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## The Legal Structure of the Chinese Socialist Market Enterprise

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# The Legal Structure of the Chinese “Socialist Market” Enterprise

William H. Simon\*

|  |     |
|--|-----|
| I. INTRODUCTION . . . . .  | 267 |
| II. THE ENTERPRISE MODELS OF THE 1980S . . . . .                         | 270 |
| A. <i>State-Owned Enterprises</i> . . . . .                              | 271 |
| B. <i>Township and Village Enterprises</i> . . . . .                     | 277 |
| III. CORPORATIZATION . . . . .   | 285 |
| A. <i>State-Owned Enterprises</i> . . . . .                              | 286 |
| B. <i>Township and Village Enterprises</i> . . . . .                     | 294 |
| IV. THE ORIGINS AND PROSPECTS OF THE SOCIALIST MARKET ENTERPRISE . . . . | 297 |
| A. <i>Authority: Governance and Property Rights</i> . . . . .            | 298 |
| B. <i>Exit Constraints and Enterprise Form</i> . . . . .                 | 303 |
| V. CONCLUSION . . . . .  | 305 |

## I. INTRODUCTION

China’s phenomenal economic growth since 1978 has been accompanied by a cascade of institutional innovation and experimentation. In at least this one sense a hundred flowers are blooming in the People’s Republic. The range of institutional forms and their defiance of the conventions of economic organization in both capitalist and socialist societies are impressive.

The Chinese leadership calls the new order by the unfamiliar (and to some, oxymoronic) term “socialist market” economy.<sup>1</sup> Its “market” dimensions include dereg-

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Note on sources: Except for generally known background facts and statements cited to published sources below, the assertions of this article are based on discussions with officials and academics in Beijing in August 1993 and August 1994, and in Shanghai in October 1995 at a conference organized by On Kit Tam.

1. Prior to 1992, the official term was “socialist commodity” economy. Another popular term is “socialism with Chinese characteristics.”

ulation of most prices, decentralization of decision-making to the household in agriculture and to the enterprise in industry, incentive schemes for peasants, managers, and workers, and encouragement or tolerance of domestic private ownership in small business and various kinds of foreign investment. At the same time, the leadership considers the economy a "socialist" one in which "public ownership constitutes the mainstay."<sup>2</sup> Despite the important growth of private enterprise and foreign investment, the great bulk of industrial production occurs under public ownership.

Public industrial production takes place in two distinct sectors. First, the State-Owned Enterprises (SOEs) are typically urban, large-scale, mostly capital-intensive industries controlled at the national, provincial, and county levels. Second, the collective sector consists of relatively labor intensive industries subject to local governments, and is in turn conventionally divided into urban and rural subsectors.

Each of these sectors has been transformed during the reform period, with varying degrees of success. From one-third to one-half of the SOEs have become self-sustaining in a competitive market environment, and the most successful have achieved formidable productivity and growth. On the other hand, at least one-third of these enterprises survive only through exorbitant government subsidies. In the rural part of the collective sector, the Township and Village Enterprises (TVEs), which get little subsidy, have, in the aggregate, achieved astounding success and have proved the most dynamic sector of the economy. From the early 1980s, while the annual growth rate for the economy as a whole has averaged a breath-taking nine percent, TVE production has grown at the rate of twenty-five percent.<sup>3</sup> These developments, especially in the TVE sector, have prompted many (including some for whom the wish is not father to the thought) to question the neo-liberal dogma that privatization is necessary for successful reform of state socialist economies.<sup>4</sup>

Each sector has developed a distinctive and in some respects novel set of institutional forms. Indeed, the economist Ronald McKinnon has called the TVEs "a form of corporate organization that has not been created before."<sup>5</sup> To call these structures "legal" begs several questions of comparative jurisprudence, but there are some salient reasons for doing so. The reform of the Chinese economy has been accompanied by the emergence of a legal system designed both to protect the independence of enterprises and facilitate their regulation. To a limited extent the enterprises are the product of

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2. Decision of the CPC Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economic Structure, Daily Rep. China (FBIS), at 22, 23 (Nov. 17, 1993) [hereinafter Decision of the CPC Central Committee].

