and guide the implementation of the CMRS. According to the Regulation, the basic contents of the CMRS are to contract the remitted profits to the state; to contract the fulfillment of the technology upgrading

projects; and to link the total wage bill with the enterprise performance.[242] However, the regulation leaves the contract form to be decided by each enterprise in light of its own specific needs.[243] Therefore, various forms of CMRS have been adopted in practice. Among the main variants of them are the following:[244]

(1) Double contracting and single linkage. Under this system, the enterprise contracts to turn over a certain amount of profit and tax each year, with any shortfall to be made up from the enterprise's equity (enterprise funds). The second "contracting" is that the enterprise guarantees to achieve its set target for modernisation investment during the Seventh Five Year Plan period (1986-1990). The growth of the enterprise's total wage bill is then linked with the growth in its total realized profits and taxes. Under this system, the enterprises will not pay any profit tax at the law-set rate. Instead, the total targets were fixed in advance.

(2) Responsibility for annual increase in profit remittance. Under this system, the enterprise pays indirect taxes at stipulated rates, and then is responsible for handing over to the government profits equal to some fixed base amount plus an annual percentage increase (often 7%). The Capital Iron and Steel Company is among the only few enterprises that have been allowed to use this method.

(3) Remittance of a fixed base amount of profit, sharing of above-quota profits. The enterprise is required to give a certain fixed amount of profits to the government every

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[242] Art. 8, The Provisional Regulation of CMRS, supra.

[243] Ibid.

[244] See Byrd, "Contractual Responsibility System in Chinese State-Owned Industry" supra at 17.

year, which does not increase over time, and profits above this amount are share between enterprise and government in a specified manner.

(4) Fixed profit remittance or loss targets, for low-profit or money-losing enterprises. The only difference from scheme (3) is that the enterprise keeps 100 percent of above-quota profits or lower-than-targeted losses.

In addition, CMRS has also absorbed some features of other systems such as the Leasing, Enterprise Management Responsibility System (EMRS), and Asset Management Responsibility System (AMRS) regarding the selection of contractors and specific arrangements in the contractual terms.

Compared to the QRS, the arrangements under the CMRS are not limited to the allocation of the profits and losses between the government and enterprises. Rather, they extend to these enterprises' management structure, for the "contract signatory" is usually singled out as the person or persons in charge. The rights and responsibilities of both parties, although not totally unambiguous, have been put forth in the CMRS. And the period covered by the contract is much longer than the QRS to avoid a short term "ratchet effect" and reduce the frequent bargaining between the enterprises and government supervisory agencies. Given these features, the CMRS has at least nominally established a kind of contractual relations between the enterprise and government, which have significant implications in the ownership and control of the state-owned enterprise.

3.2 Restructuring the State-owned Enterprise with CMRS

1. The Contractor on the Enterprise Side

The Provisional Regulation of the Contract Management Responsibility System for the State-owned Industrial Enterprise does not clearly define who is the contractor on the enterprise side of the contract. However, more often than not the manager(s) is required to be the contract signatories,[245] hence the manager is granted special authorities in the CMRS as the opposite to the government.

Director Responsibility System (DRS): In a sense, the manager's authorities under the CMRS are the result of the evolution of the DRS. A current of enterprise reforms, which had been present all along but received greater emphasis particularly after 1984, was the effort to strengthen and clearly delineate the position of the enterprise director as the primary enterprise operation decision maker.[246] While early reform experiments had attempted to give enterprise greater decision-making powers, the question of what entities within the enterprise would exercise this authority remained unresolved. Indeed, for quite a period, various experiments involving the Workers' Representative Assembly as the final decision-making authority and election of factory directors by workers had also been tried in certain enterprises. The conservatives insisted the strategic decisions should still be

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[245] See art. 14: "To conduct the CMRS, the managers who is responsible for the management of the enterprise is entitled to sign a contract with the government." The Provisional Regulation of CMRS, supra.

[246] See Byrd, "Contractual Responsibility System in Chinese State-Owned Industry" supra at 11.

retained on the hands of the Party Committee. But the general trend throughout the period of reforms, and especially since 1984, was for the enterprise director to assume the role of representative of the enterprise in dealing with outside agencies and the ultimate decision maker within the enterprise. This culminated with the promulgation of the Regulations on the Work of Factory Directors in State-owned Enterprises[247] in September 1986. This emphasis on strengthening and clarifying the position of the enterprise director gave rise to the so-called DRS and the enterprise director fixed-term goal responsibility system. However, under these systems the director was still supposed to consult with the Party Committee, Workers' Union, and other functional units within the enterprise. Thus, to a great extent, the director's authorities remained ambiguous. Many enterprises saw the vexatious relations existing between the director and party chief.

Bidding for the Manager: The Provisional Regulation stipulates that the bidding system usually should be adopted to choose the manger(s). The bidding can be conducted within the enterprise, or in the sector, or to the public if possible. Individuals, groups or the legal representative of the enterprise can be the candidate of the bidding. The government encourages a legal representative of the enterprise to bid for other enterprises in order to restructure industries.[248]

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[247] "*Guoying Qiyi Changchang Gongzuo Tiaoli* [Regulations on the Work of Factory Directors in State-owned Enterprise]" in *Guowuyuan Fazhiju* [The Bureau of Legislative Affairs of the State Council], ed., *Zhonghua Renmin Gongheguo Fagui Huibian* [The Collection of Laws and Regulations of the PRC] (January-December, 1986) (Beijing: *Falu Cubanshe* [Law Press], 1987) at 583-592.

[248] See art. 26, The Provisional Regulation of CMRS, supra.

The actual bids takes various forms in practice, but basically are three types:[249] (1) negotiated contracts: Specific terms are set forth for further negotiation after the investigation and assessment of the financial condition, asset value, product market, and potential of development. (2) Contract with predetermined terms: The specific terms of contract are fixed, but the current management would be given the first opportunity to make the bid. If it should decide in the negative, then the contract would be open to the management of enterprises in the same industry or under the same supervisory agency. (3) Competitive bidding: An announcement is made in the media to the public. The announcement must give the current financial status of the enterprise, the basic demands of the contract, the date of closing bids, and the venue to submit bids. While there are uniform standards for the public bidding, some variations are permitted depending on the size of the firm. For large firms the bids must be widely disseminated, and the detailed rules must be followed. For small firms, however, only local announcement of the bid is required and general guidelines are prescribed.

Nonetheless, dramatic as the change to select the manager to sign the contract through bidding process is, the bidding system is not often used in practice.[250] Most of the directors are still handpicked by the relevant government supervisory agencies. According to a survey study in 1987 of 403 state enterprises, the managers are selected through different ways:[251]

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[249] See Koo., Li and Peng, "State-Owned Enterprise in Transition" supra at 45-46.

[250] See Chen, Chinese Firms Between Hierarchy and Market, supra at 76.

[251] See Koo, Li and Peng, " State-Owned Enterprise in Transition" supra at 48. Also see Du Haiyan and Zheng Hongliang, Analysis of the Contract Responsibility System of State-owned Enterprises, Institute of Economics, the CASS (Beijing, 1989), Monograph, at 2.

- appointment by the supervisory agency 73.1%
- competition based on experience and past performance 12.3%
- election by workers' congress 13.0%
- successful contract bidders or their representatives 1.6%

Apparently, only a few of the enterprises have the managers who are selected through the bidding process. Most of the others are appointed by the relevant government agencies. To these appointed directors, the contracting process is characterised by the hard bargaining with them acting as the representatives of the enterprises.

Contractual Bargaining: The negotiation and bargaining could happen either in signing the first contract or in renewing the contract when the first expires. The Provisional Regulation prescribes that both sides should be in an equal position when negotiating a contract under the CMRS.[252] As the enterprises get more autonomy and more attuned to the market, the two parties of the contract under the CMRS show a more and more balanced power relationship in the contract negotiation. Some general observations can be made about the negotiation and bargaining process as follow:[253]

1) Both sides are very active. The companies emphasis all the factors affecting their performance such as government intervention, the uncertainty faced by the company, their social responsibilities, and so on while the relevant government supervisory agency stresses the importance of government policy and the prospects of future economic growth.

2) During the negotiation, various approaches, both formal and informal, individual and collective, are explored for the exchange of information.

3) The procedure for determining the profit targets remains more or less the same as before: first, to consider the previous performance, and then to make adjustments for other factors, especially the possibility of future developments.

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[252] See art. 15, The Provisional Regulation of CMRS, supra.

[253] See Chen, Chinese Firms Between Hierarchy and Market, supra at 90.

4) Perceptions on future business prospects diverge considerably, and company is inclined to be pessimistic.

5) Since several bureaus join the negotiation process together, their different interests affected its progress.

6) Sometimes, when a deadlock occurs, the help of the higher authorities are sought. Indeed, they are instrumental in breaking any deadlock.

The bidding and bargaining under the CMRS have great implications in redefining the relationships between the enterprise and the government agencies. They not only reflect the improved autonomy of the enterprises and the director's enhanced authorities with the enterprise, but highlight the buttressing of the director's position vis-à-vis the supervisory agency and other government organisations. Although some authors assert that even under the previous hierarchical arrangements, China had already been a "bargaining economy,"[254] the arm's length bargaining for a black-letter contract is otherwise different in essence. Indeed so important the director's position in the CMRS is that a major part of the contract will deal with the director's rights and duties, financial and managerial alike.

Director's Contractual Rights and Duties: One key arrangement of the CMRS is to grant the ultimate decision-making power to the director, but combine his or her performance with the fulfillment of the profit target. First, the director who is responsible for the enterprise must meet with the qualification requirements set by the government agency and the specific qualification required in the bid.[255] Second, the director is entitled

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[254] See Tedrick, G. and J. Chen, China's Industry Reforms (New York: Oxford University Press, 1987) at 198.

[255] See art. 29, The Provisional Regulation of CMRS, supra.

to choose his or her own management team during the contractual period.[256] Third, the income of the director can be one or three times more than the average income of the employees, or slightly higher if her or his contribution is higher. However, if the contract target is not fulfilled, the income of the director must be reduced to half of his or her salary.[257] This rule regarding the reward and penalty of the director is usually translated into a detailed schedule in the contract.[258] Finally, it is possible for the director to bear certain types of administrative responsibilities if he or she fails to fulfil the contract target.[259]

2. The Contractor on the Government Side

The Provisional Regulation does not clearly state who should be on the government side to negotiate the contract or organise the contract bidding. But in most cases, the organisation that handles contract bidding and negotiation is constituted by the agencies

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[256] See art 31, The Provisional Regulation of CMRS, supra.

[257] See art 33, The Provisional Regulation of CMRS, supra.

[258] e.g. In the contract of Beijing Dahua Shirt Company, the terms for reward and penalty is clearly specified as:

- if the remitted profits are just fulfilled, there will be no reward and no penalty;
- if the targets are exceeded by 5 percent, the director's income will be 0.5 time higher than average level;
- if exceeded by 10 percent, his income will be double the average;
- if exceeded by 15 percent, 1.5 time higher than average;
- if exceeded by 20 percent, his salary will be moved up one salary level;
- if failed, no bonus;
- if lowered by 5 percent, his income will be reduced by 10 percent;
- if lowered by 10 percent, it will be reduced by 20 percent

See Chen, Chinese Firms Between Hierarchy and Market, supra at 77-78.

[259] See art. 25: "If the contractor on the enterprise side does not fulfil the contract, the managers must take the administrative and economic responsibilities." in The Provisional Regulation of CMRS, supra.

directly responsible for the supervision of the state enterprises. Occasionally it may include representatives from other relevant agencies. For instance, in negotiating the contract of Beijing Electric Power Generator Company, a state key enterprise, as many as five local government bureaus were directly involved, namely, the Machinery Bureau under the Beijing Municipal Economic Commission, the Labour Bureau, the Finance Bureau, the local branch of the China industrial and Commercial Bank, and the Tax Bureau. And in the negotiation for renewing the contract, the newly-established State-Assets Administrative Bureau also joined in.[260]

Once constituted, the contractor on the government side has sweeping powers to select bidders, determine the duration and types of contracts and the procedure of bidding, and negotiate the contracts. It has the right to investigate and monitor the performance of the enterprise.[261] Should it determine that the management is poor or the contract cannot be achieved, it is authorized to terminate the contract.[262]

According to the Provisional Regulation, the contractor on the government side should organise a bidding committee which must include representatives of the employees to evaluate the candidates.[263] Formally, there are five steps in organising the contract bidding.[264] The first is preliminary preparation. To lay the groundwork for securing bidders, there is a promotional campaign to introduce the concept of bidding and the

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[260] See Chen, Chinese Firms Between Hierarchy and Market, supra at 78-79.

[261] See art. 22, The Provisional Regulation of CMRS, supra.

[262] See art. 20, The Provisional Regulation of CMRS, supra.

[263] See art. 28, The Provisional Regulation of CMRS, supra.

[264] See Koo, Li and Peng, "State-Owned Enterprise in Transition" supra at 46-47.

formation of a small core group consisting of members from the supervisory agencies in charge of regulating the enterprise. The formal announcement of the opening of bids should contain, among other things, all relevant information about the bidding, including the name of the enterprise available for bids, the purpose and scope of contract, the terms for submitting bids, the rights and responsibilities of the winner, the length of the contract, and the person to whom the bids are submitted. The most demanding part of this preparation work is determining the price of the bid. All the conditions prepared in the bid must be approved by the superior agency.

The second step consists of activities in the period of announcement and submission of bids. Applicants must be investigated with respect to profession, affiliation, the value of their personal assets and their general health conditions. Only those who are qualified are allowed to fill out detailed forms and are given the specific information, including the time schedule of various steps of investigation, the rules of bidding, relevant information on the enterprise, methods of calculation and formulas for arriving at personal net worth. The commission must arrange a time table for applicants to examine the enterprise. There should be a clear specification of the exact time and location of the bid submission. All bids are to be opened in public and no bids that are submitted will be returned.

The third step entails the preliminary examination of all bids and screening and scaling down all submitted bids to usually five to ten units. Each bidder is interviewed and examined by the members of the commission. Typical questions concern the crucial problems confronting the enterprise and how it is proposed to solve them. Written and oral exams are held to evaluate the bidders' ability.

The fourth step involves setting a time period allowing selected bidders to answer questions raised by the commission. At this stage, a new and enlarged commission is formed, consisting of bureaucrats in charge of the enterprise, specialists in related industries, outstanding enterprise managers, representatives from workers and staff, and administrative personnel from the local government. The enlarged commission will report on the minimum acceptable price and profit, and discuss the standard and method of grading bidders. After receiving replies to all questions it raised earlier, the commission proceeds to evaluate the candidates, and if necessary, prepare the bidders for a second round of bidding. In addition, an investigation is made of the candidates' personal property, record of work experience and moral character.

