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Anticipatory Ownership Reform Driven by Competition: China's Township-Village and Private Enterprises in the 1990s

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Since 1992, China's small and medium-sized enterprises (SMEs) have conducted a series of radical and successful restructuring in their ownership and governance arrangements. This paper focuses on the ownership restructure of township-village enterprises (TVEs) and private-household enterprises in the 1990s and examines the incentive-based reasons for the anticipatory restructuring in the absence of crisis in these two sectors. It highlights how market and inter-jurisdictional competitions have induced ownership reforms and how the organization of government matters in providing government itself with incentives for reform. It also explores the implications of China's SME ownership evolution for SME development in Russia and other former Soviet Union economies.

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1. Introduction

Since 1992, China's small and medium-sized enterprises (SMEs) in all sectors of the state, township-village, and private have conducted a series of radical and successful reforms of their ownership and governance structures. An innovative arrangement, *joint-stock cooperative* with variations across regions and industries, has become widespread, supplemented by traditional measures such as selling, leasing, taking over, merging, and restructuring through Sino-foreign joint venture and corporatization.

Following the historical administrative classification, SMEs in China can be classified into two large categories of the "rural" and "urban", as indicated in Table 1. Rural SMEs include almost all township and village enterprises with dominate community ownership (TVEs) and all of rural household and private enterprises. They together have produced about one-third of China's GDP since 1996 and employed over 130 million rural workers. Urban SMEs include small and medium-sized state-owned enterprises (SOEs), urban collective enterprises, urban household and private firms, and other ownership forms, mainly joint-ventures. These urban firms produced about another one-third of China's GDP and employed 115 million urban workers. In the urban SME sector, SOEs account for about half of both the value-added and employment. The significant position of SMEs in China suggests that the ownership restructure of these locally controlled SMEs in the 1990s would bring fundamental changes to China's economic system.

The State-Owned SME Sector. In the state sector, the ownership reform centers on restructuring state-owned SMEs into limited liability companies, joint-stock coorperatives, joint ventures with foreign companies and with other domestic ownership forms, and management-employee buyouts. The methods of sales, leasing, and bankruptcy are also employed. The reform has been once again initiated and led by local governments, mainly, by counties and cities with a prefectural- or county-rank within the administrative hierarchy. Since the early 1970s these county and city governments have come to control all small and a large proportion of medium-sized SOEs. Different from the situation in the former Soviet Union and Eastern Europe, the size distribution of SOEs in China is skewed toward the small and medium ones, and furthermore the distribution is spread across the country (Qian and Xu 1993). Therefore, ownership restructuring of these locally controlled SOEs is equally as significant as the restructuring of the large ones that are controlled by the central government.

As analyzed in details in Sun (1997), Cao et al. (1999) and Gu (1999), SME ownership reform in the state sector is best seen as a relatively *passive response* to the pressing financial and business difficulties faced by the state SMEs and local governments. County and prefectural SOEs have typically been the most inefficient ones. They are often too small to apply economies of scale, but too bureaucratic to be able to exploit the advantage of their small size as TVEs usually can. Finding a way to get rid of the increasing burden of bailing local SOEs out has been the number one headache for most county and

Table 1:
The Category and Significance of Small and Medium-sized Enterprises (SMEs) in China

Ownership	Value-added	Employment	Assets
Rural SMEs	33% National GDP since 1996	130.5 million, 1997	2,112.6 billion yuan, 1998
• TVEs (community ownership domination)	• 54% (in 1996)	• 50.7%	
• Household and private enterprises	• 46% (in 1996)	• 49.3%	
Urban SMEs	63.7% urban GDP in 1994	62.6% urban employment	45.6% of the urban
• Small and medium-sized SOEs	• 50%	• 47.2%	
• Collectively owned enterprises		• 31.2%	
• Household and private enterprises	• 50%	• 14.8%	
• Others		• 6.8%	

Sources: *Statistical Yearbook of China* (*Yearbook*, hereafter) *1998*, pp. 130-31, 421-24. *Yearbook of China's Township and Village Enterprises* (*TVE Yearbook*, hereafter) *1997*, pp. 121-122. Li and Wei (1996, pp. 4-5). *People's Daily*, February 19, 1997; February 28, 1998; July 17 and 20, 1999.

prefectural governments. Once obtaining support from the central government, local governments have strong incentives to implement these radical ownership reform measures.

The Township and Village Enterprise (TVE) Sector. In contrast to the situation in the SOE sector, ownership reform in the TVE sector is an *active response* to potential or foreseeable difficulties TVEs may confront in the near future. During 1992-1999, the TVE sector continued its growth miracle of the 1980s. The real growth rate of TVE value added was 22 percent per annum at average during 1992-97. In 1998 and the first half of 1999, this growth rate was still over 15 percent despite of the negative impact of deflation and East Asian economic crisis. The export performance of TVEs has been more impressive. The value of export goods delivery increased from US$21.7 billion in 1992 to US$84.6 billion in 1997 and the TVE share in total national exports rose from 25.5 percent in 1992 to 46.3 percent in 1997. Since 1995, industrial TVEs have produced more than 30 percent of the national totals of industrial value-added, profits, and output; the TVE sector as a whole has created more than 16 percent of China's GDP.[1]

There has been a large body of literature to explicate the nature of TVE ownership and governance structures and the factors leading to the TVE miracle. As summarized in a very recent TVE literature survey in this Journal (Perotti, et al. 1999), The major factors accounting for TVE success include: (a) Hard budget constraints to TVEs in general and to each township and village community in particular. (b) Relatively compatible interests and incentives within a TVE community, constantly reinforced by competitive pressures from markets and other communities. (c) Flexibility due to small size, diversified community economy, and far from strict bureaucratic control, which give TVEs an advantage to capture opportunities emerging in all markets of products, labor, capital, and the domestic and international. And (d) simpler principal-agent tier, personnel and employment system, and labor relations, which are induced by the historical institutional arrangements in rural China and subject to the adjustments required by competition. However, as correctly pointed out by Chen (2000, p. 10), the literature typically treats TVE property rights structure as static and there is a lack of explicit explanation about how this structure adapts to the rapidly changing environment and emerging institutional alternations.