3. The World Bank data put the average annual GNP growth from 1980 to 1993 at 9.6% and average annual per capita GDP growth during this period at 8.2%. WORLD BANK, WORLD DEVELOPMENT REPORT 1995 162, 164 (1995); see also Martin Weitzman & Chenggan Xu, *Chinese Township and Village Enterprises as Vaguely Defined Cooperatives*, 18 J. COMP. ECON. 121, 128 (1994) (estimating TVE annual growth in output, capital productivity, and labor productivity from 1979 to 1991 at 25.3%, 16.5%, and 11.9%, respectively); Thomas G. Rawski, *Progress Without Privatization: The Reform of China's State Industries*, in CHANGING POLITICAL ECONOMIES: PRIVATIZATION IN POST-COMMUNIST AND REFORMING COMMUNIST STATES 27-52 (Vidat Milor ed., 1994) (documenting substantial productivity increases in many SOE sectors).

4. E.g., *China: The Titan Stirs*, ECONOMIST, Nov. 28, 1992, at 6-8.

5. *Id.* at 12.

legislation. They have also been influenced by Western legal models of business organization.

On the other hand, China's effort to establish an independent judiciary is in an early stage, and the leadership's commitment to the rule of law is ambiguous. To date the courts have not been extensively involved in intra-enterprise disputes. The gap between legal prescription and practical enforcement is thus larger and less measurable than in the West. Even if the enterprise laws were completely unenforced, they would be of interest as ideological pronouncements, but ambiguity about the degree of enforcement makes assessment of their practical significance more speculative.

Aside from its intrinsic interest, an examination of the legal structure of these enterprises may offer some clues as to the broader meaning and longer term direction of "socialism with Chinese characteristics." The leadership has made little effort to explain or justify the reforms in terms of Communist or any other ideology. Sometimes it purports to have discovered a previously under-appreciated requirement in the logic of historical materialism that full-scale socialism be preceded by a period of market relations of unspecified duration. Sometimes it speaks as if socialism amounted to nothing more than an aspiration to maximize production by whatever institutions seemed likely at the moment to do so. Deng Xiaoping's famous maxim of the 1960s—"It doesn't matter whether the cat is black or white. If it catches mice, it's a good cat."—once seemed a protest against dogmatism; today it seems an excuse for unprincipled expedience.<sup>6</sup> Since there is little direct theorizing about the meaning of Chinese market socialism, the best way to study it is through more narrowly focused policy debates and the reformers' practices. The effort to produce a legal framework for public enterprises is a small but interesting corner of these activities.

Part II of this Article describes some of the legal ideas that emerged from efforts during the 1980s to reform the SOEs and TVEs. In each case, reforms proceeded by adopting features familiar to Western capitalist enterprise but retaining largely public ownership and other significant features of pre-reform socialist enterprise models. Part III discusses the more recent emergence of models based on Western corporate forms. These corporate models, which are in the early stages of implementation, tend to dilute the distinctively "Chinese characteristics" of the 1980s models but do not eliminate them. In their more innovative and daring variations, the reforms promise to create two distinctive structures of market socialism—one resonating with recent Western speculation on corporate governance through investment intermediaries and the other resonating with recent Western speculation about industrial districts. These Western ideas, however, have been considerably less influential than a more conventional set of views about the corporate form that has played a surprising and perhaps perverse role in the reforms.

Part IV speculates on the origins and prospects of public ownership and the other distinctive "characteristics." One common expectation is that, barring a collapse into

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6. HARRISON SALISBURY, *THE NEW EMPERORS* 209 (1992) (quoting Deng Xiaoping). On recent ideological developments, see generally DENG XIAOPING, *BUILD SOCIALISM WITH CHINESE CHARACTERISTICS* (1985); JOSEPH FEWSMITH, *DILEMMAS OF REFORM IN CHINA: POLITICAL CONFLICT AND ECONOMIC DEBATE* (1994); see also Alison W. Conner, *To Get Rich Is Precarious: Regulation of Private Enterprise in the People's Republic of China*, 5 J. CHINESE L. 1, 9-16 (1991).

anarchy or a reversion to totalitarianism, China's institutions, especially its industrial enterprises, will converge with the dominant models of Western capitalism. The move toward corporatization in both state and collective sectors could be read as confirming that expectation. However, the move to corporatization may not be stable and the distinctive "characteristics" may prove durable even in a prosperous market environment.