The fifth and last step is signing the contract. After the winner is selected, assets of the enterprise are audited. This is performed jointly by the incumbent manager and the winner, in cooperation with the representatives of the finance, tax, credit, and auditing departments of the enterprise. The auditing department will then issue a certificate, which also constitutes a basic document of the contract. At the same time it is also necessary to have a certification of personal assets of the winner.

The control of the bidding and contractual bargaining by the supervisory agency under the CMRS presumably serves the purpose that allows the government agencies to have a "hands-off" attitude toward the operation of the enterprise while they can maintain their authorities mainly through ex ante contracting. As stated earlier, ever since the beginning of the Chinese economic reform, to enhance the enterprise's autonomy and minimise the government intervention with its operation have been major themes of the

state-owned enterprise reforms. However, it is not until now that they are institutionalised under the CMRS.

3. The Major Terms of Contract

According to the Provisional Regulation, the main contract terms are the contractual forms; the duration of contract; the amount of the remitted profits or of loss reduction; mandatory plans for supply and production; quality control; the technology upgrading projects , and the protection and increase of the value of the state assets; the usage of the retained profits, the payback of loans and other debts; the rights and obligations of both sides; the breach of contract; and the rewards for the managers.[265]

Nevertheless, each enterprise may adopt different terms to suit to its specific needs. Three key terms are usually included, that is, the profit-sharing scheme including the target amount of gross profits to be remitted to the government and excess profits which will be shared between the government and the enterprise; the projects for upgrading the enterprise's technological ability and managerial technique; the scheme for setting wages and bonus subject to the enterprise's performance. The negotiation and bargaining between two parties are mainly concentrated on these three key terms.[266]

Once signed, the contract will bind both parties and cannot be altered and terminated at will by either side.[267] However, some exceptions exist. If the tax system and mandatory

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[265] See art. 16, The Provisional Regulation of CMRS, supra.

[266] See Chen, Chinese Firms Between Hierarchy and Market, supra at 81-87.

[267] See art. 18, The Provisional Regulation of CMRS, supra.

price are generally changed by the government, the contract can be readjusted according to regulations. The contract can also be altered or terminated due to force majeure.[268] If the management is poor or the contract cannot be achieved, the contractor on the government side has the right to terminate the contract. But, if the contractor on the government side breaks the contract, the contractor on the enterprise side is entitled to terminate the contract.[269] For example, in the contract between Beijing General Company of Clothing Industry and Beijing Dahua Shirt Company, the item 8 of the Content Part prescribes the change and termination of the contract. According to it, the contract should not be arbitrarily changed or terminated. If any party should behave in such a way, they will be responsible under the Economic Contract Law; if the government has issued an important policy, or if other significant things happen, both parties should hold discussions to modify the contract or to make additional terms. In addition, the contract could be terminated by arbitration due to the fact that: (1) The company is managed so poorly by Party B (the enterprise) that the performance goes down continually; (2) Party B does not follow the contract so that the company makes a big loss and it is impossible to find a solution; (3) Party A (the general company) seriously interferes with Party B's managerial autonomy so that Party B cannot continue its activities.[270]

In the process of contractual performance, the contractor on the government side has the right to investigate and monitor the performance of the enterprise, to protect the

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[268] See art. 19, The Provisional Regulation of CMRS, supra.

[269] See art. 20, The Provisional Regulation of CMRS, supra.

[270] See Chen, Chinese Firms Between Hierarchy and Market, supra at 192.

legal rights of the managers and to help solve any problems faced by the managers.[271] The managerial rights, on the other hand, rest on the hands of the contractor on the enterprise side.[272] Both sides must perform their contractual duties. Otherwise, they will assume the administrative and economic responsibilities.[273] When any dispute regarding the contract arises, both parties may solve it through consultation, arbitration, or lawsuit in the court.[274]

Under the CMRS, the assets of the enterprise are divided into two parts, state assets and enterprise assets. The fixed assets and circulation funds before the CMRS is adopted belong to the state. The retained profits during the period of the CMRS and the fixed assets gained by the retained profits belong to the enterprise. The ownership of fixed assets gained during the period of the CMRS depends on the way they are paid back. The funding of depreciation depends on the proportion of the fixed assets between the state and the enterprise.[275] The current enterprise funds are also used as the risk fund for the period of the contract, and will transfer into the enterprise fund in the following contractual period. If the enterprise cannot achieve the contract targets, the difference will be made up from the enterprise fund.[276] Obviously, the distinction of the state assets and enterprise assets is undoubtedly an important change in the property rights arrangements

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[271] See art. 22, The Provisional Regulation of CMRS, supra.

[272] See art. 23, The Provisional Regulation of CMRS, supra.

[273] See arts. 24 and 25, The Provisional Regulation of CMRS, supra.

[274] See art. 21, The Provisional Regulation of CMRS, supra.

[275] See art. 34, The Provisional Regulation of CMRS, supra.

[276] See art. 35, The Provisional Regulation of CMRS, supra.

between the state and enterprise though the enterprise funds are still state-owned assets.[277] As the management has almost exclusive control over the enterprise assets, it can make some business decisions related to the enterprise assets without the intervention from the supervisory government agencies.

Overall, the manager of the state-owned enterprise is given more autonomy and decision-making powers under the CMRS, but these autonomy and powers must be carried out within certain parameters besides the limitations in the contract. According to the Provisional Regulation, the enterprise must divide the retained funds into three parts: the production fund, the welfare fund and the reward fund. Part of the welfare and reward funds should be invested into employees' housing project.[278] The enterprise must also abide by the price policy, and is not allowed to raise prices arbitrarily.[279] As well, the enterprise should strengthen democratic management including the function of the employee representative assembly and the trade union.[280] These limitations imposed on the enterprises obviously have the bearings of a mixed economy due to China's partial reform.

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[277] See art. 34, The Provisional Regulation of CMRS, supra.

[278] See art 36, The Provisional Regulation of CMRS, supra.

[279] See art. 38, The Provisional Regulation of CMRS, supra.

[280] See art. 40, The Provisional Regulation of CMRS, supra.

3.3 The CMRS: A Valid Model or A Transitional Scheme?

1. An Overview

As a major scheme of the Chinese state-owned enterprise reform, the CMRS became a focus of debate soon after it was introduced. Three different views have appeared in China.[281] First view is in favour of the CMRS. It conceives the scheme as a potentially new system with Chinese characteristics which could be contribution to new institutional arrangements between the state and enterprise in the context of socialist economy. On the one hand, it can improve the enterprise efficiency and performance mainly due to the high incentive function generated from its profit-sharing scheme. On the other hand, the public ownership of the state enterprise can be effectively maintained.

Second, the opposite view argues that a few examples cannot prove the rationality of the CMRS. In fact, the system does not provide a rational approach in deciding the profit targets. Rather, it is likely to damage the interests of the government, for the determination of targets is based on previous performance not potentiality. In addition, the situation can be made worse by the hard bargaining process. Consequently, the total government revenue at central government level collected from the state-owned enterprise has continually decreased for several consecutive years (1987-1989).[282] Furthermore, without efficient control mechanisms, the profit-sharing scheme tends to encourage short-

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[281] See Chen, Chinese Firms Between Hierarchy and Market, supra at 66-67.

[282] See Yang P., The Contractual Responsibility System: The Approach towards Prosperity of the Firm (Beijing: China Economic Press, 1990) cited in Chen, Chinese Firms Between Hierarchy and Market, supra at 67.

term behaviour in diluting state assets, for instance, by increasing the employees' income and reducing the efforts on depreciation. Besides, the contractual arrangements may exclude some strategic alternatives to the enterprise such as the merger and reorganisation, which will otherwise be beneficial to the enterprise.

The third view holds that the CMRS may not be an ideal choice for the reform of the state-owned enterprise, but it is workable and acceptable in the transition period. While it is not prudent to introduce a shareholding system or other private property rights schemes, it is impossible to keep the old planned economic system either. Therefore, the CMRS is able to fill in the gap as a reasonable arrangement.

The foregoing three views are generally parallel to various perceptions of major reformist factions in China as to the critical issue how the economic reform should proceed and for what major goals. Their discussions around the CMRS are motivated more by various political agenda than theoretic analysis. Hence it is fair to say that these views are long on ideological rhetoric, but short on theoretical reasoning.

Byrd has done a relatively comprehensive study of the CMRS and other CRS.[283] Based his analysis on the case-study evidence of changed authority systems, organisation structures, behaviour patterns, and performance in enterprise implementing some of the CMRS, Byrd observes that there were indeed major new developments and changes after some of the systems were introduced, which seem to have led to improved efficiency and performance in the enterprises concerned.[284] More specifically, where implemented well

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[283] See Byrd, "Contractual Responsibility System in Chinese State-Owned Industry" supra at 21-31.

[284] Ibid. at 23-26.

and where other conditions are ripe, the CMRS is effective in bringing about major changes in the structure and orientation of enterprises, in the position of the enterprise director, and in the relationship with the supervisory agency. Such changes include (i) reorganisation and streamlining of the management team; (ii) assertion of independence from the supervisory agency; (iii) rationalisation of labour; (iv) more responsible investment behaviour; (v) better wage incentives; and (vi) more focused managerial objectives and a more business-like orientation. Meantime, he also takes the note of some problems and difficulties of the CMRS,[285] namely, the tendency to move to "lowest Common Denominator," continued scope for bargaining, questions about the credibility of contracts, rigidities of contracting, conflicts with workers, and ownership problems.

While I concur most of Byrd's observations about the CMRS, I am however of the opinion that more deep-rooted reasons should be sought to demonstrate the causation between the CMRS and the observed phenomenon. For this purpose, we need a plausible theoretical paradigm to analyse and evaluate the CMRS.

2. The Contractual Paradigm of the Firm Revisited

The Nexus of Contracts: The contractual view of the firm is one of the premises upon which almost all the schools of the law and economics develop their theories of the firm. Despite some challenges,[286] it has already played a major role in transforming our

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[285] Ibid. at 26-31.

[286] See Brudney, "Corporate Governance, Agency Costs, and the Rhetoric of Contract" (1985) 85 Colum.L.Rev. 1403; and John Coffee, "No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies" (1988) 53 Brook.L.Rev. 919.

perception of the corporation and corporate law.[287] Recall that Coase characterised the bounds of the firm as that range of exchanges over which the price mechanism was suppressed and resource allocation was accomplished instead by authority and direction. However, in addressing the inadequacy of the neo-classical economics' understanding of the firm, Coase might have over-emphasised the difference between the market transactions and the relations within the firm. Alchian and Demsetz object to the notion that the activities within the firm are governed by authority, and correctly locate the role of contracts within the firm as a vehicle for voluntary exchange.[288] Jensen and Meckling expand Alchian and Demsetz's contractual perspective to all the respects of the firm and develop the "nexus of contracts" theory.[289] According to Jensen and Meckling, contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc. The private corporation or firm is simply one form of legal fiction which, among other things, serves as a nexus for contracting relationships.[290] And it is based on this "nexus of contracts" theory that a contractual paradigm of the firm is formed.

Incomplete Contracts and Transaction Costs: As opposed to the standard economic model, complete, fully contingent, costlessly enforceable contracts do not exist. All the

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[287] For example, an important underlying themes of the ALL "Corporate Governance Project" in the 1980s is the contractual perspective of the firm.

[288] For Alchian and Demsetz's view, see supra text at 30-33, and 41-42.

[289] See Jensen and Meckling, "Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure" supra at 40.

[290] Ibid. at 40-41.

contracts in the real world are incomplete, for it would incur enormous transaction costs to write a "comprehensive" contract which specifies precisely what each party's obligations is if it was indeed possible.[291] First, uncertainty implies that the existence of a large number of possible contingencies, and it may be extremely costly to know and specify in advance responses by the transacting parties to all of these possibilities. Second, particular contractual performance may be prohibitively costly to measure and hence to put down contractually.[292] Accordingly, Coase and Williamson argue that the choice to set up the firm in lieu of the market is made to reduce transaction costs. With the firm as a nexus of contract to supersede the market transaction, some of the ex ante and ex post costs of contracting can be forgone or minimised. However, the "contractual arrangements" within the firm are incomplete too, hence incur some types of transaction costs. So long as the marginal savings in the transaction costs are positive, the firm will be adopted as a more efficient institution than the market.[293]

Agency Costs and Corporate Governance: Given incomplete contracts, a general "agency problem" is likely to exist in the contractual relations of the firm.[294] Due to the divergence of the interests between the "risk-bearers" and decision managers, agency costs arise in structuring, monitoring, and binding a set of contracts among agents with

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[291] See Benjamin Klein, "Contracting Costs and Residual Claims: The Separation of Ownership and Control" (1983) 26 J.L.& Econ. 367 at 367; also see Oliver Hart, "Incomplete Contracts and the Theory of the Firm" (1988) 4 J L. Econ. & Org. 119 at 121.

[292] See Klein, ibid.

[293] See Cheung, "The Contractual Nature of the Firm" supra at 10.

[294] Ibid.

conflicting interests. Agency costs also include the value of output lost because the costs of full enforcement of contracts exceed the benefits.[295] According to Fama and Jensen,

> [c]ontrol of agency problems in the decision process is important when the decision managers who initiate and implement important decisions are not the major residual claimants and therefore do not bear a major share of the wealth effects of their decisions. Without effective control procedures, such decision managers are more likely to take actions that deviate from the interests of residual claimants. An effective system for decision control implies, almost by definition, that the control (ratification and monitoring) of decisions is to some extent separate from the management (initiation and implementation) of decisions. Individual decision agents can be involved in the management of some of some decisions and the control of others, but separation means that an individual agent does not exercise exclusive management and control rights over the same decision.[296]

It follows that an important issue concerning the firm is to determine an optimal combination of decision management, decision control, and residual risk bearing.

Small noncomplex organisations can efficiently control the agency problems caused by the combination of decision management and control in one or a few agents by restricting residual claims to these agents. Such a combining of decision and risk-bearing functions is efficient in small noncomplex organisations because the benefits of unrestricted risk sharing and specialisation of decision functions are less than the costs that would be incurred to control the resulting agency problems. The proprietorships, partnerships, and some family and close corporations are best examples of such arrangements.

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[295] See Fama and Jensen, "Separation of Ownership and Control" supra at 304.

[296] Ibid.

In more complex organisations where residual claims are widely dispersed,[297] there will be the separation of residual risk bearing from decision control. When there are many residual claimants, it is costly for all of them to be involved in decision and it is efficient for them to delegate decision control. Thus, nearly complete separation and specialisation of decision control and residual risk bearing are common in large open corporations and some other organisations.[298] Of course, such separation and specialisation of decision management and residual risk bearing lead to agency problems between decision managers and residual claimants.

