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Laixiang Sun
International Institute for Applied Systems Analysis, Laxenburg, Austria

RP-07-011
December 2007

Reprinted from *Exit the Dragon? Privatization and State Control in China*. Edited by Stephen Green and Guy S. Liu. Chapter 5. Chatham House/Blackwell Publishing, Oxford, UK

International Institute for Applied Systems Analysis • Schlossplatz 1 • A-2361 Laxenburg • Austria
Tel: (+43 2236) 807 • Fax: (+43 2236) 71313 • E-mail: publications@iiasa.ac.at • Web: www.iiasa.ac.at

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Exit the Dragon?

Privatization and State Control in China

Edited by
Stephen Green *and*
Guy S. Liu

CHATHAM HOUSE

Blackwell
Publishing

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Ownership reform in China's township and village enterprises

Sun Laixiang

The rise of China's rural enterprises, and especially township and village enterprises (TVEs), has been one of the most striking features of the country's economic development since the late 1970s. By 1995, industrial TVEs had overtaken state-owned enterprises (SOEs) in terms of the total value of their production and thus had become the largest single contributor to China's industrial production. During 1995–2000, they produced over 30% of the national totals of industrial value-added, profits and output. Despite the decline in their relative position since 1996, in 2001 TVEs across the non-agricultural sector accounted for 11.5% of China's gross domestic product.[1]

Before recent ownership reforms, a typical TVE could best be characterized as a community enterprise controlled by its local government, the control being mainly in the form of decisions over personnel and key resources.[2] TVEs were either collectively established by rural communities in townships and villages, or closely associated with them. In official statistics in the 1980s and 1990s, rural enterprises were classified into four categories: township-run (*xiangban*), village-run (*cunban*), those owned by a group of households (*lianhu*, mainly partnerships) and those owned by an individual household (*geti*, a sole proprietorship employing less than eight employees). For present purposes, we restrict ourselves to TVE firms in the first two categories.

Although in the recent wave of ownership restructuring, most small TVEs have been sold outright to their managers and/or others, larger TVEs have developed joint ownership structures involving managers, local government, workers and outside investors.[3] Local governments have continued to be involved in the operations of the restructured firms via shares held by local state asset management bureaux and the firm's Communist Party branch. However, the government's role has generally been transformed, from sole owner and supervisor of the firms to major institutional shareholder.

Tables 5.1 and 5.2 show the distribution of ownership forms across all rural enterprises in 2002. Table 5.1 shows ownership among firms in the official, broad definition of the 'collective' TVE sector. Table 5.2 compares those firms to officially defined private firms and household-run firms. Table 5.1 indicates that by year-end 2002 about a half of large TVEs (in terms of the number of firms and employees), and some 60% of firms (in terms of value added and fixed assets) had been restructured. The resulting firms included joint-stock cooperatives, jointly run businesses, limited liability companies, shareholding companies and Sino-overseas joint ventures, in all of which local governments typically had a minority stake or from which they had exited completely. Although about a half of large TVEs remained in the narrowly defined collective category, the definition of this category has been changed to include those firms in which the local government holds a majority stake. Table 5.2 shows how significant the scale of full privatization has been in recent years. Some 40% of firms in the privately owned category are in fact fully privatized small TVEs.[4]

The pattern indicated by the official statistics is supported by several surveys.[5] Table 5.3 summarizes the ownership patterns derived from a census in 43 townships in Jiangsu and Zhejiang Provinces conducted in 2000 by Li Hongbin and Scott Rozelle. During 1993–9, of 390 collective TVEs, 222 (57%) were fully privatized; 82 (21%) were restructured with the township government retaining a minority stake; 31 (8%) were restructured with the township government retaining a majority stake; and 55 (14%) remained under full government ownership (the only change being that many were operating with management responsibility contracts).

Despite the variety of legal forms in the official registrations that restructured TVEs have taken up, they share a number of features in terms of their shareholding structure and control rights allocation. These features are summarized as follows:

(a) In the early years of restructuring, mainly before 1996, managers and employees together owned a majority of the total shares of the firm, and the relative size of their holdings differed because of the size of their cash subscriptions.
(b) Shareholdings have become increasingly concentrated among small groups of senior managers, and management groups have become keener to buy back workers' shares.
(c) The firms are often closely held, meaning that ownership is not freely tradable, although subscribed shares can be transferred within the local community.
(d) Local governments may hold a large number of collective shares in the name of the community's citizens.
(e) In addition to the shares held by firm insiders and local government,