In this paper we raise and partly answer the following questions: Why did TVEs, the creators of the TVE miracle, have the interests to reform themselves in the absence of crisis? What has motivated the township and village governments to give up a large set of their *de facto* ownership and control rights over their TVEs? What incentives are confronted by the TVE managers and workers in the reform process? What are the consequences of the reform, in terms of economic performance, the relationship between community governments and TVEs, labor-management relations, and most importantly, ownership and governance structures?

The Private and Household-run Enterprise Sector. This sector has experienced very rapid growth since 1992, thanks to the needed improvements in the ideological environment and concrete policy treatment following the renewed impulse for reform. The number of private firms increased from 139,000 in 1992 to 961,000 in 1997, of which about 60 percent are in the urban areas and the remaining 40 percent in the rural areas, and their average employment size dropped slightly from 17 in 1992 to 14 in 1997. The number of household-run firms rose from 15.3 million in 1992 to 28.5 million in 1997, of which about 65 percent are in the rural areas. Of the total number of private and household-run firms, more than half have engaged in wholesale and retail trade and in catering services, and about 20 percent are industrial firms. From 1992 to 1997, the share of these industrial firms in the national total industrial output increased from about 6 percent to 18 percent (*Yearbook* 1993: 113-14, 409, 590; 1998: 152-53, 431-33, 581).

Two specific features of this sector are of great interest to research. First, production firms in this sector, especially those in rural areas, have operated in tandem with community authorities such as village governments and with community-run TVEs. Second, an increasing number of these production firms are adopting the ownership form of joint-stock cooperative and some of them have grown out of joint-stock cooperatives and become limited liability companies. An interest question arises here as well: Why do these small private firms prefer "cooperation" when their legal status as purely private entities has been constitutionally recognized and the policy discriminations against them have been substantially diminished?

This paper mainly focuses on the ownership restructures in the TVE and private-household enterprise sectors. It reveals the incentive-based reasons for these anticipatory reforms in the absence of crisis, and highlights how the organization of government matters in providing government itself with incentives for reform. The existing theories on government-owned firms and privatization cannot answer this question (Qian and Roland 1998). To obtain new insights into the discussion, our thinking about ownership reform should go beyond the general property rights theory, and furthermore we should integrate the property right theory with the double perspectives that competition can induce ownership reform and that organizational and social capital are crucial for the transition.

We argue that the SME ownership reform has been induced by both market and inter-jurisdictional competitions. While the role of market competition is sufficiently emphasized in the transition literature, the significance of inter-jurisdictional competition has not been fully explored. We stress the importance of organizational and social capital and claim that whether governments in the transition economies functioning as a market promoter or a rent grabber generates essentially different consequences. In other words, when transition has started in an environment where there is a lack of independent market intermediaries and dispute settling institutions, local governments are usually the only available institutions with the capability to mediate transactions and with the authority to settle disputes. Under these circumstances, a proper transformation of the role of government from a rent grabber to a market promoter is critical for the emergence and development of professional market intermediaries and dispute settling institutions, and thus for the success of transition. On the other hand, competition, particularly inter-jurisdictional competition, can induce and prompt the proper transformation of the role of government.

Competition can induce ownership restructuring; the existing organizational and social capital matters and can make positive contributions to the transition; and inter-jurisdictional competition prompts the proper transformation of the role of government. These three points may be the fundamental lessons that the anticipatory reform of China's SMEs has offered.

This paper is organized as follows. Section 2 presents a theoretical discussion of the interaction between competition and ownership restructuring, with an emphasis on the role of inter-jurisdictional competition among local governments. Section 3 discusses why TVEs need ownership reform in the absence of crisis. It reveals the emerging debt problems faced by TVEs and their urgent need for capitalization. Section 4 presents the stylized features of the joint-stock cooperatives emerging in the TVE sector. Section 5 shows an illustrative model of ownership evolution of the private sector in the context of China, and analyzes the incentives for private entrepreneurs to adopt joint-stock cooperatives. Finally, Section 6 concludes the paper and explores the general implications of China's SME ownership evolution for SME development in Russia and other former Soviet Union economies.

2. Two Forms of Competition and Ownership Restructuring

Competition as Rivalry Behavior

The close link between imitative output competition and the allocation efficiency of resources has been well established in neo-classical economics. In the perfect competition model, each firm takes the prices given to it by the mysterious market clearing forces in the market, and competes with others by offering output, especially by offering output through entry. The market reaches equilibrium if neither insiders nor outsiders have an interest in changing the quantity they supply to the market, and the perfectly competitive equilibrium obtained is Pareto optimum. In this set-up, competition is nothing more or less than the undertaking of profitable imitative output responses to given market prices (Demsetz 1997: 137-138).

In terms of everyday meaning of the word, the notion of competition goes far beyond the narrow one of imitative output competition and has much broader implication than that of allocation efficiency. Competition is popularly viewed as rivalry behaviour and the leading driving force of the Schumpeterian creative destruction. Competition leads firms and organizations internally more efficient by sharpening incentives to avoid sloth and slack. Competition results in efficient organisations to prosper at the expense of inefficient ones and this selection process is good for aggregate efficiency. Competition induces innovations in all areas of technology, organisation, and institutions, which has been the major source of gains in productive efficiency (Stigler, 1987; Vickers, 1995). Since the rivalry behaviour view of competition follows the tradition of Hayek and Schumpeter and pays main attention to productive and dynamic efficiency, it is more relevant to our study of the evolutionary dynamics of firms in transition economies.

Inter-jurisdictional Competition

In the transitional China, apart from the market competition that has put pressure on and stimulated efforts of firms and local governments, the inter-jurisdictional competition across provinces, cities, counties, and rural communities (i.e. township and villages) has played perhaps a more important role in the areas of promoting markets, stimulating reform initiatives and inducing ownership restructuring (Montinola, et al. 1995; Qian and Roland, 1998; Qian and Weingast 1997).

First, inter-jurisdictional competition induces local governments to provide a hospitable environment for attracting scarce production factors such as capital and skilled labour. Local governments are induced to establish a basis for secure rights of factor owners, to provide infrastructure, utilities, and access to markets. Because those jurisdictions that fail to provide these local public goods find that the urgently needed factors move to other jurisdictions, and consequently, this causes their local economic activities and tax revenues to stagnate or even decline (Montinola et al. 1995).