It has been well argued that the external mechanisms, such as the regulatory agencies, stock market , and corporate control transactions, can be effective in controlling the agency costs of the open corporations. The internal control in these corporations is nevertheless delegated by residual claimants to a board of directors. Residual claimants generally retain approval rights on such matters as board membership, auditor choice, mergers, and other fundamental issues. The board then delegates most decision management functions to internal agents, but it also retains ultimate control over internal agents including the rights to ratify and monitor major policy initiatives and to hire, fire, and set the compensation of top level decision managers. With such a corporate governance structure, it is hoped that separation and diffusion of decision management and decision control limit the power of individual decision agents to expropriate the

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[297] Another kind of complex organisations has the feature of diffused specific information valuable for decisions. Since it is not directly related to the topic of my study, it will not be discussed here. See Fama and Jensen, "Separation of Ownership and Control" supra at 307-309.

[298] Ibid. at 309.

interests of residual claimants. The checks and balances of such decision systems have costs, but they also have important benefits. In complex organisations, the benefits of diffuse residual claims and the benefits of separation of decision functions from residual risk bearing are generally greater than the agency costs they generate, including the costs of mechanisms to separate the management and control decisions.[299] Furthermore, as social and economic conditions change, the mechanisms to govern the residual owners and managers must also be adjusted so as to accomplish an economising result, which in Williamson's view is what transaction costs economics is all about.[300]

3. The Benefits and Problems of the CMRS

At the heart of the CMRS is the separation of ownership and control, which is characterised in China as the separation of "two rights" - ownership rights and operating rights. The Provisional Regulation clearly states that the fundamental principle of the CMRS is actually the separation of ownership from management on the basis of socialist public ownership.[301] However, whether or not the CMRS provides such schemes as incur the least agency and other transaction costs invites a careful examination under the lens of the contractual paradigm illustrated above.

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[299] Ibid.

[300] See Oliver Williamson, "Corporate Governance" (1984) 93 Yale L.J. 1197 at 1201.

[301] Art. 2, The Provisional Regulation of CMRS, supra.

A. Benefits

Risk-Sharing: The arrangements under the CMRS regarding the rewards and penalties for the enterprise director make him a partial residual claimant sharing risks with the state as the enterprise owner. With such a risk-sharing scheme, the director as a decision manager is less likely to take actions that are detrimental to the interests of the state. Hence the agency problems once wrecking the Chinese state-owned enterprises may be partially avoided.

The risk-sharing arrangements also apply to the enterprise itself, and the enterprise may retain certain proportion of profits in the enterprise funds. Although the final residual claimant of the enterprise funds is nominally the state, the disposal of the funds is in the control of the enterprise director subject to some limitations. Therefore, in a sense, the director can also be assumed as a limited residual claimant of the enterprise funds.

To combine the decision and risk-baring functions of the directors through the risk-sharing scheme under the CMRS undoubtedly accounts for the responsible investment behaviour, more focused managerial objectives , and a more business-like orientation, which have been cogently observed by Byrd.[302]

Incentive Criteria: In his study of the former Soviet enterprises and Chinese state enterprises, Granick makes such an assumption that "[e]nterprise behaviour is determined by managers maximising their own discounted lifetime earnings. The key components in such earnings that are of interest here consist of managerial bonuses and the development

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[302] See Byrd, "Contractual Responsibility System in Chinese State-Owned Industry" supra at 24.

of managerial careers."[303] In China, the incentives for the enterprise managers take the forms of special privileges, social prestige, and promising position in the government agencies. Comparatively, the direct financial benefits are not a major factor as far as the incentives are concerned. The upshot is that the effects of the rewards and penalties for the enterprise directors will be greatly circumscribed if the criteria of the incentive scheme in the Chinese state-owned enterprises are not clearly stated and directly related to their economic performance. Under the CMRS, however, the enterprise director and the supervisory agency put the profit targets in a contract. Whether or not the enterprise can fulfil the targets is an important criterion for the director's promotion, special treatments, as well as the financial rewards and penalties. After adopting the CMRS, the enterprise director's focus has noticeably shifted from noneconomic objectives to more financial and enterprise development goals.[304]

Combining Multiple Principals: In China, the regional government units enjoy property rights vis-à-vis the national government and one another. Thus, the individual enterprises represented by their directors, as agents, frequently are subject to control by a number of principals. This pattern is sometimes described as involving the presence of "too many mothers-in-law."[305] Indeed, it is very common in China for medium-sized and large state-owned enterprises to be under the authority of more than one higher body. Administrative

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[303] See David Granick, Chinese State Enterprises: A Regional Property Rights Analysis (Chicago: University of Chicago Press, 1990) at 162-163.

[304] See Byrd, "Contractual Responsibility System in Chinese State-Owned Industry" supra at 24.

[305] See Granick, Chinese State Enterprise, supra at 23-24.

bodies existing at different regional levels of state administration frequently give orders directly to the same enterprise and provide independent evaluations of it. Needless to say, such multi-principals system and multilevel supervision result in confusions and contradictions in planning and managing production, which are among the major factors causing the massive waste and inefficiency of the state-owned enterprises.

In an effort to change the multiple principals arrangements and streamline the principal-agency relations between the government agencies and the enterprise, the CMRS designates them to be a contracting party as the contractor on the government side. During the process of contractual bidding or negotiation, these government bodies will organise a committee and work out their contractual conditions before negotiating any terms with the contractor on the enterprise side. Presumably, the enterprises will not be required to take orders from various government bodies, so long as they can fulfil the contract targets.

B. Problems

Costly Information-Collecting and Bargaining: The basic premises of the contractual paradigm of the firm are that market transactions are not costless, and contract is incomplete. In the case of CMRS, there are tremendous transaction costs in contract bidding and bargaining. The first is the cost to collect all the necessary information about the enterprise, and find the "right contractual price." The process stipulated in the Provisional Regulation is not only troublesome, but can hardly guarantee to come up with the right contract profit targets considering the difficulties of asset valuation and prediction of profit potential in the contract duration. The difficulty to collect the correct

information may also be compounded by the enterprise director's opportunistic actions. Since in most instances the current director represents the enterprise to sign the contract, he or she has the most incentive to hide the true information away from the contractor on the government side.

The bargaining between the government agency and the contractor on the enterprise side is no less vexatious and time-consuming than the information collection either. More often than not the supervisory agency is also subject to the administrative and financial pressure from its superior body when it negotiates the deal with the enterprise. Therefore both sides will press hard for their own interests. In addition, the contractor on the government side may in most cases include various government bodies with different agenda and even conflicting interests. Without haggling and compromising, it is impossible for them to work out an acceptable contract plan in the first place. When they come down to negotiating with the enterprise side, more conflicts and problems will emerge, and more back-and-forth bargains will take place among them. Furthermore, there are too many unforseeable contingencies and uncertainties in the contract of such a nature. The government may change its policies now and then, which will cause both parties to reset the contract targets; on the other hand the enterprise may find it impossible to fulfil certain goals in the contract due to unpredictable difficulties. Hence except the contract renewal negotiation when the duration of the current contract expires, bargaining between the enterprise and the supervisory agency must be an ongoing process. The ex post bargaining and renewal adjustments incur more transaction costs.

Ineffective Control of Agency Problems: The effects of the risk-sharing scheme under the CMRS are rather limited due to the insignificant scale of rewards and penalties for the enterprise director. Unlike the Leasing System, the director under the CMRS is not a major residual claimant. Thus, the divergence of interests between the state and the enterprise director is yet to be bridged, and the director is inclined to shirk. Even in some cases where the directors pledge or mortgage their personal assets against the contract risks, the enforcement of these contracts are problematic, for their small bank accounts and meager personal assets can hardly cover the economic losses of the enterprises.[306]

Also, the arrangements of the CMRS are such that every three years there is a negotiation between the two sides to renew the contract. The new contract targets will be set on the basis of the enterprise's economic performance in the previous period. It gives rise to a great disincentive for the enterprise director, which can compromise the incentive schemes under the CMRS.

Finally, the management mechanisms under the CMRS lack proper functions to keep the director's decisions and actions in check. The government supervisory agencies assume the role to monitor the performance of contract. But how it can carry out its monitoring role without unduly interfering with the management decisions of the enterprise director is a perplexing issue to be solved. And as an external monitor, the supervisory agency has no easy channel to get necessary information to properly discharge its monitoring duty. Internally, there is no effective governance body to which the

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[306] See Byrd, "Contractual Responsibility System in Chinese State-Owned Industry" supra at 28.

enterprise director is responsible.[307] With systematical corruption ravaging China, the issue of improving the director's accountability is more urgent than ever before. The CMRS otherwise cannot effectively deal with the issue, if not aggravate it.

The Dual Function of the Government Agencies: The dual function of the government supervisory agency both as a contractor and administrator is also a source of problems in the contractual relations between the government and the enterprise. For one thing, the contractual freedom on the part of the enterprise represented by the director is limited. The administrative pressure may be used from time to time to force the director to agree at certain arrangements that are not in the economic interests of the enterprise. For instance, when the Beijing government began to address the issue of renewing contracts in 1990, most of the companies there were very reluctant to sign any new contracts and even argued against the continuation of the CMRS. Not until the central government intervened did the debate stop and the renewal process begin.[308] Also, the government is responsible for the macro-economic policies and development of the whole country. The ad hoc contracts only serve the interests of individual enterprises. There is clearly potential conflicts between the government's role as a macro-economic policy maker and the role as a contractor of ad hoc contracts with thousands of enterprises.

The dilemma of government's dual function in the CMRS is further reflected in the CMRS' impact on the tax system. Under the CMRS, the amount of profit taxes and in

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[307] Some Chinese enterprises have followed the examples of their Western counterparts to set up the board of directors and appoint the Chairmen and CEOs. But they have no practical functions except as a kind of trapping.

[308] See Chen, Chinese Firms Between Hierarchy and Market, supra at 87-88.

some cases the amount of indirect taxes are negotiated as part of the contract. Such a system totally undermines the national tax system. In this respect, the implementation of the CMRS represented a complete reversal of the taxation reforms introduced during 1983-86 period.[309]

As stated earlier, in setting up the contractual relationships of the state and enterprise, the CMRS represents a departure from their hierarchical relation in the former planned economy, and the risk-sharing and director's autonomy under the CMRS create certain incentives to improve the economic performance of the enterprise. However, such arrangements are systemically flawed, for the underlying agency problems and other transaction costs are awesome. Therefore, the CMRS is at best a transitional device, but far from an ideal model for the Chinese state-owned enterprise. To complete China's transition to a market economy, a more reasonable model has to be sought to deal with the fundamental issue: the state ownership and the management control.

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[309] See Fan, "State-owned Enterprise Reform in China: Incentives and Environment" supra at 149-150.

Chapter Four

Ownership and Control (2): Share Ownership and Corporate Governance

As an important initiative of the Chinese state-owned enterprise reform, the shareholding system was proposed in the early 1980s. However, due to the various obstacles, it was not seriously considered to be a practical model for the state-owned enterprise until the CRS failed to establish an optimal relationship between the state and the enterprise. With the Chinese economic reform gaining more momentum in the 1990s, the emphasis has been laid on building a shareholding system, through which, it is hoped, the state-owned enterprises can be transformed into Western-style modern corporations. Whether or not such a goal is possible, and if so, then how to achieve the goal are the questions of intense interests and disagreements. Concentrating mainly on the separation of ownership and control of the state-owned enterprise, this Chapter attempts to offer some answers to these questions so as to shed more light on the issues regarding the Chinese state-owned enterprise reform.

4.1 The Securitisation of the State-owned Enterprise: Ideology and Theory

The World Bank Proposal: The relatively systematic proposal of a shareholding system was first made by the World Bank in a report to the Chinese government as the result of

its mission to China in 1983.[310] Noticing various state enterprise reform policies have been applied, the report points out that these policies "represent only marginal changes, and the fundamental problems remains of the proper relationship between the state and the enterprise."[311] In the past, the state exercised excessive and rigid control over enterprises and consequently the enterprises became subordinate bodies of administrative organs. The relationship between the state organs and the enterprises was strictly hierarchical and the former frequently interfered in enterprise operations. With the recognition that "ownership right can be duly separated from operating right," China has taken an important step. It follows then, according to the report, that "the direction of reform will be toward a more complex system of management, in which a multitude of state agencies, as well as the enterprise itself (both workers and managers), assume various responsibilities."[312]

To further illustrate its points, the report raises two questions. The first is the proper degree of enterprise autonomy: Should it be confined to day-to-day operating and market decisions, or should it extend to such fundamental areas as appointment of managers, major investment and diversification decisions, and the right to close down part or all of the enterprise? Another question is how the state could or should regulate the activities of autonomous enterprises. Should the government direct the enterprise from within or concentrate its effort on creating an external environment such that the self-interest of

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[310] See World Bank, China: Long-term Development Issues and Options, supra at 165. Also see Jianfu Chen, " Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC" (1993) 15 Sydney L.Rev. 59 at 64; and Andrew Xufeng Qian, " Riding Two Horses: Coporatisating Enterprises and the Emerging Securities Regulatory Regime in China" (1993) 12 UCLA Pac.Bas.L.J.62 at 75.

[311] See World Bank, China: Long-term Development Issues and Options, supra at 164.

[312] See World Bank, China: Long-term Development Issues and Options, supra at 165.

enterprises guides their directions consistent with the national interest, thus making it unnecessary for managers or others within enterprises to be charged specifically with representing the interests of the state?

The answer to these questions, as the report holds, lies at the internal management structure of the enterprise. Since it is impossible in a complex and rapidly changing market-regulated economy for the state to know or specify what individual enterprises should do, it is pointless or counterproductive for the state to engage in the daily business of the enterprise. Instead, the enterprises should be controlled and managed internally guiding by their self-interest, in other words, the former direct administrative control mechanism should be replaced by appropriate internal management arrangements for state enterprises.[313]

Having considered the strengths and weakness of three alternative approaches to enterprise control and management: giving direct control of the enterprises to their workers, giving control of the enterprises to their managers, and giving strategic decision-making authority to the boards of directors,[314] the report strongly recommends the establishment of the board of directors as a reasonable way to deal with the relation of control and management, as long as the board is profit-oriented and free from direct intervention by state administrative organs. Realising that these goals are in direct conflict with the nature of the state-owned enterprises and thus hard to achieve, the report also suggests that:

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[313] Ibid.

[314] See World Bank, China: Long-term Development Issues and Options, supra at 165-166.