Table 5.1: The distribution of ownership forms in China's TVEs, year-end 2002

Ownership form	*Number of firms*		*Employment*		*Value added*		*Fixed assets (net)*		*Employees per firm*	*Value-added per firm (Rmb 000)*	*Fixed assets per firm (Rmb 000)*
	000s	*Proportion (%)*	*000s*	*Proportion (%)*	*Rmb m*	*Proportion (%)*	*Rmb m*	*Proportion (%)*			
Collective	401	54.86	17,858	46.98	482,146	39.95	526,088	40.91	44.5	1,202	1,312
Joint-stock cooperative	79	10.81	3,648	9.60	131,090	10.86	121,941	9.48	46.2	1,659	1,544
Jointly run firms	29	3.97	715	1.88	24,798	2.05	20,686	1.61	24.7	855	713
Limited liability firms	150	20.52	7,865	20.69	268,307	22.23	272,306	21.18	52.4	1,789	1,815
Shareholding firms	17	2.33	1,429	3.76	60,387	5.00	67,171	5.22	84.1	3,552	3,951
Joint venture firms	55	7.52	6,496	17.09	240,007	19.89	277,764	21.60	118.1	4,364	5,050
Subtotal of collective and partly privatized firms	731	100.00	38,011	100.00	1,206,735	100.00	1,285,956	100.00	52.0	1,651	1,759

Source: *Yearbook of China's Township and Village Enterprises* (2003: 130–31, 420, 422, 424).

Table 5.2: The distribution of ownership forms in China's rural enterprises, year-end 2002

Ownership form	*Number of firms*		*Employment*		*Value added*		*Fixed assets (net)*		*Employees per firm*	*Value-added per firm (Rmb 000)*	*Fixed assets per firm (Rmb 000)*
	000s	*Proportion (%)*	*000s*	*Proportion (%)*	*Rmb m*	*Proportion (%)*	*Rmb m*	*Proportion (%)*			
Collective and partly privatized firms	731	3.43	38,011	28.61	1,206,735	37.26	1,285,956	47.78	52.0	1,651	1,759
Privately owned firms	2,298	10.78	35,022	26.36	881,798	27.23	752,417	27.96	15.2	384	327
Household firms	18,297	85.80	59,843	45.04	1,150,048	35.51	652,854	24.26	3.3	63	36
Total rural firms	21,326	100.00	132,876	100.00	3,238,581	100.00	2,691,227	100.00			

Source: *Yearbook of China's Township and Village Enterprises* (2003: 130–31, 420, 422, 424).

there are usually some (or even a large number of) shares held by outsiders that carry one vote per share (whereas insiders often have greater influence as shareholders).

(f) A representative form of governance (one person, one vote or one share, one vote, a shareholders' meeting and a board of directors) is nominally employed, but in practice the firm's management is in charge.

(g) Lay-offs of employee-shareholders have been common. When they leave the firm, employees may hold on to their shares or may sell them back to the management group.

The performance of restructured TVEs has been outstanding, partly thanks to the capital that was raised by the injection of equity from new shareholders. In provinces such as Zhejiang, Jiangsu and Anhui, leading areas of TVE development, the initial share subscription led to an immediate average reduction of the debt-asset ratio by 10 percentage points. More importantly, it is widely acknowledged that restructuring has played the leading role in maintaining the TVE growth miracle. In 1995–2002, the size of the TVE sector decreased by almost half in terms of the number of firms and employees, thanks to the privatization of small TVEs. However, the value-added created by the sector had an annual real growth rate of 3.7%.[6] This is an impressive achievement.

Why was it that local government-owned TVEs rather than private firms made the biggest contribution to China's economic growth during the first two decades of the reform? A large body of literature has attempted to answer this question. At its core is the insight that local government ownership can be a second-best arrangement when there are few constraints on the government's predatory and rent-seeking behaviour.[7] In other words,

Table 5.3: The equity position of the township government in 2000 after ownership reform and privatization in 1993–9 in township enterprises in 43 townships

Equity position of the township government (TG)	*Number of enterprises*	*Proportion of total (%)*
TG position = 100% (collective)	55	14
50% ≤ TG position < 100% (collective)	31	8
0 < TG position < 50% (restructured)	82	21
TG position = 0 (privately owned)	222	57
Total	390	100

Source: Figures in this table are derived from Table 2 and the corresponding text in Li and Rozelle (2003: 988).

local government ownership acts as a commitment mechanism to limit the government's own rent-seeking activities and to constrain the predatory behaviour of central government. Given this explanation, the recent wave of ownership change raises a number of important questions. What factors have driven this change? Given that the orthodox explanation did not predict change, is it still a useful explanation of the success of the TVE sector? And, finally, what explains the success of the new joint ownership arrangements?

The rest of this chapter is organized as follows. The first section examines the various theoretical explanations put forward for the dominance of local government-owned firms in rural China's industrialization. The second section focuses on the factors that drove the privatization wave of the mid-1990s and explains its major features, particularly the phenomenon of 'privatization with a tail' and the screening functions associated with it. The chapter concludes with a discussion of the importance of 'adaptive efficiency' in the governance and ownership structures of China's TVEs.