Second, inter-jurisdictional competition induces the endogenous emergence of harder budget constraints for lower level governments. Although the mobility of already existing "stock" resources may be limited in China, the mobility of incremental resources in general and non-state capital investment in particular raises the opportunity costs to local governments of bailing out inefficient firms or spending on wasteful public consumption (Jefferson 1998; Qian and Roland 1998). Local governments that persistently make inefficient expenditures will not only fail to attract investment and skilled labor to their jurisdictions but also find that their own resources and skilled labor have moved away from their jurisdictions. As a consequence, competition endogenously hardens budget constraint of lower level governments given the limited capacity of the higher level governments to provide fiscal subsidies (Qian and Weingast 1997).

Third, inter-jurisdictional competition helps limit government's predatory behavior against local firms. Furthermore, it leads to a reduction of restrictions on local firms and induces the local governments to look for better ownership and governance structures for their firms. When a particular local government insists on imposing an onerous restriction on its local firms, firms in this jurisdiction are confronted with a competitive disadvantage compared with competing firms from other jurisdictions that are not bound by the restriction (Montinola et al. 1995). These competition-induced effects are certainly market-promoting and reform-oriented.

Once our understanding of competition extends to the inclusion of inter-jurisdictional competition among local governments, we can better understand why the pace and outcomes of reform in China have to a great extent determined by the competition specific to localities and enterprises. Market competition was introduced and gradually enhanced by opening the state monopolized industrial sector to new entrants and by the consequent TVE miracle. The inter-jurisdictional competition was put in place by the revenue-sharing contract between central and provincial governments and between provincial and city or county governments. The revenue-sharing contract system introduced in the early years of reform was likened as "eating in your own kitchens" (*fenzao chifan*). It delegated the basic responsibility of balancing local revenue and expenditure to local governments.

Competition Can Induce Ownership Restructuring

Confronted with an increasingly competitive environment, profits are much more sensitive to the competitive ability of firms. Low or declining profits lead directly to low or declining bonuses and fringe benefits, poor reputations, and even to survival crises, thus motivating enterprise managers and employees to seek alternatives that enhance their competitive position. Among local governments, particularly those at lower levels with fewer enterprises under their jurisdictions, the erosion of enterprise profits that are the major source of local revenues, causes immediate fiscal distress. This distress alone may destabilize the distribution of fiscal revenues among regions and administrative organs, hurt the reputations of local officials and reduce the bonuses and benefits of local government employees. In order to generate more revenue and reduce expenditure pressure, local governments are induced to reform their local enterprises rather than continuously to bail out inefficient firms. It is in this sense we claim that competition induces enterprise reform and ownership restructuring.

By the mid-1990s, competition had gradually exhausted the monopoly profits of most state-owned industries, the traditional primary sources of government revenues. According to a World Bank (1997) report, about half of the industrial SOEs made a loss in 1996, up from one-third just two year earlier. Among loss-making SOEs about 90 percent were small ones controlled by city and county governments (Zhou and Shen 1997). One simple reason for this is that small SOEs hold too small a market share to seize monopoly profits longer. As a consequence, the most radical ownership reform seemed inevitable for small SOEs by the mid-1990s.

Ownership Restructuring Improves the Framework for Competition: A Virtuous Circle

Competition induces ownership restructuring and at the same time, ownership restructuring induced by competition further improves the framework for competition and opens up more areas to competition. In the 1980s, the reassignment of SOE property rights and increased SOE autonomy not only enhanced entrepreneurial responses to market-determined supply and demand signals, but also extended product markets from the secondary component to the dominant one in the dual track economy with both planned and market components. SOE property rights reform and TVE development further led to the emergence of capital and labor markets (Sun 1997). The role of governments was transformed as well from the direct management of SOEs to one more like that of a market intermediary. While the independent market intermediaries are largely absent in a transition economy like China (Stiglitz 1999), the role played by governments, particularly lower level governments, in mediating transactions and resolving disputes is of fundamental importance for both development and transition. While an attention must be paid to the negative effect of such government-business collusion, it is also worth noting that in the context of China the intensive inter-jurisdictional competition seems to have kept this collusion in check while generating positive net benefits (Li 1998).

The ownership restructuring conducted since 1992 has prompted further a functional transformation of the role of the governments at various levels. In those cities and counties where most of enterprises have waved farewell to *de facto* government ownership, the local governments have started to function more like a market regulator, although they have continued to mediate transactions and resolve disputes. Government assets are managed in the forms of share holding and venture capitals. This progress has improved and is likely to continue to improve the framework for market competition.

3. Why TVEs Need Ownership Restructure

"Township and village enterprise" (TVE) is a Chinese specific term to identify those firms that are initially collectively owned by a rural community such as a township or village and later on closely association with the community. This term has increasingly become an administrative and historical icon rather than economic one. But it is a key concept for our understanding of China's impressive economic growth since the late 1970s.

The TVE phenomenon is unique in the sense that the emergence of rural entrepreneurs and enterprises has not been experienced in any other country on such a large scale and at such a rapid rate. Its roots can be traced back to the late 1950s, but its development was not truly noticeable until the late 1970s when China began to carry out reforms and to open up to the outside world.

The TVE development so far is not an outcome of any carefully designed policy or plan. The government policy changed from tolerance to encouragement during the 1980s, only after recognizing that the TVE was a vehicle to increase rural income, and more importantly, to absorb a large amount of surplus rural labor force without much need for state investment.

As shown in Section 1, the TVE miracle of the 1980s has continued in the 1990s. However, it is worth noting that the initially favorable market and environmental conditions enjoyed by TVEs have gradually dissolved since the late 1980s. Moreover, following the expansion of TVE scale and market shares, TVE mechanism degeneration has become increasingly serious in those township and villages where grassroots democratization has lagged behind, due to the lack of mechanism to inhibit opportunistic behaviors of those increasingly powerful local officials.

Mechanism Degeneration: The Most Widely Reported Reason

The so called "mechanism degeneration" of TVEs has been widely reported since the early 1990s (cf. Ren et al. 1990; *China Information Daily*, August 2, 1993; Ministry of Agriculture 1997). Many aspects of mechanism degeneration have been linked to the problems inherent in TVE ownership and governance structures. Among them, two are often pointed out.