> A possible solution might be to spread the ownership of each state enterprise among several different institutions, each in some way representing the whole people, but with an interest mainly in the enterprise' profits rather than directly in its output, purchases, or employment. Examples of such institutions, in addition to central and local governments, are banks, pension funds, insurance companies, and other enterprises.... In China, such a system of socialist joint stock ownership could perhaps be created initially by suitable dispersion of the ownership capital of existing capital of existing state enterprises. Over time, it could be reinforced by a more diversified pattern of investment finance, with a variety of state institutions acquiring financial interests in existing and new enterprises.[315]

Apparently, a two-stage process for securitising the state-owned enterprises is proposed here: In the first stage the ownership of the enterprises is to be dispersed among different institutions. In the second stage, through a more "diversified pattern of investment finance,"[316] the enterprise ownership will be further dispersed and diversified.

Ideological and Theoretical Debate: The World Bank's proposal to set up joint-stock companies dealing with the separation of ownership right and operating right was well received by some most reform-minded theorists. However, before openly advocating the idea in the context of the state-owned enterprise reform, these theorists had a daunting task in their hands: to overcome the ideological obstacle which would treat the joint-stock as prominent feature of the capitalist system, and any other forms of property rights as a threat to the ownership by the "whole people," the essence of socialism.[317]

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[315] See World Bank, China: Long-term Development Issues and Options, supra at 166.

[316] This " diversified pattern of investment finance" in the World Bank Report context means that vertical flows of finance and compartmentalised reinvestment, as then existed, would be supplemented and eventually replaced with horizontal flows. See Jianfu Chen, " Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC" supra at 65.

[317] To have a measure of the dogmatism of orthodox " public ownership" ideology, we may note the Chinese government's reluctance to rely on debt financing. For a long time, the use of bonds as vehicles for capital accumulation had been hampered by the suspicions that reliance on debt financing for economic development would undermine China's autonomy, and thus posing threats to the position of

To be sure, the World Bank report appears to avoid any impression to propose a property rights reform by stressing the joint-stock system more as an alternative form of management than a direct measure of reforming the socialist ownership system.[318] But, as some commentators rightly pointed out, the shareholding system could not be established in China without touching the public ownership system. Some even suggested that the World Bank's proposal to securitise (instead of privatising) the state enterprises was for them to peacefully evolve into privatised enterprises by developing diversified ownership forms through securitisation.[319] Indeed, it should surprise no one that the idea to build the state-owned enterprises into joint-stock companies prompted strong ideological opposition.

The scope of such ideological battles is rather limited, for the scholars on the both sides of the debate try to claim the "legitimacy" from Marxism and justify their theories by arguing either positive or negative effect, depending on which side of the debate they belong to, of a share ownership upon the socialist public ownership system. Tong Dalin, an influential economist in China, quotes Marx as saying that the share system was private property's self-negation and a form by which capital became the property of the organised working people and argues that this statement of Marx's is therefore a theoretical starting

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state as a representative of the whole people to monopolise the property ownership. See Pitman Potter, "The Legal Framework for Securities Markets in China: the Challenge of Maintaining State Control, and Inducing Investor Confidence" (1992) 7 China L.Report 61 at 61-62.

[318] See Jianfu Chen, "Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC" supra at 66.

[319] See Jianfu Chen, "Securitisation of State-owned Enterprise and the Ownership Controversy in the PRC" supra at 66. Also see Ng and Yang, "Why China Should Jump Directly to Privatisation" *Shijie Jingji Daobao* [World Economic Herald] (Feb. 6, 1989) at 12.

point for securitisation of enterprise of the state-owned enterprises in a socialist country.[320] He further argues that, securitisation of enterprises is an inevitable consequence of an advanced development of social productive forces. Tong does not ignore the issue of possible dilution of public ownership under the stock system, but maintains that public ownership can be upheld by limiting individual shareholding. With regard to the possible polarisation of the rich and the poor and the concern over the capitalist practice "to each according to his capital," Tong suggests a ceiling can be put on the rate of return from shares, and similarities can be drawn between such dividends as a material reward for contributing capital to socialist construction and interests earned from banking deposits. Echoing the World Bank's proposal, Tong also asserts that securitisation can best serve the purpose of separating ownership from right of operation, separating the government from enterprises, separating government administrative functions from economic functions, and establishing an advanced, modern enterprise managerial system.

Another prominent economist, Li Yining of Peking University, argues strongly that ownership reform must transform the traditional public ownership into a new form of public ownership.[321] According to Li, stock companies are enterprises under a new type of public ownership: the working masses are the masters of production materials. Securitisation would not weaken, but rather would strengthen, the public ownership since

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[320] See Tong Dalin, "Securitisation Is a New Starting point of Socialist Enterprises" *People's Daily*, (August 18, 1986) at 2.

[321] See Li Yining, "Some Thoughts on the Reform of the Ownership System in Our Country" *People's Daily*, (Sept. 26, 1986) at 5.

the economy would control a greater amount of capital under a shareholding system. He points out that because of the dispersal of shares, the state would be able to control stock companies by holding two-fifth, one third or even less shares, not the 51 per cent as commonly suggested. He calls upon the state to gradually transform existing large and medium-sized state enterprises into joint-stock companies with limited liability.

As the proponents of shareholding system in China tried to accommodate the new system into the traditional orthodox Marxist ideology, their theoretical bases and analysis were mostly self-serving and doubtful.[322] In asserting that the share ownership would solve the ownership and control problem in the state-owned enterprises, they simply followed the line of the World Bank report without proper theoretical reasoning, thus were duly challenged by opponents of the shareholding system. Ma Bin and Hong Zhunyan, for example, reject the view that securitisation as an operative mechanism could invigorate the state enterprises.[323] They agree that the joint-stock system does have a role to play in a country's economy: it is to collect idle funds in rural and urban areas. However, they do not think the shareholding system can serve as the internal motivation force for enlivening large state enterprises. Their concern about the state ownership and

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[322] e.g., Shen Yilu and Li Jingzao argue that Tong Dalin has incorrectly interpreted Marx's statement. According to them, Marx viewed securitisation in a capitalist system as a point where the climate for a proletariat revolution had been created. Furthermore, they argue that Marx did not foresee a shareholding system in a socialist country and therefore, that it is incorrect to interpret Marx's statement as being a new starting point for socialist securitisation. See Shen Yilu and Li Jingzao, "A Discussion on the Article 'Securitisation Is a Ne Starting Point of Socialist Enterprises'" *People's Daily*, (Mar. 30, 1986) at 5, cited in Jianfu Chen, "Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC" supra at 68. Judging from other sources, we can see that Tong's interpretation is at best not totally correct. See Baev, "The Transformation of the Role of the State in Monitoring Large Firms in Russia: From the State's Supervision to the State's Fiduciary Duties" supra at 259.

[323] See Ma Bin and Hong Zhunyan, "Enliving Large State Enterprises: Where is the Motive[sic] Force?" in Bruce Reynolds, eds., Chinese Economic Reform: How Far, How Fast? (Boston: Academic Press, 1988) at 213-218.

socialist equality aside, some of the reasons and scenarios they present deserve our special attention.[324]

Firstly, the enterprise's public ownership remains unchanged while its property is divided into shares and put under a board of trustees. But can this facilitate democratic decision-making by letting shareholders dispute with each other, or when they fail to reach a consensus, can the manager make the final decision? If the shareholders are industrial departments or local governments, this will only lead to contradictions among these departments and local governments. Depending on state investment to ensure the public ownership of the enterprise takes one nowhere. When the state controls shares, it certainly has an impact on non-state shares. This serves only to put private shareholders at loggerheads with state control, and as a result, individual shareholders will impinge on state shares. Such a chaotic situation is inevitable because no distinction can be made in the ownership of such an enterprise, and no definite policy can be worked out to handle this.

Secondly, if the workers become shareholders but are not allowed to handle the share certificates on their own, the enterprise will not be truly owned by shareholders. If the workers are allowed to handle share certificates, their interests are not linked with those of the enterprise but with the stock market. When a worker shows an interest in his dividends, this does not mean he is concerned with the property of the enterprise, because he will only compete with the enterprise for his own interests.

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[324] Some commentators sometimes simplify their views and lightly dismiss them as opponents of the "change of colour" in the public ownership. See Jianfu Chen, "Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC" supra at 68-69.

Finally, those who want to introduce the joint-stock system mainly intend to establish a stock exchange market and use the market situation to guide investment. But if the state holds the majority of the stocks, it is still the state calling the shots; if one wants to do without state planning, this is possible only when private shares make up the majority in an enterprise.

Ma and Hong's doubts about the effective separation of ownership and management through shareholding system are also voiced by other commentators. In their view, as individual workers cannot afford to buy the state enterprises, the state will remain the majority shareholder. Hence the state will be in control of major policies and will determine operating measures and distribution of profits. This, it is argued, differs little from previous practice in which the state provided guidance plans and applied administrative measures in running the enterprises. Furthermore, the fact that the state remains a majority shareholder may legitimise various kinds of malpractice in the previous system by the state and local government.[325]

Facing the intrinsic contradictions in building a shareholding system within the public ownership context partly uncovered by the scholars who are not in favour of the share ownership like Ma and Hong above, some young scholars propose the implementation of a comprehensive private ownership system. According to them, the issuance of stocks and trading in a stock market are major parts of the privatisation scheme. Some argue that so long as the traditional system of public ownership exists, the "property relationships are

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[325] See Wu Shuqing, "Securitisation Is Not the Direction of Reforming Large and Medium-sized State Enterprises" *People's Daily*, (Mar. 16, 1986) at 5, cited in Jianfu Chen, "Securitisation of State-owned Enterprises and the Ownership controversy in the PRC" supra at 70.

still blurred and murky."[326] With the government firmly holding the enterprises in their hands, the enterprises are unable to free themselves from their sense of dependence on all levels of the government.[327] In order to completely reform the microeconomic foundations of China by converting state-owned property to an ownership by private individuals, they even outline a method to achieve the goal of nationwide individualisation of state property. First estimate the value of all state-owned property in a given area, and then divide stocks and shares. Next, a stock market will be formed for stock trading. Boards of trustees or directors will also be organized. "Ultimately, a new property rights system will be established."[328]

Such a sensitive issue as the nature of share ownership (capitalism or socialism) was only bypassed after Deng Xiaoping's southern China tour in 1992.[329] Shortly thereafter, Li Yining, following Deng's tone, asked somewhat boldly: "Even if it is capitalist in essence, shouldn't we make use of it when it is good for us to promote social productivity?"[330] Needless to say, the ideological pragmatism, as reflected in Li and other reformists' views,

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[326] See Li Yunqi et al., "*Guoyou caichan gerenhua: zhongguo jingji gaige de qushi yu xuanze-gei zhongguo lingdaoren de jianyishu* [The Individualisation of Ownership of State-owned Property: Trends and Choices for Chinese Economic Reform - Suggestions for China's Leaders]" *Shijie Jingjie Daobao* [The World Economic Herald], (Feb. 27, 1989) at 15, cited in Qian, "Riding Two Horses: Corporatisating Enterprises and the Emerging Securities Regulatory Regime in China" supra at 78.

[327] Ibid.

[328] Ibid.

[329] Deng specifically commented that "[a]re securities and stock markets good or bad? Is there any danger in adopting such things? Do they exist exclusively in capitalism? Can they also be adopted in a socialist system? People are allowed to consider such matters further, but resolute action must be taken to experiment with such things." Cited in Matthew Bersani, "Privatisation and the Creation of Stock Companies in China" (1993)3 Colum.Bus.L.Rev. 301 at 301.

[330] *Beijing Review* Mar. 30-Apr. 5, 1992, at 8. Cited in Jianfu Chen, "Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC" supra at 70.

is favourable to the establishment of a shareholding system in China. But without abandoning completely the orthodox ideology of the supremacy of the socialist public ownership system as some scholars have argued it should have been done, the reform of transforming the state-owned enterprises into the joint-stock companies not only is limited in nature, and lacks a clear sense of purpose, but also is vulnerable to the attacks on the ideological front if the political and economic climate changes in the future. Moreover, the theoretical issue of how to deal with the separation of ownership and management in the joint-stock company has hardly been adequately addressed, and remains a question to be answered.

4.2 The Securitisation of the State-owned Enterprise: Experiments and Practice

The twists in ideological debate and the theoretical inadequacy are well matched by the tumultuous process of building a shareholding system in China. The experiment of issuing bonds and/or shares started in the early 1980s with the primary purpose of raising funds for collective enterprises. After some various localities and enterprises had tried the practice to set up joint-stock companies, the official sanction came with the 1983 Interim Provisions of the State Council on Several Policy Issues Concerning Urban Collective Economy.[331] These provisions allow collective enterprises to issue shares to their own employees to raise funds. Also, under the Provisions, there is a 15 percent ceiling on the

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[331] Issued by the State Council on Mar. 14, 1983. See "*Zhonghua Renmin Gongheguo Falu Quanshu* [A Complete Collection of the PRC Laws]" (1989) at 1152-1157, cited in Jianfu Chen, "Securitisation of State-owned Enterprise and the Ownership Controversy in the PRC" supra at 60.

rate of return of the money invested and shares are to be gradually redeemed with enterprise profit. Hence the shares issued under these provisions were more like bonds and debentures.

More rapid development occurred in the mid-1980s. Experimentation with securitisation of the state-owned enterprises was authorized by a State Council Circular of 1985. It provides that "a few large-sized state-owned enterprises may issue stocks to their own employees" as a measure to raise funds and allows some small state enterprises to be transformed into collective enterprises through the way of issuing stocks. In 1986, Guangdong, Xiamen, Shenyang and Beijing issued securities regulations providing detailed rules for the issuance of stocks and bonds by various types of enterprises including the state-owned ones. In practice, these early experiments were mainly confined to small and medium-sized collective enterprises, the stock issued were mainly bonds and debentures and did not confer ownership rights.[332]

The year 1987, however, saw some significant control and check over the use of stocks as a means to raise funds, partly due to the promotion and proliferation of the Contract Responsibility System.[333] The State Council issued a notice to strengthen the administration of shares and bonds.[334] In this notice, the issuance of shares is restricted and only approved collective enterprises are allowed to issue shares on an experimental

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[332] For various sources, see Jianfu Chen, "Securitisation of State-owned Enterprise and the Ownership Controversy in the PRC" supra at 61.

[333] See Qian, "Riding Two Horses: Corporatisation Enterprises and the Emerging Securities Regulatory Regime in China" supra at 77.