THE DOMINANCE OF LOCAL GOVERNMENT OWNERSHIP IN TVE DEVELOPMENT IN THE 1980S

Why did local government ownership dominate private ownership in the industrial boom that took place in rural China in the 1980s? Much research has focused on the underdevelopment of input markets and thus on the important benefits of cooperation between government officials, who control critical inputs, and entrepreneurs, who initiate and manage the firms. These critical inputs include not only material inputs such as land, electricity and key materials but also access to bank loans, business licences, official distribution channels and political support. Although state ownership undermines financial incentives and may facilitate administrative interference, much of the literature on China's TVEs argues that the advantages of government ownership outweigh the disadvantages.[8]

A key assumption in this literature is that local governments are benevolent, have incentives to increase local commercial activity and production and are willing to cooperate with entrepreneurs to achieve certain goals. This assumption seems plausible in the context of rural China because local officials are likely to be interested in increasing local fiscal revenue, creating off-farm employment and raising per capita income. A benevolent local government is therefore a credible assumption. However, in a political system with inadequate mechanisms to check and balance the actions of local officials and to hold them accountable, there are also clear incentives for these officials to engage in rent-seeking and corruption. By allowing officials to have control rights over their firms, TVE managers can therefore never be sure about to what extent local officials will interfere. This commitment problem means that the *ex ante* effort level of the managers may be seriously undermined – and if so, the role of local government is clearly counter-productive. Another problem with this literature is that it does not answer the classic question posed by Ronald Coase in his seminal paper 'The Nature of the Firm': why does the boundary of the firm lie where it does?[9] In the TVE context, why cannot the transaction of such critical inputs controlled by officials take place in the market (for example, through bribery) and why does the firm need to grant the local government ownership of the firm?

To answer these problems, Che Jiahua examines the trade-offs involved in TVE ownership choices, assuming rent-seeking by local government officials.[10] By examining these incentive trade-offs in three stages (*ex ante*, interim and *ex post*), Che demonstrates that under certain conditions local government ownership can act as a commitment mechanism to limit the rent-seeking activities of officials. A simplified version of the story is related here. A manager needs to make an effort to initiate an investment project. After the project is initiated, a critical input is required. A government bureau is in charge of the allocation of the input. The bureau is not held accountable for its actions, and may collect a fee in addition to the official price levied for allocating the input. Once this critical input is allocated, the manager makes another effort in order that the project generates revenue. If the firm is privately owned, then after the initial effort is sunk, the government bureau can be expected to charge a fee that equals the manager's net *ex-post* payoff. Anticipating this predatory behaviour, the manager would not initiate the project.

In contrast, if the firm is wholly or partly owned by the local government, then the bureau may be less predatory. The manager would thus be willing to initiate the project, and local government ownership would be beneficial. Che models two aspects of the benefits that accrue to the local government with an ownership stake. First, the government receives a share of the firm's revenues. Second, the bureau can influence the firm's employment policy in order to create additional jobs, which of course undermines the firm's profits. The local government receives benefits from three sources: the fee linked to the allocation of the input, the share of the firm's revenue and the political benefits associated with excess employment. Che then models two types of government bureau – one 'pro-business' and the other 'pro-politics', depending on how much importance the bureau places on the over-staffing. This importance is the bureau's private information and is not disclosed to the firms.

The fee charged for allocating the key input can signal the type of bureau – 'pro-politics' or 'pro-business'. A 'pro-business' bureau has incentives to charge a low fee and to force the firm to hire fewer numbers of excess workers. Such actions signal to the firm's manager that the bureau is 'pro-business', and as a consequence the manager will have a greater incentive to invest more effort in production. In contrast, in a separate equilibrium, a 'pro-politics' bureau will fully exploit its bargaining power and charge a fee equal to the manager's net *ex post* payoff. A 'pro-business' bureau will signal its orientation by charging less than the manager's *ex post* payoff; and, anticipating that, as on average the project will bring positive benefits to the manager, he/she will have an *ex ante* incentive to initiate the project. In summary, this analysis suggests that local government ownership creates incentives for the government to limit its rent-seeking activities and even to support the firms it owns. In contrast, local government will have no incentives to limit its predation on private firms, and so, in this context, government-owned firms will perform better.

In an authoritarian political system, the central government can also operate as a rent-seeker and predator on the non-state sector. Can local government ownership also act to limit predatory behaviour on the part of the central government? Che Jiahua and Qian Yingyi develop a theory in an attempt to answer this question.[11] In an environment lacking secure property rights and in which firms are vulnerable to rent-seeking activities by officials, private ownership of firms leads to the hiding of revenues. At the same time, firms' ownership by the central government fails to provide credible performance incentives for both managers and local governments. In contrast, local government ownership integrates the normal government activities of providing local public goods and the commercial function of the controlling firm, both of which serve the interests of the national government. Local governments are more likely to invest revenue from their firms in local public goods than are private entrepreneurs because local governments have a credible expectation of capturing future revenues. Such investments also benefit the central government. Given this, the central government will be less likely to prey on local government-owned TVEs than on private enterprises. This in turn means that local governments will be less worried about revenue confiscation, and the extent of hiding of revenue by TVEs is also reduced. In summary, the ownership of firms by local government not only benefits both local and central government but can also result in greater provision of public goods.