First, township or village governments are not purely economic actors. As TVEs mature, the objectives of community government officials are coming increasingly into conflict with those of TVE managers, although initially these two sets of objectives were quite similar (Wang 1990; Shi and You 1997). Community governments have assigned priority to raising employment, local prosperity and financial revenue. This could conflict with the efficiency requirement of individual TVEs, impose SOE-similar mechanisms to TVEs and thus hinder the stable, long-term development of TVEs. The powerful control rights of community governments could thus lead to unfavorable interference into TVE management. Community governments also seem to be shifting the responsibility for the overall development of their communities onto individual TVEs. As a result, many TVEs are also experiencing redundant employment and increasingly heavy social burden, become quite similar to SOEs in many ways, and have strong desire for reform (Byrd and Lin 1990: 125, 304 and 351; Shi and You 1997; Xu and Zhang 1997).

Second, bureaucratization and corruption among community officials and TVE managers are growing in many communities. In those communities where the development of grassroots democratization has lagged behind, the problem of who monitors the monitors becomes increasingly serious. This is because there is a lack of effective restraint devices to curb corrupt behavior of those increasingly powerful local officials. For example, many TVEs are becoming "purses" of their community governments, required to pay many sorts of expenses for the government; and many TVE managers are stripping TVE assets for their own uses (Shi and You, 1997).

Although there has been supervisions from county governments as highlighted in Che and Qian (1998), this kind of monitoring may be limited due to the problem of information asymmetry. The restraints from county governments are mainly based on the discipline of the Communist Party. This may not make sense for most officials at grassroots level, because the probability that they will be promoted to the status of a formal bureaucrat is small. Indeed, compared with the economic and social rents they enjoy from the TVEs, the career of being a low-rank bureaucrat is not that attractive. In addition, this monitoring is bound to be weak because of the communication difficulties in rural areas and the fact that there are usually a large number of community-run TVEs, townships and villages in a county.[2]

The phenomenon of "mechanism degeneration" is reported to have become increasingly widespread and to be able to justify the demand for ownership reform. However, this explanation cannot justify the supply-side reason for ownership reform. Since the TVE managers and community officials clearly benefit from the mechanism degeneration, why do they have incentive to give up their benefits and to initiate ownership reform? In order to understand the incentive-compatible reason for ownership reform of TVEs, we need to examine the intertemporal asset structure of TVEs in comparison with other ownership forms.

An Incentive Compatible Reason: Capitalization Urge

In Table 2 we compare the debt-asset ratios between TVEs and industrial SOEs and among rural firms with different ownership forms for 1995, when comparable data are available. It can be seen that township-run TVEs had the highest debt-assets ratio (68 percent), then industrial SOEs in second (66 percent), village-run TVEs in third (55 percent). Debt-asset ratios in the private sector were very low, 35 percent for joint-households-run firms and 25 percent for individual household-run firms. Although industrial SOEs are typically more capital intensive and have enjoyed more equity investment from the state, making the direct comparison unfair for TVEs, the comparison indicates that both industrial SOEs and township-run SOEs were highly leveraged on average in 1995. Village-run TVEs started to have excessive debts as well.

Data that would allow extension of Table 2 through time are not available. However, we do have such intertemporal data for an illustrative prefecture-level city, Suzhou in Jiangsu Province. TVEs in Suzhou have been regarded as representative of the well-known Southern Jiangsu Model, in which all rural firms have kept pure community ownership until very recently. Table 3 shows the rising trend of debt-asset ratio of all community-run TVEs in Suzhou. Tables 2 and 3 show that community-run TVEs in Suzhou had the debt-asset ratio of 61.9 percent in 1994, very similar to the corresponding national average of 62.8 in 1995. This similarity may be instructive for our understanding of the worsening debt burden issue of TVEs at the national level. Second, Table 3 shows a rapid rising of debt-asset ratios from 1980 onwards. In the first half of the 1980s, TVEs in Suzhou had a quite healthy debt-equity structure. However, along with their success and take-off over the next decade, their debt-asset ratios increased rapidly and have reached over 60 percent since 1992.

In consideration of the fact that the average debt-asset ratio may cover the heterogeneous real debt-equity structures across firms, Sun (1999) conducts a grouped comparison of debt-asset ratios and performance for 111 surveyed township-run TVEs in Southern Jiangsu in 1995. It is found that there is an obvious positive correlation between the proportions of loss-making firms in each group and group debt-asset ratios. In the first group with healthy debt-asset ratios, no firms made a loss. In the groups with debt-asset ratios of 80-90, 90-100, and over 100 percent, loss-making firms accounted for about 28, 43, and 52 percent of the total number of TVEs in each group, respectively. This positive correlation indicates that the firm with higher debt-asset ratio faces not only higher cost of debt services but also higher risks of business failure.

Why has the leverage state of TVEs worsened so rapidly in the late 1980s and has it remained at so unhealthy level in the 1990s? There are two intuitively plausible and instructive reasons. First, the continuous entry of a large number of TVEs and other type firms intensified competition, eroding the exceptional profits available early on. As a result, the ratio of profits after taxes over assets for TVEs steadily decreased from more than 30 percent in the early 1980s to about 7.5 percent in 1995 and 1996 (*Yearbook* 1993: 396-397; *TVE Yearbook* 1996: 100, 1997: 122). The steadily declining profitability has significantly reduced the capital accumulation capability of TVEs and pushed them to increasingly depend on credit financing.

Second, along with the rapid expansion of community conglomerates, the financial capability for the community government to cross-subsidize its TVEs and to guarantee more loans for them has increased rapidly as well. This makes it feasible for TVEs to increasingly rely on debt financing. At the same time, information asymmetry problem becomes increasingly severe due to the speedily expanded scale of the community conglomerate and the accompanying bureaucratization. As a consequence, individual TVEs take the advantage of softening budget constraint to borrow more, choose higher risk, but reduce their effort (Zou and Sun 1996: Proposition 1).

Because the budget constraint for the community as a whole has been and will continue to be hard, the implication of opportunistic activities by individual TVEs for the community government is clear and straightforward: The community government ultimately bears the unlimited liability for its TVEs. This increasingly softening budget constraint to individual TVEs may finally induce the bankruptcy of the whole community. In order to get rid of the unlimited liability it holds for its TVEs and avoid the threat of community bankruptcy, the community government with many highly leveraged TVEs has strong incentive to initiate ownership reform program within the community.