[334] "The State Council Requires Various Regional Governments to Strengthen Administration of Shares and Bonds" *People's Daily*,(Apr. 7, 1987) at 3, cited in Jianfu Chen, "Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC" supra at 61.

basis. The state-owned enterprises are allowed to issue bonds but no stocks. The only exception is made for those state enterprises which have already had approval to issue shares and still need to. The main reason for the restriction cited in the notice is to control excessive spending outside state plan as a result of unchecked issuance of stocks and such illegal practice as forcing employees or other persons to purchase stocks. But some commentators believe that it was a consequence of ideological opposition.[335]

Nevertheless, later that year, Zhao Ziyang, then the CPC's General Secretary, in his report to the 13th Party Congress, seemed to reaffirm the securities program in principle and approved experimentation with the securities program. According to his report:

> Various forms of s system of shares in enterprises have appeared during the reform. These include purchase of shares by the state, collective purchase by departments, localities and other enterprises and purchase by individuals. This system is one means of raising money for socialist enterprises and can be further implemented on a trial basis.[336]

The economic situations in the late-1980s prompted more heated discussion about the share ownership and shareholding system. The volatile political atmosphere was also encouraging for more radical approaches toward the ownership reform.[337] Except interrupted by the 1989 Tiananmen Event for a short while, this trend continued into the 1990s. In April 1990, the Shenzhen Stock Exchange was formally opened, followed by the

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[335] See Jianfu Chen, "Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC' supra at 62.

[336] See Zhao Ziyang, *Advance Along the Road of Socialism with Chinese Characteristics-Report Delivered at the 13th National Congress of the CPC* on Oct. 25, 1987. Cited and translated in Qian, "Riding Two Horses: Corporatisating Enterprises and the Emerging Securities Regulatory Regime in China" supra at 77.

[337] For the economic situation and main viewpoints during this period, see Qian, "Riding Two Horses: Corporatising Enterprises and the Emerging Securities Regulatory Regime in China" supra at 80-85.

Shanghai Stock Exchange, which opened its door to the public in the December of the same year. Also in late 1990, a national automatic quotation system was set up in Beijing and began operation. The quotation system provides a national computerised network linking major cities that have stock markets. Consequently, despite ongoing doubts, the shareholding system was formally established. By the end of 1991, there were 3,220 enterprises adopting the shareholding system. Twenty percent of them were state enterprises; 86 percent issued shares to their own employees only; 12 percent issued shares to other legal persons (enterprises). But only 89 enterprises issued shares to the public; among them, 35 enterprises had their shares traded in Shanghai and Shenzhen Exchanges. Large scale experimentation in the shareholding system had been approved by the Central Government.[338] Attempts have also been made to attract foreign investors. The Shenzhen and Shanghai Exchanges began to list "B shares" exclusively to foreign investors in 1991. Some Chinese enterprises have successfully listed their shares ("H") in the Hong Kong Exchange. And a couple of them have even gone so far as to list their shares under different arrangements in the New York Stock Exchange.

With the establishment of the shareholding system, China has also built up a rudimentary legal framework to regulate the stock companies. On the national level, in May 1992, the State Economic Commission and other interested departments issued the Share Enterprise Trial Measures. Pursuant to these measures, the Opinion on Standards for Companies Limited by Shares (the "Opinion") was issued. The Opinion sets forth guidelines for establishing stock companies. Twelve sets of provisional rules were also

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[338] Various sources are cited in Jianfu Chen, "Securitisation of State-owned Enterprises and the Ownership Controversy in the PRC" supra at 63.

issued under the national regulations governing such matters as accounting, labour, taxation and financial management of stock companies.

On the local level, at about the same time the Opinion was promulgated, the Shenzhen[339] and Shanghai[340] municipalities each promulgated their own separate guidelines for the establishment of stock companies. The Shenzhen and Shanghai regulations apply to any company operating in those municipalities or listing securities on the Shenzhen or Shanghai stock exchanges. The Opinion, however, applies to all PRC stock companies. Not until 1993 did China adopt a national Company Law.[341] Modelled on American and other Western corporation codes, the Company Law covers the rules of corporate organisation and governance, liability, stock and dividends, and other corporate matters for both limited liability companies and companies limited by shares.[342] In a sense, the Company Law has laid a foundation for a new share ownership system in China, though the foundation is still far from very solid as my study will show.

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[339] " Shenzhen Municipality Provisional Regulations on Companies Limited by Shares" (1992) 4 China Law & Practice 12 at 12-51.

[340] " Shanghai Municipality Provisional Regulations on Companies Limited by Shares" (1992) 7 China Law & Practice 21 at 21-46.

[341] See The PRC Company Law supra.

[342] For a detailed analysis of China's Company Law, see Art and Gu, " China Incorporated: The First Corporation Law of the People's Republic of China" supra at 273-307.

4.3 Share Structure and Corporate Governance: Evaluated and Redefined

Although the main purpose of the 1983 World Bank's proposal for a shareholding system is to solve the problem in the separation of ownership right and operating right of the Chinese state-owned enterprises. However, due to the limitation in both ideological and theoretical aspects, the Chinese reformists failed to appreciate profoundly the issues raised in the World Bank's report, and pursue the cause with more concrete analytical work and specific plans. Instead, they were trapped in the ideological argument with the opponents of the shareholding system over whether or not a share ownership would have positive or negative impacts upon the orthodox socialist public ownership system, and how to maintain the superior position of the state in the joint-stock companies.[343] Not surprisingly, when China undertook the experimentation with the issuance of shares in collective enterprises, and later set up two stock exchanges to publicly list some enterprises including state-owned enterprises, the principal motivation was generally deemed as to take the massive savings away from private hands[344] and cope with the Chinese enterprise's bottleneck problem in the short supply of capital.

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[343] e.g., Xu Jing'an, "The Stock-Share System: A New Avenue for China's Economic Reform" supra at 219-224.

[344] As of the end of 1990, the private savings of PRC citizens totalled 703.4 billion yuan. By the end of 1992, the amount increased to $ 310 billion. The huge amount of funds were vividly described as a "tiger in the cage," which created a potential threat to both political and economic stability of China. See Qian, "Riding Two Horses: Corporatisating Enterprises and the Emerging Securities Regulatory Regime in China" supra at 80; also see Bersani, "Privatisation and the Creation of Stock Companies in China" supra at 304.

Not until recently has the focus of both the policy and theoretical discussions gradually shifted to such issues as the modernisation of the enterprise system and clarification of property rights. With the promulgation of the Company Law, it is contemplated that the corporatisation of the state-owned enterprises may be instrumental in fulfilling these goals.[345] The 1993 "Decision of the Chinese Communist Party Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economic Structure" describes as the first "basic feature" of a "modern enterprise system" that "the property rights relations are clearly defined" and then proceeds to recommend "experimentation with the corporate system."[346] Seeing the failure of the CRS in solving the decapitalisation, managerial self-dealing, and other problems plaguing the state-owned enterprises, the strongest emphasis has been on the potential contribution of the corporate form to balancing official and managerial power and limiting state economic responsibility. It is argued that "corporations can effectively accomplish the separation between the ownership of investors and the rights of enterprise" and are "conducive to ... enabling enterprises to get rid of reliance on administrative organisations and enabling the state to

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[345] Some commentators are puzzled by China's rhetoric to connect the clarification of property rights with the corporate system, because to them the property rights in modern corporation are actually mingled. But in the view of my study, it may be plausible to use the corporate system to clarify the property rights *relationship* in the context of transforming the "public ownership" of the Chinese state-owned enterprise as I have argued earlier. However, whether or not such an idea or vision is in the Chinese government's mind when it made the statement is rather doubtful. It is more possible that the reform-minded theorists put forth such an ambiguous expression to accommodate their more radical agenda in the future. It is revealing that, when inquired, some Chinese economists referred the idea to work by Harold Demsetz. (e.g., See Demsetz, "Toward a Theory of Property Rights" supra.). See William H. Simon, "The Legal Structure of the Chinese 'Socialist Market' Enterprise" (1996) 21 J.Corp.L.267 at 285.

[346] "Decision of the Chinese Communist Party Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economic Structure" Daily Report China FBIS-CHI-93-220 (Nov. 17, 1993) at 24-25.

get rid of its unlimited responsibility for enterprises."[347] True or not? No easy and short answer can be satisfactorily given in this juncture, considering the complexity of the separation of ownership and control in the Western corporate practice and scholarship, not to mention the more disarrayed Chinese state-owned enterprises. Rather, both the share structure and governance mechanism provided in the Chinese Company Law and other regulations must be examined positively and normatively in the light of law and economics scholarship before we arrive at any conclusion.

1. The Implications of Ownership in Corporate Control

The control mechanism of the firm is, in essence, determined by the nature and form of the ownership.[348] Fama and Jensen assert that the organisation forms depend on the general characteristics of residual claims and decision functions. The underlying cause for the various arrangements of the firm is the transaction costs, among which the agency cost is of most significance. Accordingly, "[a]bsent fiat, the form of organisation that survives in activity is the one that delivers the product demanded by customers at the lowest price while covering costs."[349] Hansmann makes it more clear by stating that "the ownership relationship itself can involve substantial costs."[350] He specifically demonstrates three

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[347] Ibid., at 24.

[348] A specific example can be seen from different control practice between two major Western corporate control systems: (1) Germany and Japan, where financial intermediaries holding substantial blocks of shares deal directly with management; (2) the United States, where shares are more dispersed and intermediaries more constrained, and the stock market (and the takeover) play more important roles. See William Simon, "The Legal Structure of the Chinese 'Socialist Market' Enterprise" supra at 289.

[349] See Fama and Jensen, "Separation of Ownership and Control" supra at 301.

[350] See Henry Hansmann, "Ownership of the Firm" (1988) 4 J.L.Econ.Org. 267 at 275.

types of major ownership costs.[351] First is the cost of monitoring. If a given class of patrons is to exercise effective control over the management of a firm, they must incur the costs of (1) becoming informed about the operations of the firm, (2) communicating among themselves for the purpose of exchanging information and making decisions, and (3) bringing their decisions to bear on the firm's management. Following this line of reasoning, we can safely conclude that there are "efficient owners" and "inefficient owners" as far as the monitoring cost is concerned.

Secondly, collective decision-making costs. When ownership of a firm is shared among a class of patrons, a method for collective decision-making must be devised. Hansmann points out, although a variety of factors influence the magnitude of the collective decision-making costs, a fundamental consideration is the extent to which the patron-owners have divergent interests concerning the conduct of the firm's affair. Where the patrons involved all have essentially identical interests, the costs associated with collective decision-making are naturally small if no subgroup is to take strategic advantage of the decision-making mechanism to exploit other owners. On the other hand however, even where patrons diverge considerably in interest, the costs associated with collective decision-making may be low if there is some simple and salient criterion for balancing their interests.

Thirdly, risk-bearing costs. The first two costs associate with the first element of ownership: the exercise of control. But costs are also associated with the second element of ownership: the receipt of compensation in the form of residual earnings. One class of a

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[351] Ibid. at 275-281.

firm's patrons may be in much better position than others to bear such risk, for example, through diversification. Assigning ownership to those patrons can then bring important economies.

I have argued repeatedly that the state as the representative of the whole people is not an efficient owner, for there are tremendous transaction costs managing the decision and control by the government bureaucrats. Even if enterprises enjoy full autonomy and markets are totally liberalised, there is still great doubt as to how well the state can supervise the behaviour of management in these enterprises. Now, with securitisation, can the state be an efficient owner as a controlling shareholder of the joint-stock company, which was implictly suggested by the World Bank in the mid-1980s, and has been strongly advocated by the majority of reformists?

Li Yining envisioned such a shareholders' classification as (a) the state; (b) the enterprise; (c) individuals in society; and (d) the employees of the enterprises. The first two involve a public ownership nature, and fourth entails a measure of collective economic cooperation. Only the third type shares involve private element.[352] Accordingly, a Chinese stock companies' equity securities must be divided into four categories defined in terms of stockholder status: (1) "state shares" are shares invested by government departments in exchange for state assets; such shares are generally held by a specially established entity, acting as the state's agent; (2) "legal person shares" are shares purchased by the enterprises and other social units with the qualification as a legal person; (3) "individual shares" are shares purchased by individuals, including employees of the

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[352] See Qian, "Riding Two Horses: Corporatisating Enterprises and the Emerging Securities Regulatory Regime in China" supra at 82.

company (collectively "individuals"), with their own legal assets; (4) "foreign investment shares" ("B" shares) are held by foreign parties, enterprises and individuals alike.[353] Also, depending on the sources of assets, the shares purchased or exchanged with the assets invested by the state or collective enterprises are classified as the "public equity shares," and the rest as the "non-public equity shares."

To maintain the control of the state in the joint-stock companies is a basic principle in China's securitisation of the state enterprises. According to the Opinion, no single individual may own more than 0.5% of any company's total share amount, but at least 25% of the total share amount of a public company must be held by individuals. In general. company employees collectively cannot purchase more than 20% of the company's total share amount and employees of a public company collectively cannot purchase more than 10% of the company's shares issued to the general public.[354] Unlike the practice in the former Soviet Union and Eastern European countries, it is prohibited to distribute the state shares to enterprises or individuals, and enterprise's shares to individuals.[355]

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[353] See Bersani, "Privatisation and the Creation of Stock Companies in China" supra at 314. Also see Item 4, "*Gufenzhi Shidian Banfa* [The Share Enterprise Trial Measures] (1992)" in *Gufenzhi Shidian Zhengce Fagui Huibian* [The Collection of Policies and Rules on Shareholding System Experimentation], *Shangahishi Jingji Tizhi Gaige Bangongshi (Bian)* [The Economic Structure Reform Office of Shanghai Municipality], ed. (July, 1992) at 11.

[354] Art. 24, "*Gugen Youxian Gongshi Gueifan Yijian* [The Opinion on Standards for Companies Limited by Shares]" in *Gufenzhi Shidian Zhengce Fagui Huibian* [The Collection of Policies and Rules on Shareholding System Experimentation], supra at 23.

[355] Item 2 , "The Share Enterprise Trial Measures" in The Collection of Policies and Rules on Shareholding System Experimentation, supra at 9-10.

With such a disproportional share control in the hands of the state, the securitisation of the state-owned enterprises into the limited liability companies (similar to closely-held corporation) has changed little the agency problems and other transaction costs of managing and controlling these enterprises prior to the securitisation. It follows that the substitution of the former manager responsibility system with a corporate governance mechanism may only add some modern flavour to these enterprises. Indeed, in a 1992 report to the State Council jointly delivered by the Production Office and the State Structural Reform Commission of the State Council, it is well documented that "a considerable number of joint-stock companies are not standard," and "their organisational structure and management systems are still inherited from the traditional state enterprises only with a changed name."[356] Also, "the shareholder meetings and the boards of directors of most enterprises exist only in name," and "the chairmen, directors, and CEOs of the joint-stock companies are continually appointed by the supervisory agencies, or held by the former managers of these enterprises."[357]

In the companies limited by shares (similar to the public corporation) the share ownership is more diffused. The Chinese practice seems to follow the model suggested by the World Bank, which is also concurred by some theorists in China. Xu Jing'an, for one, proposed to establish the holding companies as managers of state assets. He took notes of the concern that "in the stock system, participation in enterprise management by the state

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[356] "*Guanyu Gufenzhi Shidian Qiyi Gongzuo Zuotanhui Qingkuang de Baogao* [Report of the Workshop on the Share Enterprise Trial Work]" in The Collection of Policies and Rules on Shareholding System Experimentation, supra at 4.