## II. THE ENTERPRISE MODELS OF THE 1980S

China has moved gradually but decisively to facilitate private enterprise. Nonetheless, most of the economy remains publicly owned.<sup>7</sup> Moreover, official doctrine holds that public ownership remains "the basis of the socialist economic system [of the PRC]."<sup>8</sup>

The reforms have privatized many small enterprises, usually by sale or lease to managers and workers. However, the leadership has insisted that the large state enterprises remain under public control. The leadership rejects large-scale privatization of the sort occurring in Eastern Europe, in which state assets are auctioned to the wealthy or given away to the masses, on several grounds. First, mass privatization would likely produce an undesirable concentration of capital in private (especially foreign) hands. Second, given the difficulties of valuing state assets, the dangers of shortchanging the state are great. Third, the distributive and allocative consequences of stock trading by masses of uninformed citizens in informationally inefficient markets are likely to be undesirable. Insiders and speculators would grow rich at the expense of ordinary citizens, and the stock market would not play a useful role in corporate monitoring. Fourth, China lacks a developed system of tax collection and the social conventions that support it. At least until it can develop these things, the revenues of the state enterprises are the most plausible form of government finance.

Moreover, despite the enthusiasm of many segments of the population for capitalist institutions, private enterprise still lacks legitimacy in many quarters. Private enterprise also lacks the legal protection it enjoys in the West. Thus, privatization is rejected not only by those who oppose it on ideological and political grounds, but also by cadres and managers who feel that they can get rich more safely at the helm of a public, rather than a private, enterprise.

In the tradition of most Communist legal systems, China continues to distinguish between two types of public ownership. "State ownership," which in Chinese jargon is synonymous with "ownership by the whole people," gives ultimate control to the central government (though many state enterprises are assigned conditionally to provinces or counties). "Collective ownership" involves association with lower levels of government and connotes, in theory, control over the enterprise by its participants.<sup>9</sup>

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7. Official statistics for 1993 show 81% of the gross value of industrial output coming from public (state and collective) enterprises and less than 19% coming from private (individual and "other") ones. They show more than 90% of employment in public enterprises. STATISTICAL YEARBOOK OF CHINA 1994 351, 365 (1995) [hereinafter STATISTICAL YEARBOOK 1994].

8. XIANFA [Constitution] art. VI (P.R.C.) (1982).

9. See generally XIANFA [Constitution] arts. VI-VIII (P.R.C.) (1982). See also GENERAL PRINCIPLES OF CIVIL LAW [GEN. PRINCIPLES CIV. L.] art. 48 (P.R.C.) (explaining that property of a state enterprise is "given

The large-scale, capital-intensive, urban economy tends to take the form of SOEs. There are between 100,000 and 200,000 of them. Many small-scale urban enterprises and most rural enterprises have tended to take the form of collectives. Since the dramatic agricultural gains of the early reform years, the most dynamic growth has been in rural industry—the “township and village enterprises.” There are between one and two million of them.

In both sectors, the reforms of the 1980s produced enterprise structures that combined familiar features of Western business institutions with features reflecting the pre-reform socialist economy. Aside from public ownership, perhaps the most distinctive of these latter features are: First, the models express an ambiguous and perhaps paradoxical conception of enterprise governance that, in comparison to the formal Western corporate model, combines an exceptional degree of managerial power with an exceptional degree of worker participation. Second, these models retain from the pre-reform era a conception of the enterprise as a relatively encompassing community and the worker’s participation as a form of *membership*, as opposed to a narrowly contractual employment relation. Third, they presume or require a relatively high degree of internal finance and income reinvestment.

#### A. State-Owned Enterprises

The PRC regime continues to portray “ownership by the whole people” as historically and economically the most advanced form of property and to see the SOEs as the “leading sector” or “mainstay” of the economy.<sup>10</sup> The ultimate representative of the “whole people” is the national government. Nevertheless, the national government can delegate to inferior jurisdictions. When it does so, the lower level government’s rights are a matter of national government discretion or intergovernmental contract; the national government retains some claims to the property, notably the right to resume control or re-delegate to some other entity.