How will TVE ownership structures evolve as market reforms mature? Both strands of literature surveyed above – that which views government as predominantly predatory and that which sees government as predominantly benevolent – suggest that a gradual exit of local government from ownership will occur as markets for inputs develop, as the licence-granting powers of government decline, and as regulation is increasingly characterized by transparency, predictability and uniformity. All these factors weaken the ability of local government to support its own firms. However, until markets for the key inputs of land and bank finance develop, and until transparent regulation and the rule of law are established, the advantages of local government ownership are assumed still to outweigh the disadvantages. Given this, one would expect continued government ownership of TVEs until these conditions are met. But even if these conditions are met, local governments will still lack incentives to give up their control rights voluntarily.

It is surprising, therefore, to find that local government ownership has faded away before significant marketization of land and bank financing has taken place and, indeed, before the significant presence of the rule of law in areas such as licensing and regulation. Even more interestingly, TVE ownership reform has been initiated and led largely by local government. The next section examines why local governments have voluntarily given up important control rights over TVEs.

EXPLAINING THE CHANGE IN TVE OWNERSHIP

Two sets of factors have led to the shift in ownership patterns: 'supply-side' factors arising from within the economy and 'demand-side' factors emerging from wider society. The former are probably more important in triggering the reforms, as they have provided incentives for action by the major players, while demand-side factors have provided a supportive environment. The two incentives for the players are the desire of managers to recapitalize their firms and their desire to attract and retain skilled staff through employee share ownership. On the other side, there is evidence of a breakdown in the mechanism that allowed TVEs to function and prosper in the 1980s.

The desire for recapitalization

By year-end 1995, township-run TVEs had the highest average debt-asset ratio (68%) among enterprise types. Industrial SOEs had the second highest (66%), with village-run TVEs in third place (55%). Debt-asset ratios among private firms were low: 35% for joint-household firms and 25% for individual household firms.[12] Industrial SOEs tend to operate in more capital-intensive industries, and have received more equity investment from the state, making a direct comparison with TVEs unfair. However, these figures do show that both industrial SOEs and township-run TVEs were highly leveraged in 1995, while village-run TVEs were also building up high levels of debt.

Comparable time-series data on debt–asset ratios are not available at the national level. However, we do have an illustration at the prefecture level, in Suzhou City, Jiangsu province. TVEs in Suzhou can be regarded as representative of the well-known 'Southern Jiangsu model', in which rural firms have retained the original community ownership form until recently. In 1994, TVEs in Suzhou had an average debt–asset ratio of 61.9%, similar to the national average of 62.8% in 1995. In 1980–85, TVEs in Suzhou tended to have healthy debt structures (with debt–equity ratios varying between 37% and 51%). However, their debt increased rapidly in the late 1980s, exceeding an average of 60% by 1992.[13] Sun (1999) compared debt–asset ratios and performance for 111 township-run TVEs in southern Jiangsu in 1995. He found a significant positive correlation between the proportion of loss-making firms in each group of firms with a similar debt–asset ratio and the group's debt–asset ratio, indicating that TVEs with high debt–asset ratios not only had to cope with higher levels of debt servicing but also had a greater risk of business failure.

Press reports and official documents also indicate that TVEs took on greater debt in the late 1980s, and this remained at unhealthy levels into the early 1990s. There appear to have been two reasons for this. First, the entry of foreign-invested and private firms as well as more TVEs into markets previously monopolized by TVEs led to increased competition and an erosion of the exceptional profits of the early years. The ratio of post-tax profits over assets for TVEs decreased from more than 30% in the early 1980s to about 7.5% in 1995 and 1996.[14] Declining profitability forced TVEs to depend on greater amounts of debt financing. Second, and more importantly, following the rapid expansion of corporate groups of TVEs, the ability of local government (the *de facto* headquarters of the TVE group) to cross-subsidize its individual TVEs and to guarantee bank loans for them increased. This made it more feasible for TVEs to rely on debt financing. At the same time, information asymmetry problems between local government officials and TVE managers were increasing owing to the rapid expansion of community TVE conglomerates and the accompanying increase in bureaucracy. As a consequence, individual TVEs took advantage of the opportunity to exploit what was in effect a softening budget constraint and borrow more, with managers choosing higher-risk projects but reducing their effort to maximize firms' worth.[15]

The problem was that local governments themselves faced hard budget constraints, and the debt-maximizing behaviour of individual TVEs undermined local governments' budgets. In order to escape these liabilities (and to recapitalize the firms) the local governments that owned many highly leveraged TVEs had strong incentives to initiate ownership reforms. Before ownership reforms, profitable TVEs would be expected to lend funds to TVEs with a poorer performance. The opportunity cost of such lending is high because the likelihood of repayment is low and the lenders themselves are likely to use the money more efficiently. In this sense, profitable TVEs are losers *ex post* under government ownership. *Ex ante*, if there is a high probability that a TVE will be profitable, then the perceived value of the cross-subsidy will be negative.[16] Therefore managers in profitable TVEs will have strong incentives to seek more autonomy, to improve the asset structure of their firms and to strengthen their competitive edge through ownership reform. For the managers of loss-making TVEs, the incentives to push for ownership reform are different but also clear. Although they can benefit from the subsidies and loans provided by local government, they also face the pressures of declining reputation and being blamed for undermining local government finances and the threat of liquidation. Of course, once the firm is closed down, both managers and workers will lose their non-agricultural jobs, sources of both income and higher social status. However, if the firm continues in business, compensation for managers and workers will still be limited because of the firm's poor performance and debt burden. Therefore, managers in loss-making TVEs too have clear incentives to avoid bankruptcy and to increase their equity capital through ownership reform.