[357] Ibid., at 5.

in its capacity as stockholder may undercut the separation of government administration from enterprise management." Thus, he suggested that state asset operating companies, or holding companies be responsible for the direct management of state assets through control of the boards of the stock companies and reinvestment of state assets.[358] In the Interim Regulation on the Macro-Management of Experimented Share Enterprise of 1992, the State Planning Committee and the State Structural Reform Commission set forth that "the state invests its assets [in the stock companies] mainly through its state investment companies with the forms of shareholding and share-controlling," and "these state investment companies are also responsible for managing and reinvesting the returns of the state shares."[359]

To be sure, compared to the bureaucratic control of the state enterprises, the government will economically benefit from the management speciality of these investment companies. However, the organisation of all these investment companies and holding companies is not only costly, but also incurs the same agency problems. The government is still faced with the problem to control the investment companies and make their managers accountable to the state.[360] Indeed, in most cases the cure may not be much better than the disease, if not worse.

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[358] See Xu Jing'an, "The Stock Share System: A New Avenue for China's Economic Reform" supra at 222-223.

[359] See "*Gufenzhi Shidian Qiyi Hongguan Guanli de Zhanxing Guiding* [The Interim Provisions for the Marcomanagment of Share Experiment Enterprises]" in The Collection of Policies and Rules on Shareholding System Experimentation, supra at 185.

[360] The State Administrative Bureau of State-owned Property was set up in 1988 for this purpose, but the effect of such an organisation is always doubtful.

Another problem with the majority ownership of the state is that its interests can hardly be convergent with that of other shareholders, in particular the private shareholders, whose main objectives lie in the value of their shares. While the private shareholders' goal is the profit-maximisation, the government is known to have the objectives that may not coincide with the profitable operation of the companies. The government is inevitably concerned with dealing with various social, political, economic, and other agenda.[361] Thus there is always a potential for the government to make the management decision to serve its own purposes at the expense of other shareholders. The complexity of the issue is compounded by the fact that the state as a controlling shareholder may hardly be held accountable for its opportunistic actions under the fiduciary principle, for modern companies are allowed, if not obliged, to take the public interest into their consideration.[362] Furthermore, the state may exercise protectionism toward those companies in which the state has larger percentage of shares.

Diffused private shareholders are more efficient residual claimants, for they can diversify their portfolios so that they can be close to risk-neutral. If they are not satisfied with the performance of their companies, they have the easiest exit in the capital market. Also, the private investors have much greater freedom to make their choices between the limited liability company and the company limited by shares, and their decisions about the organisation forms of the firm are mostly based on a benefit-and-cost analysis. The state,

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[361] e.g., Andrei Baev lists combating inflation, unemployment, balancing the budget, defence spending, social service, regional development and obtaining the maximum number of votes during election. See Baev, "The Transformation of the Role of the State in Monitoring Large Firms in Russia: From the State's Supervision to the State's Fiduciary Duties" supra at 286.

[362] See Baev," The Transformation of the Role of the State in Monitoring Large Firms in Russia: From the State's Supervision to the State's Fiduciary Duties" supra at 281-282.

however, has less choices in diversifying its residual risks, in particular, when the state owns the majority shares of the company.

Apparently, due to the implications of the state share ownership in the corporate control mechanism concisely described above, the efficient corporate governance cannot be successfully established in a company with the state as its controlling shareholder. In order to build a modern enterprise system through the securitisation and corporatisation the state-owned enterprises as envisaged by the Chinese government, the share structure of the Chinese joint-stock companies should be transformed. The majority shares should be distributed to private shareholders, enterprises and individuals alike.

2. Corporate Governance Under the Chinese Company Law

In form, the Chinese Company Law has followed the "received legal model"[363] of the Western corporate law in delineating a corporate governing structure. Under this model, the board of directors manages the corporation's business and makes business policy; the officers act as agents of the board and execute on "major corporate actions," or "fundamental," "extraordinary," or "organic" changes.[364] Frequently referred to as the corporate norm, the standard operating procedure for such a model is described as pyramidal. At the base are the shareholders whose vote is required for major corporate actions; the next level is represented by the directors who constitute the policy-making body of the corporation, and select the officers; finally, at the top of the pyramid are the

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[363] See Melvin A. Eisenberg, The Structure of the Corporation: A Legal Analysis (Boston: Little, Brown, 1976) at 1.

[364] Ibid.

officers who have some discretion but in general are deemed to execute policies formulated by the board.[365] However, reflecting the concerns about the dominant position of the state, some clear marks can be found in the corporate governance structure under the Chinese Company Law.

Board of Directors and Supervisory Committee: Every company must have a board of directors, which consists of three to thirteen directors in the case of the limited liability company, or five to nineteen in the case of the company limited by shares.[366] The board selects managers and makes other key decisions.[367] Managers of a company are not mere agents subject to the general authority of the shareholders. Aside from a limited class of decisions, while they are in office, managers have general authority to run business. Moreover, although shareholders can remove directors with whom they are displeased, the Company law permits removal during their terms only for "proper justification."[368] Influenced by German law, the Chinese company has the option to set up a supervisory committee. If a company opts to have one, the supervisory committee must be composed of at least three members, each with a term of three years.[369] Some are elected by shareholders, others by workers, in a ratio specified by company regulations.[370] Directors,

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[365] Ibid., at 1-2. Such a corporate governance model is also referred to as a "political model." See John Pound, "The Rise of the Political Model of Corporate Governance and Corporate Control" (1993) 68 N.Y.U.L.Rev. 1003.

[366] Arts. 45 and 112 of the PRC Company Law supra.

[367] Art. 46 of the PRC Company Law supra.

[368] Art. 115 of the PRC Company Law supra.

[369] Arts. 51, 52, 124 and 125 of the PRC Company Law supra.

[370] Arts. 52 and 124 of the PRC Company Law supra.

managers, and personnel in charge of financial affairs may not serve concurrently as supervisors.[371] The supervisory committee is supposed to oversee the board of directors and assure that it pursues the policies fixed by shareholders. Its members attend board meetings in a nonvoting capacity and inspect the company's financial affairs.[372]

But according to some studies, the managerial power of the Chinese company is fragmented[373] in a comparison to that of Western company. First, a "manager" is given the responsibility to "take charge of the company's operation [and] management;" second. a chairman of the board of directors is the "company's legal representative;" third, a board of directors is charged with formulating the company's operating and strategic plans and hiring, firing, and supervising senior management; and fourth, the supervisory committee is charged with "monitoring" managers and directors to insure they "perform their duties to the company."[374] Also, the relationship between the board of directors as a whole and a single shareholder or a group of shareholders is not well defined. In a 1991 Notice jointly issued by several government organs including the People's Bank of China and Ministry of Finance, it is stipulated that the state shares should be represented by "state share representatives," who will be designated by the government agency and assume clear responsibility for the value-keeping and appreciation of the state assets. These

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[371] Ibid.

[372] Arts. 54 and 126 of the PRC Company Law supra.

[373] See William Simon, "The Legal Structure of the Chinese 'Socialist Market' Enterprise" supra at 291.

[374] Arts. 126, 119, and 112 of the PRC Company Law supra.

representatives seem to be board members, but their rewards, penalties, and promotions are in the charge of the relevant government agencies.[375]

Shareholders' Rights and Powers: The Law provides that the "shareholders' meeting is the most powerful authority."[376] In addition to mandatory annual meetings, shareholders, directors, directors, or supervisors may call special meetings.[377] At this meeting, shareholders elect and dismiss directors and members of the supervisory committee, set their compensation, and consider their reports.[378] Shareholders have the right to inspect financial records, to decide on issuance of additional shares, and to vote on such fundamental changes as merges, dissolution, and liquidation.[379] Shareholders may vote by proxy.[380]

The Law also provides some other rights for shareholders, which catch the attention of the commentators.[381] Unlike their Western counterparts, the Chinese shareholders can "decide the policy of management and the plan of investment of the company," approve

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[375] "*Guanyu zai Gufenzhi Shidian zhong Jiaqiang Weihu Guoyou Zhichan Quanyi de Tongzhi* [The Notice on Strengthening the Protection of the State Asset Interest in the Share Enterprise Experimentation]" issued by the State Administrative Bureau of the State Assets, the State Structural Reform Committee, Ministry of Finance, the People's Bank of China, and the State Administration for the Taxation in The Collection of Policies and Rules on Shareholding System Experimentation, supra at 230.

[376] Arts. 37 and 102 of the PRC Company Law supra.

[377] Arts. 43 and 104 of the PRC Company Law supra.

[378] Arts. 38 and 103 of the PRC Company Law supra.

[379] Art. 39 of the PRC Company Law supra. A two-thirds majority can approve fundamental changes.

[380] Art. 108 of the PRC Company Law supra.

[381] See William Simon, "The Legal Structure of the Chinese 'Socialist Market' Enterprise" supra at 291; also see Art and Gu, "China Incorporated: The First Corporation Law of the People's Republic of China" supra at 296-297.

the budget, and vote on the issuance of bonds.[382] More notably, the shareholders consider and approve the plan of distribution of profits and recovery for losses[383] and decide whether to issue dividends.[384] These unconventional shareholder rights serve more for the government's control of the joint-stock company than the protection of ordinary shareholders. It also highlights the contradictions underlying the state's position as a controlling shareholder. Art and Gu put it rather precisely:

> The extraordinary power accorded to shareholders is consistent with the Corporation Law's overall approach to managing state-owned enterprises. The government, which will be a huge shareholder in corporatised companies, did not intend to relinquish ownership or ultimate control over China's productive enterprises. Rather, it sought to remove itself from the micro-management of enterprise decisions. By assigning management authority to the board of directors, while retaining majority stock ownership and a strong role for shareholders, the government can maintain the level of control it chooses.[385]

Ideally, the Company Law confers the same rights and powers upon all shareholders. However, both due to the predominant position of the state shareholder and the lack of enforcement mechanisms, these rights and powers have little practical meaning to the ordinary shareholders.[386]

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[382] Art. 38 of the PRC Company Law supra.

[383] Ibid.

[384] Art. 103(7) of the PRC Company Law supra.

[385] See Art and Gu, "China Incorporated: The First Corporation Law of the People's Republic of China" supra at 297.

[386] See Matthew D. Latimer, "Gilding the Iron Rice Bowl: The Illustration of Shareholder Rights in China" (1994) 69 Wash.L.Rev. 1097 at 1105-1111.

Workers' Role in Corporate Governance: The worker theme remains salient in the Company Law. But the workers' rights do not include voting and appear far more limited than the rights provided for under earlier legislation.[387] Two sections of the Law require the company to "invite" or "heed" worker opinions, and to allow worker attendance at management meetings on issues of "immediate concern" to workers and "important issues relating to production and operation."[388] The Supervisory Committee must include an "appropriate" number of "democratically elected" worker representatives.[389] The Law also requires the board representation of workers in certain situations.[390] Indeed, the aggregate of explicit powers accorded to workers by these provisions is so limited that some commentators assert that "workers in Chinese corporations appear to have less power than their peers in Germany, which has statutorily mandated nearly equal representation of workers and shareholders on the board of supervisors."[391] And according to Simon, the German supervisory board is more powerful than the supervisory committee in the

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[387] e.g., The Law of the PRC on Industrial Enterprises Owned by the Whole People of 1988 provides workers the rights to remove the director of an enterprise, subject to government approval, and to decide matters directly affecting the workers.

[388] Arts. 121 and 122 of the PRC Company Law supra.

[389] Art. 124 of the PRC Company Law supra.

[390] Art. 45. e.g., companies formed by more than two state-owned enterprises or state-owned investing bodies must include democratically elected representatives of the workers on the board of directors. The PRC Company Law supra.

[391] See Art and Gu, " China Incorporated: The First Corporation Law of the People's Republic of China" supra at 298.

Chinese company, for German law actually gives to the supervisory board, among other things, the power to appoint the managing board.[392]

As known, the main goal of the corporate form in the West is to facilitate participation in large-scale enterprise of large numbers of dispersed investors. A key move is a control structure that allows investors some hold over management but leaves management a broad range of discretion over most business decision.[393] Since the major concern of the Chinese Company Law is to maintain the control of the state, rather than to facilitate the participation of dispersed small investors, the governance structure under the Company Law discussed above deviates in some important aspects from the model under the modern Western corporate law. Also due to the limitation of the Chinese legal theories and enterprise practice,[394] such important concept in the corporate governance as the fiduciary principle has not been adopted in the Company Law. Instead, the Law specifies that the directors and managers must obey administrative rules and company regulations and that they are responsible for damages if a breach harms the corporation.[395] As to

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[392] See Simon, "The Legal Structure of the Chinese 'Socialist Market' Enterprise" supra at 292. Baev lists more specifically such powers for the supervisory board under German law as (1) the supervision of management; (2) the appointment of the members of the managing board and, if there is good cause, their dismissal; (3) the right to examine the company's documents and assets (annual reports, balance sheets, etc.) and receive other comprehensive information; (4) the right to question managers; (5) the right to call shareholder meetings; and (6) the right to approve certain important transactions. See Baev, "The Transformation of the Role of the State in Monitoring Large Firms in Russia: From the State's Supervision to the State's Fiduciary Duties" supra at 257.

[393] See Simon, "The Legal Structure of the Chinese "Socialist Market' Enterprise" supra at 299. Another key move is the limited liability.

[394] According to Beav, the idea of fiduciary duties, as well as trust, due to its conceptual vagueness and open-endness, was absent from civil and Russian law. Since China is of a civil law tradition, it is naturally that there is no such ideas in China, either. See Beav, "The Transformation of the Role of the State in Monitoring Large Firms in Russia: From the State's Supervision to the State's Fiduciary Duties" supra at 279.

[395] Arts. 63 and 128 of the PRC Company Law supra.

constraints on managerial self-dealing, the Company Law is very brief and vague. The Law forbids directors and managers to "use their positions and powers in the company to seek personal gains" and to "sign contracts or conduct transactions with the company."[396] In the context of the current Chinese legal system, it is certainly impossible to enforce these rules. Moreover, recent Western scholarship has suggested that key issues of corporate governance are largely outside corporate law, as conventionally defined.[397] Understandably, these external factors have not been accommodated into the corporate governance mechanisms in China.