Chinese government has long been relatively decentralized and jurisdictionally pluralistic. Thus, control of the SOEs has always been at various governmental levels. “Property in China,” Andrew Walder writes, “has never been held by ‘the state’—it always has been held by thousands of separate government jurisdictions, from villages right up to the central ministries.”<sup>11</sup>

The economic reforms dramatically increased the practice of downward delegation of control over state enterprises. Upper level governments turned control of enterprises to lower level governments in return for the latter’s agreements to remit a share of tax or profit collections. At the same time, governments at all levels created or enhanced relatively autonomous entities to undertake investments. These included investment companies, holding companies, foundations (akin to charitable corporations), and joint ventures with foreign enterprises. At the same time, government service providers such as schools, hospitals, and (most notoriously) prisons were encouraged to develop for-

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it to manage” by the state; property of a collective is “owned” by the collective).

10. XIANFA [Constitution] art. VI (P.R.C.) (1982).

11. Andrew G. Walder, *Corporate Organization and Local Government Property Rights in China*, in CHANGING POLITICAL ECONOMIES, *supra* note 3, at 53, 58.

profit sideline enterprises. The People's Liberation Army (PLA), which has always had its own enterprise sector, became a major player in a variety of new investments, many unconnected to its military mission.

Collaboration between different governmental entities created myriad joint ownership structures. For example, the Ministries of Finance and Commerce created the Commodities Investment Futures Corporation through a joint initiative. It provides trading services for derivative securities. The Ministries of Finance and Commerce divide its income and nominate its governing board. The Jinbei Passenger Vehicle Manufacturing Company of Shenyang, initially entirely controlled by the Shenyang government, sold minority interests to some of its suppliers, which were also SOEs (and eventually to the public on the Shanghai stock exchange). When it recently created a joint venture (financed in part by a public offering in the United States), a major investor was the Chinese Financial Education Development Foundation, a "social" organization devoted to "financial education and research" sponsored by the Bank of China and affiliated institutions.

The reforms of the 1980s revised the terms on which government would deal with SOEs. The central government phased out price control and administrative allocation for most goods. Under the "contract responsibility system" instituted throughout the 1980s, governments at all levels gave enterprises subject to their control more latitude over operating and even investment matters. They ceased claiming all the enterprises' operating profits, instead settling for a fixed payment alone or accompanied by a profit share.<sup>12</sup>

The initial major attempt to impose formal legal structure on SOE reform was the Enterprise Law of 1988.<sup>13</sup> It is vague and fragmentary. Yet, the three distinctive themes of the "socialist market" enterprise of this period are apparent.

*Authority.* The basic purpose of the "contract responsibility" system was to create incentives to pursue profits and then give enterprises the autonomy to do so by restraining interference by government agencies.<sup>14</sup> The 1988 Enterprise Law reflects the autonomy goal in four prominent provisions. First, it proclaims the "principle of separation of ownership and control," which it then interprets to allow the enterprise to enjoy the rights to "control, utilize, and dispose" of the enterprise assets.<sup>15</sup> Second, it makes each enterprise a profit center that must "take responsibility for its own profits and losses."<sup>16</sup> Third, it makes each enterprise an independent "legal person," connoting that the enterprise can independently contract, convey property, and sue and be sued.<sup>17</sup> Finally,

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12. See generally SUSAN L. SHIRK, *THE POLITICAL LOGIC OF ECONOMIC REFORM IN CHINA* 149-330 (1993).

13. Law on Industrial Enterprises Owned by the Whole People, Daily Rep. China (FBIS), at 42-49 (Apr. 26, 1988) [hereinafter Enterprise Law].

14. What constitutes objectionable "interference" as opposed to appropriate regulation has not always been clear. Presumably general regulation to correct market failure and implement social goals remained legitimate. What was objectionable was the imposition of business judgments by government cadres and the making of unprincipled or ad hoc demands that the enterprise support social goals or simply make payments to agencies or cadres.