The terms and conditions of ownership reforms are typically set by local governments and TVE managers. Employee stock ownership has played a prominent role in the reform of larger TVEs, thanks to the need to raise larger amounts of capital and to bolster support among insiders for reform. There are two main reasons why workers would support employee stock ownership. There should be general support among all workers for the scheme, whether they become owners of shares or not, as the increase in the equity capital of their firm boosts overall job security and should result in higher wages as well as more secure social welfare provision. In addition, support should of course come from the new employee shareholders, especially as the paid subscription of shares is often immediately rewarded by the distribution of 'matching shares' (*peigu*), distributed free of charge on a one-to-one or two-to-one basis with the purchased shares. Together these shares generate future dividends for their owners, and can be traded within the local community and in some cases outside it too. Moreover, these shares bring the TVE workers partial control rights over the firm. As a result, TVE workers who have the right to subscribe to shares are usually strong supporters of employee stock ownership.[17] However, it is important to note that around a half of TVE workers, usually temporary workers from other areas, do not have the right to subscribe to TVE shares and therefore tend to feel dissatisfied with such restructuring.[18]

The desire to promote human capital and attract outside investment

To survive in what have become highly competitive product markets, TVEs have had to make a huge effort to overcome the comparative disadvantages associated with their location in underdeveloped rural areas. The two major constraints have been, first, a shortage of professional managers, technicians and skilled workers and, second, a shortage of financial capital in general and equity capital in particular. During the 1980s, TVEs paid highly competitive salaries and bonuses to attract professional managers and skilled workers. However, with increasing labour market competition (and thus higher levels of compensation) and liquidity constraints, greater numbers of TVEs have been unable to retain valuable staff with salaries alone. In such a situation, there are obvious benefits to including shares in the compensation packages of senior managers. Not only does this circumvent the hard liquidity constraint, it also introduces financial incentives for performance, enhances the loyalty of employees and should help to improve relations between management and employees.[19] In this sense, employee stock ownership has generally been regarded as an effective means of promoting human capital development within TVEs.

Incorporation and the distribution of shares for asset injections are also regarded as effective means of clarifying the relationship between local governments and the TVEs they own. This is important for attracting additional equity investment from outsiders. Once government rights over control and cash flows of the TVE are clearly defined as, and limited to, a proportion of a firm's shares, outside equity investors have credible assurance that they will receive returns proportional to their investment and that they will enjoy control rights proportional to their shares. Outside equity investment both helps to alleviate a shortage of capital and to 'open up' the governance of the firm. Too often TVEs have failed to grasp new growth opportunities or they have failed adjust to changes in the market place or to new technologies because their leadership has been too insular and they have lacked access to knowledgeable outsiders.[20] The knowledge of outsiders is a valuable thing in a rapidly changing economy, a factor that has probably contributed to the increasing popularity of stock ownership in the TVE sector.

The degeneration of the TVE 'mechanism'

'Mechanism degeneration' (*jizhi tuihua*) refers to the phenomenon of increased rent-seeking behaviour and increased bureaucratic interference in the firm by local governments in areas with successful TVEs. In other words, these local governments are moving from providing a 'helping hand' to undermining their enterprises with a 'grabbing hand'. This phenomenon is, of course, not new and has been observed in many areas, even in the second half of the 1980s.[21] Increasing levels of public attention to this issue since the early 1990s, however, may well indicate that the public is becoming less tolerant of government predation and bureaucracy.[22] This shift in climate may have contributed greatly to the appeal of phasing out local government ownership.

Local governments are not pure economic actors – they pursue multiple social, political and economic objectives. Even assuming a benevolent local government, its ownership of commercial firms creates several potential conflicts of interest. Although at the initial stages of growth the interests of the two sides (government and firm) are roughly compatible, their interests diverge as the firm matures.[23] Local governments tend to give priority to maximizing employment, and to boosting local growth and financial revenue. In contrast, the managers of TVEs are most interested in firm-level efficiency and net profits. It is therefore possible that local officials will try to impose operational limits on their TVEs and thus hinder their long-term development. In some locales, officials have also shifted social responsibilities onto individual firms, and, as a result, many firms have become overstaffed and been financially drained by their social welfare burden. In such circumstances, managers have strong incentives for escaping local government control.[24] Another issue is, of course, rent-seeking on the part of local officials. Many successful TVEs have become 'purses' for their local governments, required to pay various sorts of expense for the government and its officials. In addition, many TVE managers, in collusion with government officials, have stripped firms' assets for their own use.[25]

A second set of problems is related to corruption and the problem of who monitors the monitors. Although there is some supervision by county-level government, as discussed by Che and Qian, this monitoring is limited in scope owing to problems with the incentives of officials and the information available to them.[26] Local officials are monitored and constrained only by local Communist Party branches, and this may well be inadequate because for most officials at grassroots level, there is only a small probability that they will be promoted. Indeed, compared with the economic and social rents they might enjoy from preying on local TVEs, the benefits of recruitment to the status of a low-ranking bureaucrat are not great. In addition, monitoring at the county-village level is further undermined by communication difficulties in rural areas as well as by the fact that there are usually a large number of TVEs in a single county.[27] To solve the problem of monitoring management, joint-stock ownership (including employee stock ownership) has clear advantages, as it creates clear owners with an interest in the firm performing well.