Nevertheless, if the Chinese government truly commits itself to establishing a market economy, and for that purpose, to building up a "modern enterprise system" through the corporatisation, it has to redefine the corporate governance structure provided in the current Company Law besides relinquishing the state shares as I have argued earlier.

3. Corporate Governance Redefined

Adam Smith noted the issue of separation of ownership and control almost as soon as the modern company came into being. In his view, the companies were established so that the risk of conducting business particularly, foreign commerce, could be shared by a group of individuals and also because no single individual possessed the funds needed to finance foreign trade. However, such business arrangement produced owners (shareholders) who knew relatively little about the operations of their company. They

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[396] Arts. 61 and 123 of the PRC Company Law supra.

[397] See Simon, "The Legal Structure of the Chinese 'Socialist Market' Enterprise" supra at 289.

treated the company as an investment, focusing on the dividends paid out and relying on directors to oversee the daily operation of the firm. Smith also observed that these directors, or managers, who were charged with the responsibility of running the corporation, did not always do so in the best interests of the shareholders.[398] The pervasiveness and the effects of the issue, however, had not been well articulated until Berle and Means' seminal book The Modern Corporation and Private Property was published in 1932, when the United States was witnessing the growing level of dispersion of share ownership among the largest industrial corporations. They cogently observed that

> "[a]s the ownership of corporate wealth has become more widely dispersed, ownership of that wealth and control over it have come to lie less and less in the same hands. Under the corporate system, control over industrial wealth can be and is being exercised with a minimum of ownership interest. Conceivably it can be exercised without any such interest. Ownership of wealth without appreciable control and control without appreciable ownership appear to be the logical outcome of corporate development."[399]

Also known as "the Berle-Means Hypothesis,"[400] their theory indicates that managers may be motivated to pursue not only personal profit objectives, but also prestige and power. Thus, goals of management may be quite different from those of the shareholders. Consequently the best interests of the owners will most assuredly not be served when a personal profit-seeking group is in control. This situation prevails even though the law

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[398] See Adam Smith, The Wealth of Nations, (Cannan ed. 1937), at 690, 699-700. Cited in Henry Tosi, Luis Gome-Mejia and Debra Moody, "The Separation of Ownership and Control; Increasing the Responsiveness of Boards of Directors to Shareholders' Interests?" (1991) 4 U.Fla.J.L.& Pub. Pol'y 39 at 42.

[399] See Berle and Means, the Modern Corporation and Private Property, rev. ed. (New York: Harcourt, Bruce and World, 1968) at 66.

[400] See Tosi at el., "The Separation of Ownership and Control: Increasing the Responsiveness of Boards of Directors to Shareholders' Interests?" supra at 42.

requires that management must devote attention to business and to the interests of the corporation and must exhibit reasonable business prudence. Only if shareholders collaborate to become a majority interest, the situation could be changed. It is more possible that dissatisfied equity holders simply sell their shares.[401]

Ever since the publication of Berle and Means' treatise, the concern over the unbridled scope for opportunism by corporate management has been a central theme of corporate law scholarship.[402] However, their prognosis of corporate governance remained virtually unchallenged for almost four decades. Only by the 1970s did their analysis receive close scrutiny by scholars belonging to the law and economics movement.[403] Basing their analysis on the institutional economic theories, in particular, the contractual paradigm of the firm, these law and economics scholars have not only enriched the understanding of the nature of separation of the ownership and control in the modern corporation, but greatly broadened the dimensions of the corporate governance mechanisms as well. Indeed, more and more stresses in that regard have been laid beyond the statutory provisions of company law. Likewise, I would like to redefine the Chinese corporate governance from the following three aspects, namely: internal structure, external mechanism, and liability principle.

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[401] Ibid. at 43.

[402] See Ziegel, Daniels, Johnston and MacIntosh, Partnerships and Business Corporations, v.1 2d ed. (Carswell, 1989) at 367.

[403] Ibid. at 368.

Internal Structure: Although China's Company Law is modelled more or less after the Western corporate law in the internal structure as discussed above, some points warrant special attention here. Above all, it is the modern corporate norm that management is identified with the directors. It is the directors, and not the shareholders, who manage. In Canada, for example, both BCCA and CBCA provide that the directors have managerial control of the company.[404] Notwithstanding owing the shareholders fiduciary duties, directors are not their agents. As long as they act within the limits of the authority, the majority of shareholders cannot impose obligations on the directors; and it is almost impossible for a mere majority at a meeting to override the views of the directors. If the directors' powers are to be altered it must be done by an extraordinary resolution and not by a simple majority at an ordinary meeting.[405] Moreover, while the company law says that "directors shall manage," it is in fact more usual for the corporation's senior officers to manage, and for directors, at most, to supervise the officers.[406] The board of directors is authorized to delegate their powers. Internally, directors can delegate their powers, however not all of them, to committees.[407] Externally, it is sometimes necessary for the board to delegate jobs for the directors to people outside the board.[408] In addition, as Eisenberg observes, although the traditional corporate statutes typically do require

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[404] BCCA s. 141(1); CBCA s. 97.

[405] Automatic Self-Cleansing Filter Syndicate Co. v. Cunninghame, [1906] 2. Ch. 34, (C.A.).

[406] See F. H. Buckley and Mark Q. Connelly, Corporations: Principles and Policies, 2d ed. (Toronto: Emond Montgomery, 1988) at 354.

[407] See BCCA Table A, 12.3.

[408] e.g. BCCA s. 157(4)(c) and CBCA s. 116.

shareholder approval of transactions which may be referred to as the classical fundamental changes, they fail to explicitly require shareholder approval for a number of other actions which may be referred to as the modern fundamental changes - business combinations other than mergers, corporate contractions, and corporate divisions. Even for most of these classical fundamental decisions, more often than not the corporate statutes require the board approval as well. Indeed, "[b]y providing instead that for the most part shareholders have no power of initiation, no power to formulate details, and only concurrent power of approval over the classical fundamental changes, the traditional statutes have given the board not only a formal voice but a major and decisive legal role in such transactions."[409]

Giving managerial authority to a separate class of managers facilitates specialisation economies in the firm's business decisions. According to Posner, "[t]he separation of ownership and control is a false issue. Separation is efficient, and indeed inescapable, given that for most shareholders the opportunity costs of active participation in the management of the firm would be prohibitively high."[410]

On the other hand, despite the fact that wildly-dispersed shareholders are commonly regarded as passive owners of large companies, they, as residual claimants, have some rights and powers of considerable significance. Shareholder voting is both a device for controlling managerial diversion and slack and for registering shareholder preferences relating to important business decisions in the life of the corporation. Shareholders are

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[409] See Eisenberg, The Structure of the Corporation: A legal Analysis, supra at 3-5.

[410] See Posner, Economic Analysis of Law, supra at 384.

statutorily empowered to vote for directors and also in respect of an enumerated set of transactions that are often referred to as corporate "fundamental changes." In some cases, for example, the election of the board members, the corporate statutes provide the cumulative voting to ensure the minority representation in the board of directors.[411]

The shareholders meeting is the key instrument through which the shareholders exercise their oversight power. Such meetings generally include two types: annual and special. It is usually mandatory for the company to have an annual general meeting each year, in which the directors are elected, the auditors are appointed, and financial statements and auditor's report are presented to shareholders. Should any important businesses arise between annual meetings, the directors may call a special meeting of shareholders. BCCA and CBCA also provide that the holders of no less than 5% of the issued voting shares may "requisition" a shareholders' meeting[412] to transact the business stated in the requisition. Aside from allowing shareholders to vote on such important matters as the election of directors and fundamental corporate changes, the shareholders' meeting is designed, at least in theory, to provide a forum for shareholders to discuss matters relating to the business and affairs of the corporation.

To ensure the shareholders to make an informed decision, corporate statutes require corporation to maintain specified records and to allow access to these records by shareholders and other designated persons.[413] The shareholders have the right to appoint

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[411] e.g. CBCA s. 107.

[412] BCCA s. 171; CBCA s. 143.

[413] e.g., CBCA ss. 19-22, and 138.

their own auditor, who is to assess the financial statements which the corporation proposes to place before the shareholders and to report on the preparation and accuracy of those statements.

The shareholders have the right to vote by proxy in the public corporation. Corporate statutes thus provide detailed proxy solicitation rules to ensure the adequacy of information disclosure and the fairness of process. In Canada, for example, mainly as the result of the 1965 Kimber Report, management of a publicly held corporation must, concurrently with giving notice of a shareholders' meeting, send a form of proxy and information circular to each shareholder entitled to receive notice of the meeting.[414] Indeed, the mandatory solicitation by management is the linchpin of the modern proxy rules because the most complete disclosure regulations would not work if management was free to ignore them by not soliciting proxies or by soliciting them only from sufficient friendly shareholders to constitute a quorum.[415] Where management fails to send a required information circular, then a court will nullify the results of the shareholders' meeting.[416] Management is also obliged to give notice of a shareholder's proposal in management's proxy soliciting materials and include a brief statement in support of the proposal if the shareholder supplies such a statement.

Shareholders are accorded certain legal remedies when their rights and benefits are transgressed. They can bring a personal action to enforce their personal rights. As a

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[414] e.g., CBCA s. 143, and BCCA s. 177(1) (2).

[415] See Buckley and Connelly, Corporations: Principles and Policies, supra at 439.

[416] Babic v. Milinkovic (1971), 22 D. L. R. (3d) 732 (B.C.), *aff'd*, (1972), 25 D. L. R. (3d) 752 (C.A.).

member of the company, usually a closely-held one or the one going private, a shareholder can apply under the oppression remedy.[417] When the company is to be changed, the dissenting minority can apply for an appraisal remedy by having their shares bought out by the company at fair value. They may also take a derivative action on the behalf of the company to enforce the rights of the company or to seek redress for wrongs done to the company.

It is still a debatable question as to how effective the foregoing internal corporate governance mechanism is. However, by no means can these arrangements be dispensed. As more emphases are being laid on the need of more independent directors[418] to oversee the corporate officials, and more and more institutional shareholders have emerged, the internal governance model is being strengthened.[419] Instead of incurring drastic changes, such a model creates a process through which shareholders can govern the corporation in an ongoing manner.[420]

External Mechanism: Another major dimension of the corporate governance is the external market mechanisms, among which the most important one is the corporate

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[417] BCCA s. 224 (1), CBCA s. 234 (1). CBCA's scope of oppression remedy is more broader than that of BCCA.

[418] e.g. See Eisenberg, The Structure of the Corporation: A Legal Analysis, supra at 170-172; also Robert C. Clark, " Agency Costs Versus Fiduciary Duties" in Pratt and Zeckhauser eds., Principals and Agents: The Structure of Business (Boston, Mass.: Harvard Business School Press, 1985) at 55, 57-58. Further, more and more corporate statutes and securities regulation require that the public company must have certain numbers of independent directors in the board.

[419] See Pound, " The Rise of the Political Model of Corporate Governance and Corporate Control" supra at 1038-1061.

[420] See Pound, " The Rise of the Political Model of Corporate Governance and Corporate Control" supra at 1029-1031.

control transaction, sometimes described as the takeover model.[421] Henry Manne, writing in 1965, captured the sentiment of an entire era when he stated that acquisitions were the most efficient mechanism for overseeing management and correcting inefficiencies in existing corporate policies. By mid-1980s, economists and other free-market adherents further argued that takeovers vector-dominated other forms of oversight.[422]

The basic theory behind these proponents of the take-over model is the Efficient Capital Market Theory, which holds that, it is very unlikely that price and "value" of stock will diverge in large capital markets. If there was such divergence, investors could reap substantial gains by identifying and buying underpriced shares and selling overpriced shares. Since there are many sophisticated investors with ample capital, the arbitrage process would proceed quite quickly, and it would become impossible to make systematic gains by finding underpriced shares. Such a theory is commonly referred to as the Efficient Capital Market Hypothesis.

Nevertheless, though it is difficult to gain by finding underpriced stock due to the efficiency of the capital market, it is possible to identify the poorly managed corporations. If a company is not well managed, this will be reflected in its stock price. The only acquirors of the stock who would be willing to purchase the stock at substantial premium would be those who believe that their more efficient management skills can put the assets of the target corporation to more profitable and efficient use. Thus, according to Easterbrook and Fischel, tender offers are a method of monitoring the work of

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[421] See pound, "The Rise of the Political Model of Corporate Governance and Corporate Control" supra at 1018.

[422] Ibid.

management teams. Prospective bidders monitor the performance of managerial teams by comparing a corporation's potential value with its value as reflected by share prices under current management. When the difference between the market price of a firm's shares and the price those shares might have under different circumstances becomes too great, an outsider can profit by buying the firm and improving its management. In this process all parties benefit. The target's shareholders gain because they receive a premium over the market price. The bidder obtains the difference between the new value of the firm and payment to the old shareholders. Nontendering shareholders receive part of the appreciation in the price of the shares. What is more, shareholders benefit even if their corporation never is the subject of a tender offer. The process of monitoring by outsiders poses a continuous threat of takeover if performance lags. Consequently, managers will attempt to reduce agency costs in order to reduce the chance of takeover, thus greatly narrowing the divergence of interests between shareholders and management.[423]

Indeed, it has been well recognized that the capital market itself may provide the necessary information to the shareholders as the corporate performance will be reflected in the share price. The takeovers further spur a thriving market for information and research on corporate policy, which greatly diminishes the information costs of shareholders' monitoring. Takeovers are efficient also because they eschew cumbersome and bureaucratic "process" associated with traditional voting-based challenges. They dispense with the need for formal and time-consuming solicitation, and are remarkably simple and direct. Unlike the proxy contest, shareholders are not asked to evaluate complex

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[423] See Easterbrook and Fischel, "The Proper Role of A Target's Management in Responding to A Tender Offer" (1981) 94 Harv. L. Rev. 1161.

alternative business plans for the company. Instead, they need only to assess who is offering a higher value for their shares. Proponents of the takeover have also argued that by transferring assets to new owners, acquisitions facilitate quick shifts in policy with least costs.[424]

The theories of the proponents of the takeover model do not go without being seriously challenged. Their theoretical foundation, the Efficient Capital Market Hypothesis, is regarded as an unproved assumption at best.[425] Pound, for one, argues that takeovers carry political and economic costs that were under-appreciated throughout the 1980s.[426] Takeover bids are costly to mount. The information with respect to management misbehaviour may not be public.[427] At the same time, since most of the large public corporations have adopted numerous defences to deter the potential takeovers mainly with a view to entrench the incumbent management, the effect of the takeover model may not be as great as some authors have expected.

Nevertheless, there is little doubt that the takeover and other market forces are organic components of the modern corporate governance. The free flow of stock information, the existence of a competitive manager market, and above all a potential of

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[424] Various arguments are cited in Pound, "The Rise of the Political Model of Corporate Governance and Corporate Control" supra at 1018-1020.