15. Enterprise Law, *supra* note 13, art. 2.

16. *Id.*

17. *Id.*

it gives the enterprise a series of control rights including the rights to make various business decisions on matters of what to make, who to sell to at what price, and how to invest retained earnings, as well as "the power to reject the exaction of its manpower, materials and financial resources . . . by any state agency."<sup>18</sup> The enterprise is given a right of appeal from government orders it believes unlawful.<sup>19</sup> These provisions are qualified by duties to safeguard the property of the enterprise,<sup>20</sup> and by an open-ended right of the government to "issue unified mandatory plans for the enterprise" and to "remove, reward, or punish" the enterprise director.<sup>21</sup>

Within the enterprise, the statute defines an extremely powerful managerial role. It requires enterprises to implement "the factory director (manager) responsibility system," apparently a synonym for the "contract responsibility system," but one that emphasizes the director's preeminence within the system.<sup>22</sup> The statute further provides that the director "shall occupy the central position in the enterprise,"<sup>23</sup> that the enterprise system of "production, operation and management [be] headed by the director," and that the "factory director shall be the legal representative of the enterprise."<sup>24</sup> A list of specific managerial powers includes powers "to decide on various plans for the enterprise," to appoint subordinate managers, and to reward and discipline subordinate managers and workers.<sup>25</sup> The latter powers are qualified by powers of approval of the government entities responsible for the enterprise. Viewed in isolation, these provisions suggest a more powerful managerial role than can be found in any Western corporate statute. However, these provisions co-exist with provisions on worker participation that are also unusual by Western standards.

The PRC Constitution requires that "[s]tate enterprises practice democratic management through congresses of workers and staff and in other ways according to law."<sup>26</sup> The Enterprise Law affirms the commitment to "democratic management"<sup>27</sup> and further declares that workers "enjoy the status of masters."<sup>28</sup> This term is not immediately defined, but later provisions are relevant, though also ambiguous. Two provisions suggest that the workers *might* have *some* role in choosing the director. One article gives the workers' congress the power to "elect [the factory director], according to the decision of [i.e., with the approval of] the competent department of the government."<sup>29</sup> The other article provides that the director is to be elected *either* by appointment of the responsible government agency or by election by the workers' congress that separate legislation required all enterprises to establish.<sup>30</sup>

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18. *Id.* arts. 22-33.

19. *Id.* art. 61.

20. Enterprise Law, *supra* note 13, art. 61.

21. *Id.* art. 55.

22. *Id.* art. 7.

23. *Id.* art. 44.

24. *Id.* art. 45.

25. Enterprise Law, *supra* note 13, art. 45.

26. XIANFA [Constitution] art. XVI (P.R.C.) (1982).

27. Enterprise Law, *supra* note 13, art. 49.

28. *Id.* art. 9.

29. *Id.* art. 52(5).

30. *Id.* art. 44.

Workers are to participate in management directly through the general assembly of the workers' congress and in shop floor work teams, as well as through the representatives that the congress chooses.<sup>31</sup> The powers of the workers' congress include "to hear and deliberate [i.e., consider]" management's plans for all aspects of the enterprise, "to examine and agree to or reject" management's plans regarding wages and working conditions," "to deliberate and decide" on housing and other welfare expenditures for the workers, and to "appraise and supervise" managers "at various levels of the enterprise." These powers, ambiguous in themselves, are made more so by the qualification that the workers "support the factory director in exercising his functions."<sup>32</sup>

Overall, these provisions suggest deliberate ambiguity. Depending on whether the workers are allowed independently to elect the director and how the workers' power to "deliberate," "supervise," and "approve or reject" are construed, the workers could have strong participatory rights or very weak ones. In practice, most observers believe the workers have weak participatory rights. Directors are generally appointed, usually by the relevant branch of the Party Organization Department, and the ongoing role of the workers' congresses is rarely strong. Even workers in the more financially successful enterprises and who may have great respect for their bosses often believe that participation is a sham and that the reforms have increased the director's power relative to their own. "He used to act like a director; now he acts like an owner," is a widely expressed worker view about the evolution of authority under the reforms.

While unusual, meaningful worker control apparently has occurred. A few workers' congresses have elected enterprise directors and have been active in management, though there are no detailed reports on them. Some SOEs have used elaborate committee structures to involve workers in work design and allocation in a way that to outsiders might resemble collective bargaining. Thus, the main significance of the statutory provisions is as an expression of a public aspiration toward workers' control, albeit a qualified and ambiguous one.