TVE OWNERSHIP REFORM: FROM GOVERNMENT TO THE PRIVATE SECTOR

Since the mid-1990s, China's rural enterprises have quietly experienced a surge of ownership reforms. More than 800,000 TVEs had been fully privatized and more than 330,000 had been partly privatized by year-end 2002.[28] In terms of numbers of firms, this amounts to many times more than the total number of privatizations in the rest of the world during the entire 1990s. In addition to its magnitude, two other features of this privatization trend are worth noting. First, the most common form of ownership reform is insider privatization. Township and village governments almost always sell the majority of shares of their TVEs to insiders, specifically to the managers of the firm involved.[29] In contrast, the most popular privatization method in most other parts of the world has been to sell controlling stakes to groups of outsiders.[30] Second, insider privatization generally failed to improve performance in Russia, and in central and east European countries, but even in the case of a change to sole proprietorship, large numbers (though not all) of China's TVEs have experienced improved performances.[31] As a result, the overall performance of the sector has been outstanding. To understand why this has occurred, it is useful to look at the kinds of contractual mechanism that have been used to facilitate insider privatization.

The first step in the privatization process is an assessment of the value of a firm's net assets. An evaluation team, usually organized by the local government, typically make the assessment based on the firm's book value. Once the firm's net asset value (NAV) has been determined, the second step is taken of setting a price. In some areas, auctions are employed to help the government to get the best deal. These sometimes take place at local property rights transactions centres. However, as government officials are often unwilling to sell enterprises to outsiders whose ability and background are unknown, the backgrounds of all bidders tend to be checked. In practice, only insiders and the close relatives or friends of insiders are successful buyers, even if outsiders' bids are higher. In many areas, the sale is determined by negotiations between government officials and the firm's managers. The negotiations over price start with the firm's NAV and work towards a consensus on the premium to be paid based on assumptions about the future profitability of the firm.

Although this procedure does not vary much within and across regions, buy-out prices vary widely even within townships. Prices also show only a weak correlation with official NAVs. Li and Rozelle report that, among 88 TVEs privatized in 1994–7 in Jiangsu and Zhejiang provinces, 20 were sold to managers at a price higher than the NAV.[32] However, another 21 firms were sold at a very low price (or even changed hands for nothing), despite the fact that their NAV was on average 2.5 times greater than that of the 20 firms. Seven firms had a negative NAV, but on average the new owners still paid Rmb200,000 ($24,000) for them. This indicates that in 31% of the sample (27 firms), the buyers paid a price exceeding the best *ex ante* estimates of the firm's NAV.

Analysis by Li and Rozelle (2001) indicates as well that the normalized buy-out price (the premium paid on top of the NAV divided by the NAV) decreases with the degree of information asymmetry between insiders and local government. They find too that the post-privatization performance of a firm is positively correlated with the normalized buy-out price. Their research suggests that not all firms have improved their performance equally. Those whose buyers paid a premium on top of the NAV have achieved performance levels similar to private firms in terms of accounts receivable, value-added per worker and the manager's working hours. The performance of the firms which were sold at heavily discounted prices is indistinguishable from that of government-controlled firms. The performance of firms sold at a moderate discount falls between the two. These differences in post-sale performance are very likely the result of the different incentives provided to the new owners in the form of the different contractual terms of the privatization.

'PRIVATIZATION WITH A TAIL' AS A SCREENING MECHANISM

One of the biggest constraints on insider privatization in transition economies is the lack of a mechanism to determine a reasonable buy-out price. The government officials in charge of privatization typically do not have any accurate means of assessing how valuable a firm will become after control has been transferred to its management. Although the manager possesses insider information about the firm's profit potential, officials cannot rely on his valuation because there are substantial incentives on his part for understating the firm's value. It is also difficult to rely on the assessment of a third party as even basic accounting standards and practices tend to be underdeveloped in transition economies. Without any mechanism to reveal the firm's true value, officials often have to accept the price offered by the manager, usually resulting in the manager gaining a large windfall rent. This rent often undermines the incentives of the manager because if the firm is doing too well relative to the buy-out price, government officials are likely to ask for additional payments. In some extreme cases, a reversal of the privatization may actually take place because of popular disapproval of what are perceived as corrupt sales, as has been observed in Russia.[33]