Table 2:
The Comparison of Debt-Asset Ratios by Ownership, the end of 1995

	Industrial SOEs	Township-run TVEs	Village-run TVEs	Community-run TVEs	Joint-households	Individual households
Total assets (billion yuan)	4747.21	1182.00	806.70	1988.70	156.50	568.00
Total debts (billion yuan)	3123.66	803.60	446.00	1249.60	54.80	144.10
Debt/asset (%)	65.80	67.99	55.29	62.84	35.02	25.37

Sources: Data for industrial SOEs are taken from "Selection from the 1995 National Industrial Census" published in *People's Daily*, July 25, 1998. Data for TVEs with different ownership forms are from *TVE Yearbook, 1996*: 100-101.

Table 3:
The Rising Debt/Asset Ratio of Community-run TVEs in Suzhou City, Jiangsu Province, 1980-1994

Year	Total asset[a]	Total debt	Total equity[b]	Debt/Asset
1980	1.71	0.64	1.08	37.17
1982	2.47	1.02	1.46	41.15
1983	3.10	1.27	1.83	41.04
1984	4.62	2.34	2.28	50.62
1985	6.90	3.67	3.23	53.23
1986	8.34	4.84	3.50	58.00
1987	10.92	6.55	4.37	59.98
1988	15.36	9.53	5.83	62.07
1989	18.06	10.50	7.56	58.13
1990	20.86	12.01	8.86	57.54
1991	26.90	15.77	11.22	58.64
1992	40.00	24.01	15.98	60.03
1993	57.80	35.32	22.48	61.11
1994	72.96	45.18	27.78	61.92

Sources: Xu and Zhang (1997).
Notes: (a) Total assets are defined as the sum of year-end book value of fixed assets, working capital, incorporeal capital, and long term investment.
(b) Total equity is held by the communities (townships or villages) and the enterprises, respectively, according to the sources of investment.

For the interest of the community government, the first purpose of the reform is capitalization of the community-run TVEs. In comparison with county and city governments, township and village governments face fewer political constraints: avoidance of layoffs is not a constraint for TVEs (Sun 1999: Section 4.2) and the community governments have constantly initiated reorganization and liquidation of community TVEs since the very beginning.

Profitable TVEs have to follow the orders from the community government to lend money in scarce to fellow TVEs with poorer performance. The opportunity costs of such lending is very high, because the likelihood of repayment is low and the lenders can use the money more efficiently. In this sense, they are losers *ex post* under the community ownership. *Ex ante*, if the probability is high that a TVE will be profitable, the perceived value of the cross-subsidy for this TVE will be negative (Zou and Sun 1996). Therefore the profitable TVE will have strong incentive to seek more autonomy, to improve asset structure, and to strengthen its competitive ability through ownership restructuring.

Although loss-making TVEs benefit from the cross-subsidies within the community and from the loans guaranteed by the community government, they face the pressure of lowering reputation and the threat of liquidation and closing-down. Once the firm is closed down, both managers and workers will lose their non-agricultural jobs thus the sources of higher income and more respected social status. When the firm continues its business, the compensation for both managers and workers is typically low because the firm has to pay the interest and part of principals of its debt first. Therefore, the loss-making TVEs have strong motivation to avoid closing-down and to increase their equity capital through ownership restructuring.

For TVE workers the increase of equity capital in their TVEs will strengthen their job security and bring them more income in terms of wage, bonuses, social welfare, and others. Paid subscription of shares is often immediately compensated in part by the distribution of the "matching shares" (*pei gu*). The matching shares are free of charge, in the proportion of one subscription to one or two matching shares, and correspond to the original collective equity. These shares together will bring dividends in the future and the subscribed shares can be transferred within the community and in some case out of the community. In addition, these shares bring the TVE workers certain control rights over their TVEs. Therefore, TVE workers who have rights to subscribe shares often strongly support the ownership restructuring through formation of joint-stock cooperatives, However the half of those workers who have no such rights (temporary workers from other communities) feel dissatisfied with such restructuring (Wang et al. 1997: 233-244).

4. The Emergence of Joint-Stock Cooperatives in the TVE Sector

The spontaneous initiations of joint-stock cooperatives (JSCs) at the grass-root level appeared during 1982-85 in Wenzhou (Zhejiang Province), Fuyang (Anhui Province), and several other rural counties. These initial JSCs were typically based on joint-stock cooperation of household and small private firms. Using the JSC as an experimental form for the ownership restructuring of TVEs was initiated in 1987 in Zhoucun District of Zibo City, Shangdong Province. However, this experimental restructuring was seriously constrained by the requirement that the majority of stock should be collectively held by the community or TVE entity (Vermeer 1996). In 1992, following the decisive push for renewed reform by Deng Xiaoping, the official restriction on share distribution between the collective and individuals became increasingly unpopular and has been gradually abandoned *de facto* since then. The removal of this restriction combined with the renewed reform impulse has led to the rapid expansion of JSCs (*TVE Yearbook* 1998, pp. 271-280; Wang et al. 1997).

Among the diverse forms of TVE ownership restructuring, the dominant one is the JSC. Table 4 reports the distribution of the forms of ownership restructuring in the TVE sector by the end of 1997. Nation-wide 33.5 percent of TVEs had restructured their ownership form by that time. Of these restructured TVEs, 63.37 percent adopted the form of JSCs, 12.15 percent (mainly, small ones) were sold to private investors, 4.66 percent were transformed into limited liability companies with management- or investor-ownership, 3.82 percent were merged into corporate groups, 1.58 percent were restructured into joint-stock companies (some became public companies), 0.66 percent went into bankruptcy, and finally, 13.91 percent were leased or re-registered back to private ownership.

Table 4:
The Distribution of Ownership Restructuring Forms in The TVE Sector, by the end of 1997 (percent)

	Joint-stock cooperative	Selling	Limited Liability	Merge & Grouping	Joint-stock company	Bankruptcy	Others
In restructed TVEs	63.37	12.15	4.66	3.82	1.58	0.66	13.91
In total TVEs	21.23	4.07	1.56	1.28	0.53	0.22	4.66

Sources: *People's Daily*, July 25, 1998.
Notes: The data are from Ministry of Agriculture. In total, 33.50 percent of community-owned TVEs restructured their ownership form by the end of 1997. "Others" consist of mainly leasing and the re-registration of "fake" collective TVEs back to private ownership.