*Membership.* In the pre-reform era, the state-owned enterprise was an encompassing community. It was the lowest level of a hierarchy of governance and social control institutions, as well as a social welfare and insurance agency attending to a broad range of consumption needs commonly including food, housing, and entertainment. The state-owned enterprise provided health and retirement benefits and perhaps education to its workers and their families. Workers presumptively had lifelong tenure; indeed, for many years they had the right to bequeath their jobs to their heirs. Although compensation practices varied over the years, they were always egalitarian by Western capitalist standards.<sup>33</sup>

During the reform era, however, the leadership has sought to move away from this model toward a more conventional vision of employment referred to as "the contract system."<sup>34</sup> This model contemplates that workers will be subject to layoff after the specified term of their employment contract. The vulnerability of individual employees

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31. *Id.* art. 43.

32. Enterprise Law, *supra* note 13, art. 52.

33. See ANDREW G. WALDER, COMMUNIST NEO-TRADITIONALISM: WORK AND AUTHORITY IN CHINESE INDUSTRY 28-84 (1986).

34. See HILARY K. JOSEPHS, LABOR LAW IN CHINA 33-58 (1990).

to discharge for redundancy complements the "contract responsibility system" notion that the enterprise should be "responsible for its own profits and losses" and subject to bankruptcy if it fails to achieve profitability. In addition, the "contract system" contemplates that the enterprise will shed responsibility for most housing and welfare functions, many of which will be left increasingly to the market, and for retirement and disability benefits, which are to be taken up by general social insurance systems. Moreover, the system urges productivity-based compensation differentials.

In fact, the implementation of the new system has been slow and erratic, and, at least de facto, the SOEs have retained three salient features of encompassing community—tenure, collective consumption, and internal egalitarianism. First, it has proved politically impossible to harden the budget constraints of many state enterprises; layoffs have been rare and bankruptcies rarer still. Moreover, the establishment of government programs capable of assuming the social insurance functions of the SOEs has been slow. Thus, the enterprises retain many of their welfare functions. The idea of presumptive tenure for workers in all except the more troubled enterprises is unlikely to be abolished. Urban families have come to expect presumptive tenure, and it is a norm espoused in many sectors of capitalist industry abroad. A self-respecting "market socialist" society would seemingly want to achieve at least this much. The 1994 Labor Law makes tenure mandatory for workers who have been with the enterprise for ten years.<sup>35</sup>

Second, the reformed enterprises have continued the SOE tradition of enterprise-focused collective consumption. Although the new consumer goods markets have reduced dependence on enterprises for such goods, enterprises continue to provide consumer goods to their workers. Moreover, the establishment of public social insurance programs capable of assuming the SOEs' welfare functions have been slow, so the enterprises have continued to provide these benefits.

One explanation for the practice is that it facilitates evasion of the constraints on wage dispersion. In-kind compensation is much more unequally distributed than cash compensation. The successful enterprise director receives a small salary by Western standards, but he also enjoys an expense-account life that approaches Western standards. However, it seems likely as well that the practice of in-kind and collective compensation reflects a continuation of the expectation that the enterprise will concern itself with the needs of its workers.

Enterprises set aside specified percentages of their profits in welfare funds that fund consumption and social benefits. The 1992 regulations supplementing the Enterprise Law mandate that amounts equal to at least ten percent of any increase in total wages be put in the welfare fund.<sup>36</sup> Provincial and city regulations contain additional restrictions of this sort.

Third, there remains a high degree of internal egalitarianism in cash wage compensation. Senior executive salaries even in the more successful enterprises are typically no more than three times the salaries of rank-and-file production workers. The constraints on inequality are not mandated by the enterprise and labor law;<sup>37</sup> they result from poli-

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35. Labor Law, art. 20 (State Council 1994) (P.R.C.).

36. *Id.* art. 24.

37. The 1992 regulations on "Changing the Operating Mechanism of Enterprises Owned by the Whole People," which supplement the Enterprise Law, contain some restrictions on wages in articles 24 and 25, but

cies of the ministries and the party and presumably the continued power of egalitarian ideals among the workforce. While there is considerable pressure toward widening the differentials, it is hard to imagine them reaching the levels typical of the West.

*Reinvestment.* Successful SOEs reinvest a large fraction of their profits. When they reach the limits of expansion of existing lines of business, they enter new ones, sometimes turning themselves into conglomerates. They often undertake joint ventures with other enterprises. Purely passive investments, however, are rare.