These constraints on information can partly be overcome by a 'screening contract'.[34] Such a contract typically has two parts: a buy-out price and a contingent payment due to the seller, the local government, in the form of a claim on the firm's future profits. The final contract is one in which the manager(s) pays a high price to acquire the firm completely and retain all or most of its future profits or it is one in which the manager(s) pays a lower price and must share any future profits with the government seller. The Chinese aphorism 'privatization with a tail' (*gaizhi liuweiba*) refers to this phenomenon of the local government claiming part of the firm's future profits if it is sold at a heavily discounted price. This appears to be a widely occurring phenomenon in China, concentrated in Jiangsu and Zhejiang provinces. Such a screening mechanism helps officials to elicit information from managers about the value of their firms. Good managers (or managers of high-quality firms) will choose high buy-out prices as they know that they can make substantial profits after sale and are therefore willing to pay a high price for a contract which grants them control of the firm's future profits. In contrast, poor managers (or managers of low-quality firms) will choose low buy-out prices as they do not expect to make high profits and understand that they will have to share any that they do make with the government.

The benefit of this screening mechanism is that it makes it possible for local governments to elicit important information about the value of the firm before the buy-out – as well as providing incentives to those managers who pay high prices to invest effort in their firm. The reverse side of the story is that the contract terms accepted by poor managers (or managers of low-quality firms) provide only weak incentives, and this in turn may lead their firms to underperform after privatization. The empirical findings tend to support this prediction.[35]

REMAINING CHALLENGES TO TVE DEVELOPMENT

TVE ownership reform in general, and the emergence of insider stock ownership in particular, have been effective in boosting the capital resources of TVEs as well as providing some protection from government predation; but these reforms are still ongoing, and they are uneven across the country. Large numbers of TVEs with diverse ownership and control structures have registered themselves as employee shareholding cooperatives, indicating that this term itself is now vague and varied in use. Another problem has been that government influence remains in many areas. Reports indicate that in some places 'privatization' is a transfer in name only for one-third of formally privatized TVEs.[36] As Samuel Ho et al. reveal, in Wujin county, Jiangsu province, more than 70% of restructured TVEs were registered as 'employee shareholding cooperatives' in 1999 and 2000, but in fact only 30% of these firms had some actual resemblance to a cooperative, with shares held by both employees and local government. Another problem has been the uneven development of political institutions at the grassroots level. This has hindered the healthy evolution of joint-ownership forms and the orderly phasing out of government ownership. The problem is often most serious at the village level, where powerful village heads (often the Party secretary) transfer the best collective assets to their private ownership.

There are several other factors related to the development of China's rural economy that have constrained the development of TVEs. It is worth noting three of them. The first is that in general the quality of management in rural areas tends to be low. Managers are typically from the local area, and have poor educational backgrounds; and even though they display a strong desire to develop their business, they often lack the management skills needed to deal effectively with market competition and the challenge of running efficient firms. In addition, the development of tools for good decision-making has lagged behind the growth of the TVE sector. For example, owing to shortages of professional accountants, many TVE managers have no access to information generated by modern accounting practices, which in turn hinders them from making rational and timely business decisions.[37] The shortage of competent engineers and technicians has also undermined technological development at many TVEs. Second there is the question of scale. TVEs are typically locally initiated and locally based. In order to diversify the business risks they face, it is rational for a township or a village to establish several small-scale TVEs operating across a number of different sectors. However, in many industries small-scale production is simply not sustainable over the long term because other firms will expand and enjoy greater economies of scale and investment. Third, almost all TVEs were initiated by township and village governments, households and groups of households, and are based on local resources. This local identity has both benefits and costs. The comparative benefits include very low entry costs into non-agricultural industries and an ability to exploit local resources. However, the comparative costs are significant too. Rural industrialization has not yet induced meaningful urbanization. As a consequence, the development of TVEs is increasingly restricted by deficient rural infrastructure, a lack of professional services and poor transportation and communication networks. Furthermore, the ability of firms to develop their human capital will be more and more limited by pressures to employ local people, particularly those connected to powerful interests in the community, and by the dual role of many employees as both employees and farmers.

Human capital development, the professionalization of management, an ability to grow to the optimum scale and the creation of infrastructure and urban services are all essential to the growth of China's TVEs. These challenges cannot be solved by ownership reforms alone, although those reforms will certainly create a better institutional environment for tackling them.

CONCLUDING REMARKS

This chapter has provided an overview of recent developments in TVE ownership reform in China. The most striking feature of these reforms has been the unexpected phasing out of local government ownership through joint-stock ownership involving managers, local government, employees and external equity investors. This has been driven by a number of factors, including the desire for the recapitalization of firms, the need for governments to insulate their budgets and the need for firms to offer shares to their managers. Differences between insider privatization within China's TVEs and similar sales in other countries were identified. Special attention was paid to the screening mechanism employed by governments to resolve the information asymmetries between themselves (the seller) and the managers (the buyers). By using a contract consisting of a buy-out price and a contingent claim on future profits, local governments have been able to elicit information from the buyer about the firm's predicted future profitability. This contractual mechanism has helped local governments to maximize sales revenue and to separate good managers from poor ones (and high-quality firms from poor-quality ones).