The dominance of JSCs deserves the greatest research interest. Although there have been many local varieties of the JSC forms, which have evolved path-dependently and adapted to local conditions, the stylized features of them can be spelled out as follows. (a) Managers and employees own a *majority* of the total share of the firm, and share-holdings among them differ on the basis of paid subscriptions. (b) The firm is closely held, implying that ownership shares are typically not freely marketable, although subscribed shares can be transferred within the community. (c) The local government may hold a large part of shares in the name of community citizens. That is, city and county governments may be shareholders of the restructured SOEs, and township and village governments may hold shares in the restructured TVEs. (d) In addition to the shares held by the insiders and local government, there usually exist some (or even large) shares of outside equity which carry one vote per share. (e) A representative form of governance is usually employed based on "one-person-one-vote" or "one-share-one-vote" or a combination of both voting principles. (f) The firm is small or medium-sized.

The adoption of JSCs meets the urgent need for capitalization very well. In those provinces such as Zhejiang, Jiangsu, and Anhui, where have been the leading areas for TVE development, this adoption leads to an intermediate reduction of the debt/asset ratio by 10 percentage points at average. More importantly, it is widely reported that those TVEs which have transformed themselves into JSCs have typically shown a significant improvement in performance, exhibited more dynamic features, and played the leading role in maintaining the TVE miracle (see, e.g., *TVE yearbook* 1997: 299-306, 1998: 271-280; Han and Zhang 1993; Wang et al. 1997).

There are typically different types of shares. One of them, for example, may be similar to a trust fund for employee pensions, the fund is owned by employees as a whole and benefits from the fund are distributed mainly according to seniority. Shares that confer the greatest ownership rights are those that have been subscribed by employees as individuals, which are called the most *active shares*. However, because of the smallness of the firms, these most active shares are not freely marketable. It makes these individually subscribed shares be of more similarity to a venture capital investment with a simple profit sharing scheme than to the shares of Western public companies. The profit sharing scheme is typically that: a fixed proportion of total profits (after taxes) is earmarked as the shareholding fund for the distribution of dividends.

The local government has continued to be involved in the governance of the restructured enterprises via its assets administration body and financial bureau instead of the original industrial bureaus. Its role in governance has been increasingly transformed from sole owner and supervisor of the firm to one more similar to that of a major venture capitalist. A typical venture capitalist often serves on the board of directors, provides help in recruiting and compensating key individuals, works with suppliers and customers, gets involved in establishing business strategies, and most importantly plays a major role in raising additional capital (Admati and Pfleiderer 1994; Dasgupta and

Tao, 1998). At present, however, the local government seems to play a stronger role than a pure venture capitalist even in situations where the only capital provided by the government is the land. This reality may be partly attributed to the need by all parties concerned for more time to live up to the letter and spirit of their newly defined roles. But more evidence suggests that this involvement is mutually beneficial during the transition when well-functioning market intermediaries and dispute-settling institutions are still in their infancy, and that it serves to promote a smooth institutional transition with lower social costs (Sun 1999: Chapters 2 and 4).

The fact that managers and employees hold a majority of the shares makes the JSC quite similar to those firms with employee ownership. The performance characteristics of employee owned firms have been hotly debated and an enormous literature has developed. For the cooperative type of employee ownership and closely held employee stock ownership in developed economies, the theoretical and empirical literature suggests that while these arrangements may bring both advantages and disadvantages for the performance of the firm, on balance in most circumstance the disadvantages seem outweigh the advantages (Bonin et al. 1993). The recent literature dealing with employee ownership in the former Soviet Union and Eastern Europe seems to further alter the balance toward the disadvantages (Earle and Estrin 1996).

The conclusions in the Western literature indicates that the relative scarcity of worker cooperatives in the industrial sector lies in their disadvantages in collective decision making and capital financing (Bonin et al. 1993; Craig and Pencavel 1995; Hansmann 1996). Contrary to the disadvantages faced by worker cooperatives in the West, in China JSCs have had much higher social trust and economic accountability in local communities and credit institutions than private enterprises. Consequently, they have enjoyed significant advantages in capital market over private enterprises (Sun 1999; Zou and Sun 2000; Wang 1997). With the help of the hybrid mode, Chinese JSCs can use socio-economic and institutional resources from more than one existing channels. They can develop innovative mechanisms that facilitate to avoid high costs of collective decision making, to check insider control, to mobilise internal financial resources and to diversify risk.

The conclusions in the transition literature rely on the implicit assumption that the employee-owned firm has rents or other firm-specific surpluses in one way or another due to the lack of fair competition and contract enforcement mechanism. This assumption is hardly applicable to the case of China's JSCs that have faced highly competitive product markets and increasingly competitive labour market, and have little political power to maintain some kind of firm-specific rents.

Because of these important differences, a better understanding of how China's JSCs actually work will bring new insights into not only the ongoing debate over the advantages and disadvantages of employee ownership, but also its evolving in the future. In Sun (1999: Chapter 2) four core mechanisms that function in the JSCs in China are examined in details. They are those that check insider control, that facilitate to avoid high costs of collective decision making, that serve to diversify financial and business risks and thus induce higher financial accountability, and that provide the desirable flexibility to evolve.

5. The Wenzhou Model of the Private Sector Development in China[3]

The economic achievement of Wenzhou is most impressive among prefectures in China. From 1978 to 1997, the municipal GDP increased from 1.3 billion yuan to 60.5 billion yuan, government revenue increased from 135 million yuan to 870 million yuan, and annual per capita income of rural residents increased from 113.5 yuan to 3,700 yuan. All these growth rate records are about double the national average and have been dominantly created by the private sector (*Economist*, May 30, 1998, p. 63; *People's Daily*, March 30, 1999).

Wenzhou is a prefecture-level municipality and located in the south-east corner of coastal Zhenjiang province. It has a population of seven million and is the most populous among Zhejiang's prefectures. Due to its mountainous terrain, high population density, and natural resource shortage, life based on only agriculture was extremely difficult as proven in the pre-reform period (Yuan 1987, p. 10). The high scarcity of land had in fact stimulated "underground" household workshops to conduct traditional handicrafts such as umbrella making, shoe making, cotton spinning, weaving, and fluffing, and even production of vital materials and energy before the mid-1970s. Since 1978, the development of the private sector in Wenzhou has undergone two stages of transformations from scattering household businesses to business affiliation (*guahu*) with SOEs, TVEs and other corporations and from business affiliation to JSCs and corporations.