[425] See W. Harrington, "If It Ain't Broke, Don't Fix It: The Legal Propriety of Defences against Hostile Takeover Bids" (1938) 34 Syr.L.Rev. 977 at 1008. Also see M. Lipton, "Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel" in Leo Herzel, ed., Fiduciary Problem in Acquisition and Takeovers (New York: Practising Law Institute, 1981).

[426] For a detailed analysis, see Pound, "The Rise of the Political Model of Corporate Governance and Corporate Control" supra at 1020-1027.

[427] See Buckley and Connelly, Corporations: Principles and Policies, supra at 493.

takeover bids are not only powerful monitoring mechanisms, but also cheap, quick and efficient ones. Presently, China's capital market is still in its infant stage. Without adequate securities regulations and the government's strong commitment to building a open, fair and efficient stock market, the Chinese capital market is frequently intervened by various government agencies, the government-affiliated brokerage firms and other financial institutions often corner the market and violate the trading rules,[428] and public investors are hardly protected. However, if a share ownership system with most of the shares being distributed to the private enterprises and individuals is to be established in China as I have argued earlier, an efficient, open and fair capital market is indispensable. It is essential to an effective corporate governance under the principle of separation of ownership and control, as well as the efficient flow and distribution of capital.

Liability Principle: Under the corporate law doctrine, officers and directors are held to be in a fiduciary relation with the company, and thus owe it the fiduciary duties. For example, CBCA s. 122(1) and BCCA s.142(1) require every director and officer of a company in exercising his or her powers and discharging his or her duties shall act honestly and in good faith with a view to the best interests of the company, and also exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

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[428] e.g., not long ago, Shanghai International Securities Co., then the largest one in China, caused a crisis in Shanghai's future bond market by violating the margin rule and engaging in collusive market practice with other security firms. Finally, the Chairman and CEO of Shanghai Int'l Securities was arrested, and the firm was merged with another securities brokerage firm.

The reason why corporate law resorts to fiduciary liability instead of the well-articulated contractual liabilities[429] to govern the relation between the management and owners is the incompleteness of corporate contract.[430] As Easterbrook and Fischel point out, "[f]iduciary principles are uncommon in contractual relations. Parties dealing at arm's length may bargain hard and enforce their deals to the letter, no matter how severe the consequences for the other side."[431] Rather, the fiduciary principle is an alternative to elaborate promises and extra monitoring. Since it is costly, implausible, and impossible to write a detailed ex ante contract to control the divergence of interests between the owners and managers, the open-ended fiduciary duties are applied to fill in the contractual gap. Macey states that "fiduciary duties exist because the decisions that face officers and directors of corporations are sufficiently complex and difficult to predict that it would not be feasible to specify in advance how to respond to a wide range of future contingencies. Fiduciary duties are the mechanism invented by the legal system for filling in the unspecified terms of shareholders' contingent contracts."[432]

As a rule, the fiduciary duties of directors and officers are composed of two wings: the duties of loyalty and good faith and the duties of care and skill. Unlike other kinds of

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[429] It is common for the owners to have "some pure contractual liability arrangements" with the management regarding to the risk-sharing, compensation, and other liabilities to partly deal with the agency problems. But as I have shown before, such arrangements are not only costly, but ineffective. Thus, those liability strategies will not be discussed as a part of general corporate governance mechanisms.

[430] See Hart, "An Economist's View of Fiduciary Duty" supra; also Easterbrook and Fischel, Economic Structure of Corporate Law, supra at 90-93.

[431] See Easterbrook and Fischel, Economic Structure of Corporate Law, supra at 90.

[432] See Jonathan Macey, "An Economic Analysis of the Various Rationales for Making Shareholders the exclusive Beneficiaries of Corporate Fiduciary Duties" (1991) 21 Stetson L.Rev. 23 at 28.

fiduciary relationships, the corporate duties of loyalty and good faith are exceptionally strict, and the corporate duties of care, skill and diligence exceptionally lax.[433] Indeed, as long as the directors and officers act in good faith and for the best interests of the company, court is generally reluctant to interfere with or second-guess their business decisions. For instance, in Re Brazillian Rubber Plantations and Estates, Ltd.,[434] it was held that "so long as they act honestly they cannot be made responsible in damages unless guilty of gross negligence.... A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience." In the United States, courts adopt a more systematic approach to the fiduciary duties of directors and officers, commonly known as "the business judgement rule."[435] Accordingly, the U.S. court will not interfere in the management of a corporation in the absence of an allegation that the directors' actions have been tainted with fraud, illegality or conflict of interest.[436]

Seemingly, such a bifurcation of the fiduciary principle and the adoption of the business judgment rule may create the impression of leaving too much room for directors and officers to manoeuvre, and thus hardly be able to control the agency problems.

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[433] See Gower, Gower's Principles of Modern Corporation Law, 5th ed. (London: Sweet & Maxwell, 1992) at 589.

[434] (1911) 1 CH. 425 (C.A.)

[435] Canadian case law is less coherent in this respect. It adopts "the proper purpose test," (e.g. Howard Smith v. Ampol Petroleum (1974)) and "the best interest test" (e.g. Teck Corp. Ltd. v. Millar (1973)) to deal with the fiduciary duties of the directors and officers. But some literature shows that tendency is close to the business judgment rule as witnessed in Teck.

[436] Shelensky v. Wrigley, 237 N. E. 2d 776 (1968), Appellate Court of Illinois, 1st district.

However, underneath these rules lie the economic rationales.[437] According to Easterbrook and Fischel, a satisfactory explanation for the distinction between the duty of care and duty of loyalty may be found in the differential payoffs from breach and policing. Duty-of-loyalty problems often involve spectacular, one-shot appropriations, in which subsequent penalties through markets are inadequate. Thus the duty of loyalty supplements market penalties for breach in those situations where the market penalties themselves might be insufficient. It is also easier for courts to detect appropriation, so the costs of inquiry and error are lower.[438] As to the duty of care, courts are however less well suited to detecting and rectifying shortcomings in the boardroom.[439] It is precisely because of the transaction costs concerning the ex post judging and relative attitude toward risk that owners resort to the market penalties instead of strict liabilities to control the business decisions and performance of the directors and officers.

The current corporate governing practice and theories are still very much in flux.[440] More attempts must be made to tackle the agency problem of the modern corporations. However, the corporate governance mechanisms as I have defined above is essential to transforming the management system of the Chinese state-owned enterprises into a

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[437] For some detailed analysis, see Robert Cooter and Bradley Freedman, "The Fiduciary Relationship: Its Economic Character and Legal Consequences" (1991) 66 N.Y.U.L.Rev. 1045; also see Easterbrook and Fischel, Economic Structure of Corporate Law, supra at 93-103.

[438] See Easterbrook and Fischel, Economic Structure of Corporate Law, supra at 103.

[439] See Easterbrook and Fischel, Economic Structure of Corporate Law, supra at 98.

[440] e.g., heated discussions and disputes exist on various issues regarding the corporate social liability, the fiduciary duties toward other constituencies besides the shareholders, and the comparative advantages of different governance models.

modern corporate governance under a private share ownership system. The current governance structure under the China's new Company Law is flawed, not simply because it has not entirely copied the Western corporate rules, but because the dominance of state ownership is still religiously maintained as a fundamental principle. Examined from the ownership and control perspective, there are irreconcilable contradictions between the dominant position of the state and a modern corporate system. Instead, the state should relinquish its shares to the public. In this sense, the establishment of the share ownership through securitisation is an important and viable step in the reform of the state-owned enterprises. But to build a modern enterprise system through corporatisation calls for the further effort to a complete privatisation of Chinese economy.

Conclusion

Having analyzed the whole process of the Chinese state-owned enterprise reform, this study draws unequivocally the conclusion that extensive privatisation is called for to complete China's transition to a market economy. In summarising the "Chinese privatisation model" Cao specifically states:

> While "better" privatisation is obviously called for, should the government opt for more privatisation? The answer to this question depends on the following fundamental factors: (1) what will more privatisation achieve, or what does the government hope to achieve with more privatisation; (2) whether the purpose can be accomplished by means other than more privatisation; and (3) what the costs of more privatisation may be and whether they are palatable to the Chinese government.[441]

Following the line of the theories of the firm in law and economics such as transaction cost economics, property rights theory, and nexus-of-contracts theory, this study has established that enormous transaction costs still exist in a mixed economy, and the most crucial one is the agency costs underlying in the special relation of state ownership and enterprise management. These transaction costs have greatly hampered the progress of the Chinese economy, and threaten its further growth. As the fundamental source of such costs is nothing but the state ownership of enterprise due to its intrinsic incompatibility with a free market economy, the only solution is the privatisation of the state-owned enterprise.

To be sure, the property rights arrangements have undergone profound changes after more than a decade's reform, and the Chinese authorities have undertaken some measures

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[441] See Cao, " The Cat that Catches Mice: China's Challenge to the Dominant Privatisation Model" supra at 170.

to directly deal with the problems of the state ownership of enterprise. While the proposal of the enterprise's operating rights, the CMRS, and the securitisation and corporatisation of state enterprises have failed to clarify the property rights relation of the state-owned enterprise, they have, however, totally transformed the landscape of its property rights arrangement, and set the stage for future privatisation.

With a socialist market economy pronounced as its goal, the Chinese economic reform has got more momentum since entering into the 1990s. Among other things, the objectives to modernise enterprise incentive and governance systems and diversify corporate ownership have been on the top agenda of the Chinese government. More and more evidence has indicated that there are irreconcilable contradictions between the optimal incentive and governance systems and the state ownership. Hence, in order to modernise the state-owned enterprises, the first and foremost step should be relinquish the state ownership, which, as this study has suggested earlier, could be effectively accomplished through the dispersal of the state shares into the private hands. Ironically, four decades ago, the Chinese government resorted to such measures as compulsorily purchasing (not confiscating) the shares from capitalists with greatly discounted prices to successfully complete the so-called "industrial reform." Now selling shares to the public may prove to be an effective way to transit to a market economy.

Yet the Chinese government still publicly denounces the proposition to privatise the state-owned enterprise, and sticks to the partial reform measures. The political implications of a private economy have been so forcefully demonstrated by the experience of the Eastern European countries and former Soviet Union that it is hardly disputed that an extensive privatisation will bring about profound political transformation. In China,

several student movements, in particular the 1989 Tiananmen Event, have also given the regime the foretaste of the political liberalisation that comes with economic reform. Therefore, it needs strong political will, self-confidence, and proper organisational preparation for the Chinese authorities to make the privatisation move. On the other hand, the economic chaos and social dislocation resulting from the "big bang" and "shock therapy" in the former Soviet-bloc countries may also thwart more radical economic policies to be adopted in China. Indeed, many commentators who favour the Chinese reform path draw their decisions more from the contrast of economic performances between China and other former socialist countries than from economic analysis and reasoning. The fundamental problems and intrinsic contradictions are overshadowed by the seemingly successful "Chinese economic miracle."

Unlike the "half-Westernisation" of the Chinese "self-strengthening movement" happened a century ago,[442] the viability and sustainability of the current Chinese partial reform will mainly be tested by the internal forces rather than the external powers. The deceiving rationality of the "half-Westernisation", although so eloquently argued then by the eminent self-strengthenists, was soon smashed by the gunfire of Japan, France, and other Western countries. Otherwise, the partial reform without extensive privatisation may last until the moment when the economic and political pressures generated by the irrational property relations and huge transaction costs under the mixed economy are shaking the foundation of the regime. Fortunately, more and more signs of such pressures have

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[442] For a brief introduction of the "self-strengthening movement" and the "half-Westernisation" of China, see John King Fairbank, The United States and China, 4th ed. (Cambridge, Mass.: Harvard University Press, 1983) at 196-205. A more detail description can be seen in Jonathan D. Spence, The Search for Modern China (New York and London: W. W. Norton, 1990) at 216-230.

appeared in the 1990s. With high percentage of state enterprises reportedly in red and whole economy dragged by their huge losses, the Chinese government has earmarked state sector reform as the number one priority. However, since the only way for the state-owned enterprise to get out of the dilemma is to "go to private," an extensive privatisation is clearly in order.

The privatisation of the state-owned enterprise is a "seamless web," which will cause changes in almost all aspects of society. Among all the changes, the legal system reform occupies the most important position. Not only is the law essential to defining the property rights, but also it assumes the critical role to protect the private property and related transactional arrangements. Without the certainty and assurance provided by the law, the sheer difference between the private and public property rights is meaningless in practice. For example, the effectiveness of the operating rights of the state-owned enterprise, an important initiative of the Chinese economic reform, has been greatly impaired by frequent illegal infringement and the lax legal protection afforded to them. The notorious "triangular debts" existing among state enterprises are so extensive and deep-rooted that a central government-orchestrated action has failed to clean the mess.[443] They have rendered the operating rights and hard budget restraints nearly useless.

Furthermore, law is also indispensable in building up a share ownership and modern corporate governance systems. The protection of shareholders, the maintenance of the

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[443] In the early 1990s, China's Vice Premier Zhu Rongji, commonly known as China's economic tsar, determined to clean the long-existing "triangular debts." And under his supervision a nation-scaled action was taken for the purpose. But since the problem was too extensive and deep-rooted to solve without fundamental changes, the notional action caused a grave backlash, and was stopped within a short time span.

integrity of the capital market, and the delineation of rights and duties of various corporate actors all need appropriate legal rules. In this regard, simply imitating the Western legislation is not enough. Rather, the underlying principles must be incorporated into the Chinese legal system. Certain legal institutions and procedures ought to be adjusted accordingly.

Although the Chinese legal reform has achieved some accomplishments in legislation and institution-building,[444] they amount only to a first step in what promises to be a very long journey. At present, due to institutional, cultural, and political limitations, the rule of law still seems to be a remote target.[445] However, as the rule of law is one of the most important prerequisites to a private economy, the greater efforts must be taken in the legal front. On the other hand, the further privatisation of the state-owned enterprise will undoubtedly accelerate the pace of the Chinese legal reform.

All roads lead to Rome. The transitional nations, China and other former socialist countries alike, are destined to a Western-type economy with dominant private property rights. Because of its special social-economic conditions, China has embarked on a different reform path, which leads to a mixed economy instead of a free market economy. To complete its transition to a market economy, China however must adopted the policy of a wholesale privatisation, more specifically, the privatisation of the state-owned enterprise.

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[444] See supra text at 16-20; also, for a good summary and analysis of the Chinese legal reform and its future, see Stanley Lubman, " Introduction: The Future of Chinese Law" (1995) 141 China Quarterly 1 at 1-21.

[445] See Lubman, "Introduction: The Future of Chinese Law" supra at 21.

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