From a comparative perspective, joint-stock TVEs can be regarded as a hybrid of the closely held joint-stock firm common in the West and the collective TVE which preceded it. They aim to combine the profit incentives associated with individual ownership with the strengths inherent in the institutional and social capital embedded in township and village communities. Of course, the joint-stock model will be transitional in those cases where these firms grow out of the community and become openly held companies with outside shareholders. However, it is entirely possible that closely held firms will continue to be the dominant corporate form in China's rural economy, especially if the institutional and social capital of a rural community continues to be valuable. The corporate governance challenges presented by firms whose shares are held by only a small group of investors are very different from those posed by firms with more open shareholder structures. In contrast to stock market-listed firms, their governance involves the use of multiple classes of share and various managerial networks; ownership and control are changed via multilateral negotiations; and different stakeholders seek informal means of influence. In all these areas, the social and institutional capital held by the community can provide information advantages and cost-saving potential.[38]

During a transition process, ownership structures and governance mechanisms should ideally be 'adaptively efficient'. In other words, they need to provide enough flexibility so that firms' managers and owners can adapt to new market opportunities, absorb new know-how, have incentives for additional learning and be encouraged to take risks and engage in creative activities. The dynamic nature of institutional change involved in TVE insider privatization and the formation of employee stock ownership suggests that China's TVEs exhibit just this adaptive efficiency. Although their current ownership and governance forms may well be only transitional, some of them have a good chance of surviving beyond the transition period.

NOTES

1 Sun (2000); *Yearbook of China's Township and Village Enterprises* (2000: 113; 2001: 3–5, 95).
2 Che and Qian (1998a); Perotti, Sun and Zou (1999); Che (2002).
3 On TVE ownership reform, see also Yep (2001); Chen (2004).
4 *Yearbook of China's Township and Village Enterprises* (2003: 420, 422).
5 Ho, Bowles and Dong (2003); Li and Rozelle (2003).
6 *Yearbook of China's Township and Village Enterprises* (1997: 299–306, 1998: 271–80, 1999: 4, 2003: 420–24); *China Statistical Yearbook* (2003: 313). 'Ex-factory price indices of industrial products' are used to deflate the nominal growth rate; see *China Statistical Yearbook* (2003: 313).
7 See, among others, Che (2002); Che and Qian (1998a, 1998b); Chen and Rozelle (1999); Li (1996); Tian (2000).
8 Chen and Rozelle (1999); Li (1996); Tian (2000).
9 Coase (1937).
10 Che (2002).
11 Che and Qian (1998a).
12 *Renmin Ribao* (1998), *Yearbook of China's Township and Village Enterprises* (1996: 100–101).
13 Xu and Zhang (1997).
14 *China Statistical Yearbook* (1993: 396–7); *Yearbook of China's Township and Village Enterprises* (1996: 100, 1997: 122).
15 Zou and Sun (1996).
16 Zou and Sun (1996).
17 Dong, Bowles and Ho (2002).
18 Wang, Yang and Qiao (1997: 233-44).
19 Dong, Bowles and Ho (2002); Liu and Zhang (2001).
20 *China Information Daily*, 2 August 1993, pp. 1–3; Ministry of Agriculture (1997).
21 Byrd and Lin (1990).
22 *China Information Daily*, 2 August 1993, pp. 1–3; Ministry of Agriculture (1997).
23 Shi and You (1997); Byrd and Lin (1990).
24 Shi and You (1997); Xu and Zhang (1997).
25 Shi and You (1997).
26 Che and Qian (1998b).

27 In 1996 each county had on average 21.2 townships, 345.5 villages, and 723.2 community-run TVEs (*China Statistical Yearbook* 1997: 3, 21, 399).
28 *Yearbook of China's Township and Village Enterprises* (2003: 420).
29 Research suggests that the vast majority of privatized TVEs – more than 90% – have been sold to insiders, especially to managers. In the remaining cases, although outsiders formally won the bid, they were often in fact a past manager or deputy manager who had moved to another firm, a wealthy relative of the incumbent manager or a long-standing collaborator of the firm. See Ho, Bowles and Dong (2003); Kung (1999); Li and Rozelle (2001, 2003).
30 Megginson and Netter (2001).
31 Barberis, Boycko, Schleifer et al. (1996); Frydman et al. (1999).
32 Li and Rozelle (2001, 2003).
33 Boycko, Schleifer and Vishny (1995); Black, Kraakman and Tarassova (2000).
34 Township and village governments face the problem of information asymmetry. A township or village government usually owns either multiple TVEs or none, mainly owing to the risk-diversion considerations as analysed in Sun (1997) and Perotti, Sun and Zou (1999). In the survey of Li and Rozelle (2001, 2003), the sample median is 12 collective firms per township in 1994. In addition, each collective firm sold its products to four different counties. The local government leaders have many duties other than controlling TVEs. Village government leaders are typically attached to their villages, but township leaders switch posts to different townships every three years on average. In contrast, a typical new owner of a privatized firm in Li and Rozelle's sample had managed the firm for five years and worked in it for 12 years.
35 Li and Rozelle (2001, 2003).
36 Ho et al. (2003: 19).
37 *China Daily*, 26 October 1995, p. 2.
38 Aoki (2001).

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