From Scattering Household Business to Business Affiliation (guahu)

For individual households, the development of scattered household business is severely constrained by their disadvantages in areas such as product marketing, input material search, license application and approval, and establishment of commercial trust and reputation. For local governments, monitoring numerous household businesses in terms of license qualification and the follow-up qualification control alone would be too onerous to be practical.

To solve these difficulties at the least cost, in addition to the popular practice of sub-contracting, the innovative arrangement *business affiliation* was initiated and developed in the late 1970s and 1980s. Under this arrangement, household industrial and commercial firms attached themselves to an established collectively-owned or state-owned enterprise, paying a fee for the use of its name (and thus its license and commercial reputation), stationery, letters of introduction, and most importantly, bank account numbers and receipt books. Taxes were collected from the established public enterprises rather than these attached households. In comparison with sub-contracting, business affiliation gives more autonomy and flexibility to household firms. The cost is that some attached household firms have more room to undertake opportunistic behavior and damage the reputation of the established public enterprise. In both forms of sub-contracting and business affiliation, local governments delegate *de facto* monitoring rights to the established public firm. As a result, local governments obtained much greater administrative control over what were essentially underground firms before. Although the relevant statistical data are not available, one source indicates that by the mid-1980s, about 62 percent of household industrial and commercial firms were *guahu* firms. In some areas the figure was as high as 90 percent (Huang 1986).

Paralleling to the business affiliation practice of household firms, private firms grown beyond family-based entities largely registered as collective ownership with their neighborhood committee or village government as their responsible administrative body. In exchange, the administrative body collected a management fee and shared other benefits and control rights to a varying degree. This practice was known as "wearing a red hat" (*dai hongmaozi*). The "red hat" allows these *de facto* private firms to avoid political risk and the stigma long associated with private business in China. It also brought them greater access to bank credits, raw materials, land, power and fuel quotas, contract, etc. On the other hand, local governments and officials benefited by being able to register, police and collect taxes and fees from this otherwise underground economy (Parris, 1993).

From Business Affiliation to Joint-Stock Cooperatives and Corporations

The practice of business affiliation and "wearing red hat" is a transactional relationship which can be distinguished as "quasi-market contracting" between private firms and the administrative bodies or public firms for purchasing or renting the desired institutional and social capital (Sun 1999: Sections 1.3 and 2.1). In the case of "business as usual", the costs of such quasi-market contracting (including costs associated with implementing, enforcing and re-negotiating agreements, and protecting against third-party infringement of property rights) in terms of time, money and risk may not increase too much. However, in an economy with impressive growth and dynamics like Wenzhou, these transactional costs increase very rapidly. The established public enterprises become increasingly interested in predatory rent-maximization rather than effective services. Disputes are raised typically before the fixed re-negotiation date by the public firm and the attached firms have to follow its predatory requirement due to the lock-in effect. On the other hand, many attached household firms behave opportunistically to maximize their own profit at the cost of the business reputation of the whole group. By the mid-1980, products with poor quality and/or fake brand names produced by the business affiliation firms brought bad reputation to all Wenzhou's firms. As a consequence, even local governments became intolerant of, and started to re-organize, the business affiliation firms (Han and Zhang 1993, p. 181).

In comparison with the business affiliation and "wearing red hat", the arrangement of JSCs has obvious cost-benefit advantages. The disputes over the issue of sharing residual benefits and residual control rights between the individual attached firm and its "nominal supervisor", namely the established public firm or institution, disappear for a JSC firm. In other words, the previous quasi-market contracting arrangement over residual benefits and residual control rights is now replaced by direct ownership arrangement, resulting in a significant reduction of transaction costs. The joint-stock form creates economies of scales in terms of capital, production and marketing for the firm. The legal position of the cooperative and the significantly enlarged scale of business bring in the much needed institutional and social trust to the firm, for which the firms in the affiliated relationship were having to pay a high and increasing price. Disputes may occur among share-holders of the firm over some important issues. However, the distribution of residual benefits is well-defined by shares now, and the exercise of residual control rights become better-matched with the corresponding residual benefits rights.

Driven by these cost-benefit advantages, the negative effects of the reputation collapse, and the government-promoted reorganization of the business affiliation firms, the ownership arrangement of JSC emerged and developed much earlier in Wenzhou than in other regions. By 1990, there already were about 13,000 JSCs in Wnezhou. Of them, 2,325 were certified by the city government as having achieved the norm in terms of standardized institutional arrangements, accounting system, and decision-making procedures (Han and Zhang 1993: 185-187). In 1997, the number of JSCs in Wenzhou reached about 43,000. Of them, about 31,000 were industrial firms, which produced about 86 billion yuan of output, accounting for over 70 percent of the city's total industrial output (Li 1997; *People's Daily*, March 30, 1999).

The most distinctive feature of JSCs in Wenzhou is that about 90 percent of them originate from the voluntary cooperation of private and household enterprises, rather than from the ownership restructuring of the original collective firms (Han and Zhang 1993: 182-183). As a result, JSCs in Wenzhou have been dominated by management joint-stock ownership and employee joint-stock ownership, in which there is no community share or collective share. The management joint-stock ownership makes it easy for cooperatives to transform themselves into limited liability company and joint-stock company. From 1994 to 1997, 6,738 joint-stock cooperatives with management ownership restructured themselves into the forms of limited liability company and joint-stock company. By 1997 there were 10,868 limited liability companies and 15 joint-stock companies in Wenzhou (Wang and Wang 1998). At the same time, in many employee-joint-stock cooperatives, the tendency of increasing share-concentration to the core share-holders (mainly, core managers) has continued.

Wenzhou model has shown a successful process of the private sector development and evolution in China. In the evolution process, all available capitals of the material, human, institutional and social have seemed to be efficiently utilized. The evolution has fitted well into the development levels of these capitals, particularly the gradually rising level of "knowing-how". The process is a typical one of "reforming from below". Although reform policy from above provides a favorable atmosphere for local initiatives, the radical extent of these initiatives and their subsequent evolution are determined by individuals, households, groups and government officials at the local level pursuing their pragmatic interests and responding to the failure of the state sector to meet local demands. They have managed to work the state socialist system to their own advantage, and to transform the existing institutions into market-oriented ones.

Local governments have played a pivotal role in the evolutionary process. They not only collude with local entrepreneurs to pursue local interests, but also function as an active market regulator to promote fair competition, technology improvement, and the establishment of the quality reputation of Wenzhou's products in national and international markets (Li 1997). At the same time they have actively inter-mediated the "chronic negotiation" between local groups and the agents of central and provincial governments to resolve conflicts, accommodate the changing environments, and recommend the new institutions and policy options (Parris 1993).

6. Concluding Remarks

Transition from a centrally planned to a market economy is one of the most significant economic and social events in the twentieth century. Two big surprises happened during the transition. The first was the sharp initial decline in output in most countries of former Soviet Union and Eastern Europe. The second one was China's outstanding achievement on its different path of transition and its own development. By maintaining nearly 10 percent average growth rate for two decades alongside the successful transition from a centrally planned to an emerging market economy, China produced more than one-half of the total GDP produced by all transition economies in 1998. China's GDP structure now become similar to that of Poland and the Soviet Union in the 1980s, with the agricultural share of GDP being 18 percent in 1998 (*People's Daily*, February 26, 1999; Qian 1999). In the years to come, both China and the transition countries of former Soviet Union and Eastern Europe will face similar development challenges, in addition to the ones linked with the ongoing transition.

While it is widely acknowledged that the general process and sequencing of China's transition is unlikely for Russia and other Eastern European transition economies to follow, China's novel ways to provide positive incentives, introduce hard budget constraints and promote competition have attracted increasing attentions (Qian 1999; Stiglitz 1999). In China, positive incentives were provided not only to enterprise management and workers but more importantly to local governments. Competition was created not only among firms with various ownership forms but also among local governments at provincial, prefectural, city, county, township and village level. Positive incentives and hard budget constraints to local governments were provided or induced by fiscal contracting under regional decentralization, local government ownership, and increasing monetary centralization. Competition was brought in through the entry and expansion of non-state enterprises, mainly TVEs. After first fifteen years of pragmatic reform with the emphasis on positive incentive, hardening budget constraints and competition, China came to set a clear goal during 1993 to 1998: to establish a rule-based market economy incorporating internationally recognized best practice institutions. Because the questions of how to install positive incentives and hard budget constraints to enterprises and local governments and how to introduce and promote competition are still largely open in Russia and other Eastern European transition economies, China's experiences in these respects are relevant and instructive.

In the specific areas such as the emergence and evolution of SMEs with diversified ownership forms, China's experience may be more instructive. The emergence and evolution of the private and community-based SMEs are mainly pushed by the survival urges and initiatives of individuals, households, communities and grass-root institutions, and local governments at lower levels. Such survival urges and grass-root initiatives exist and work spontaneously even in a very hostile environment like one in Wenzhou in the early 1970s. In fact, during the transition in Russia and other former Soviet Union countries from 1989 to 1995 the so-called hidden economy had shown a highest growth rate as well. In the case of Russia, hidden economy was estimated to be equal to about 14 percent of official GDP in 1989. Six years later, the corresponding share were put by different estimate approaches to 39-71 percent, although at the same time, some of the hidden businesses had grown out of the hiding (Johnson, et al. 1997; Lackó 2000). If the society and governments can provide an increasingly friendly environment to the hidden businesses as did by Chinese, Polish, and Czech, the hidden economy will certainly grow into formal one and become the engine of economic growth.

To explore further the general implications of China's SME ownership evolution for SME development in Russia and other former Soviet Union economies, five lessons need to be highlighted.

First, Wenzhou model may be instructive for the large hidden economy to grow out of the hiding, in which survival urge, innovative initiatives of individuals, households, communities, and local governments are the key for success.

Second, there are two key vehicles for informal SMEs to grow out of hiding and for general SME development: The protection and support by local government; and voluntary cooperation of individuals and households in the form of joint-stock cooperatives or joint-stock partnerships.

Third, proper transformation of the role of governments in general and local governments in particular are critical for SME development. Two key vehicles can be identified for providing local government itself with the incentive to reform: creating inter-jurisdictional competition; and changing the incentive structure of local government through creditable revenue-sharing and subsidy-reduction contracts between supervisory and subordinate level governments.

Fourth, although TVEs with dominant community ownership are being transformed in China, the TVE form may well be a plausible "next step model" for many of the countries where local government ownership has emerged. A build up of activity and experience under TVE-like forms may be desirable in these cases, before considering another round of ownership restructuring.

Fifth, the ownership arrangement of joint-stock cooperatives may have cost-benefit advantages in other transition economies as well. The joint-stock form creates economies of scales in terms of capital, production and marketing for the firm. The cooperative structure will bring in more reliable business partners and a set of extended social and economic connections to the firm, thus increasing business security. The enlarged business scale and social/economic network will bring in the much-needed institutional and social trust to the firm as well.

For an individual firm, the flexibility of the ownership arrangement of joint-stock cooperative allow it easily to transform into a limited liability company or publicly listed stock company along with the expansion of the firm. On the other hand, for the majority of SMEs, which have little chance to become an openly held company, joint-stock cooperatives may not be a transitional ownership arrangement and may be going to play a significant role in the development of the SME sector in transition economies.

Notes

1. The relevant growth rates for 1992-1997 are deflated by the general retail price index. TVE export includes direct and indirect (e.g. in the form of subcontracting with SOEs and foreign companies) exports, and charges on processing for foreign firms. A large part of TVE export has been produced by household and private enterprises in the form of subcontracting with larger TVEs. Data sources in this paragraph are *Statistical Yearbook of China* (*Yearbook*, hereafter) *1993*: 633, *1997*: 587, *1998*: 302; *Yearbook of China's Township and Village Enterprises* (*TVE Yearbook*, hereafter), *1996*: 102-108, 122-123, *1998*: 107; Ministry of Agriculture, 1997; *People's Daily*, February 19, 1997, February 5 and March 22, 1998, July 20, 1999.
2. In 1996 each county had on average 21.2 townships, 345.5 villages, and 723.2 community run TVEs (*Yearbook 1997*: 3, 21, and 399).
3. For English publications on the Wenzhou Model, see, Liu (1992) and Parris (1993), among others.

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