Some state and municipal legislation mandates that a minimum fixed percentage of profit be reinvested. The national legislation creates more indirect pressures and incentives toward the same general result. One such feature is a kind of "reinvestment tax credit" that rebates a portion of tax payments on reinvested income.<sup>38</sup>

The "contract responsibility" system reflected in the Enterprise Law creates a structure in which management (perhaps with the workers) has most aspects of control. The state, however, remains the residual claimant on the firm's income. The state's residual claim is qualified by what is effectively a profit-sharing arrangement in which management and workers receive bonus compensation based on performance.

There are two streams of money that the state, as the residual financial claimant, might have been expected to appropriate. The first is that of depreciation funds. As in the Western enterprise, some fraction of the firm's gross receipts are considered as a recovery of the loss in value of its capital equipment incurred in producing the goods that generated the income. The second cash stream, of course, is the profit stream. Instead of requiring these funds to be remitted to the state, the system gives management full control over depreciation funds, which can be invested in the upkeep of existing assets or the purchase of new ones, and it allows the enterprise to retain for reinvestment all profits in excess of a specified amount.

This structure represents a departure from the Communist system in which the central government controlled both depreciation funds and enterprise surpluses. It bears substantial resemblance to Western corporate structures in which managers often have de facto control over such funds and have strong incentives to retain them in the enterprise. But in the Chinese case the incentives are stronger and more explicit. Managers are under a legal duty to reinvest depreciation funds, and the residual claimant is committed not to demand pay out of more than a specified fraction of profits.

Of course, the reinvestment requirements are consistent with the policies and propensities reflected in China's phenomenal savings and investment rates, which have exceeded a third of gross domestic product throughout most of the reform period.<sup>39</sup> But these policies do not explain the requirement that profits be reinvested *in the enterprise* (or affiliated ones). There seem to be two reasons for the strong commitment to reinvestment. First, the state's commitment to allowing successful firms to grow gives managers and workers incentives to work harder and to work with a perspective to the long run success of the firm. Second, China does not have a fully developed system of

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they are concerned with keeping wage increases in line with increases in profitability and labor productivity, not internal dispersion. A detailed summary of the regulations appears at JPRS Rep. China (JPRS), at 14, 21-22 (Oct. 13, 1992).

38. *Id.* at 18-19.

39. WORLD BANK, *supra* note 3, at 178; STATISTICAL YEARBOOK 1994, *supra* note 7, at tbl. 2-16.

institutions—either in the form of government agencies or capital markets—to reallocate income across firms. The state agencies are distrusted particularly as vehicles for investment decisions, and capital markets are undeveloped.

### B. Township and Village Enterprises

From the late 1950s until the 1980s, government choked off private enterprise, but it gave a significant role to collective ownership. Light industry in urban areas has been commonly organized in the collective form. During the Great Leap Forward (1958-61) and the Cultural Revolution (1966-76), strenuous efforts were made to introduce small-scale industry into the countryside, and these nearly always took the collective form.

Outsiders have tended to view collectives as just as much creatures of the state as the nominally state-owned enterprises. They have attributed the significance of the distinction between the two forms of ownership to two practical features different from the ones emphasized in Communist theory. First, unlike the state-owned enterprises, the collective ones were not included in the State Economic Plan and were not subject to direct control at the central, provincial, or county levels. This meant that state control was weaker and that it occurred at the local government level (districts or neighborhood associations in cities, townships, and villages in the countryside). It also meant that, in principle, collective property was not subject to reallocation by the central government.<sup>40</sup> Second, the package of welfare, health, and retirement benefits that the collectives were required to extend to their employees was much less generous than the one guaranteed to state enterprise workers.<sup>41</sup>

In Communist theory, however, the most important connotations of the collective form were different, and while these theoretical connotations may not have had a great deal of influence on practice prior to the reform period, they have been influential in recent years and may prove more so in the future.<sup>42</sup> In theory, state ownership entitles the state, on behalf of the society, both to control the enterprise and to appropriate the residual returns from its operation. By contrast, under collective ownership both control and the right to residual returns belong to the collective's members. This implies enterprise autonomy, self-management, and distribution of residual returns to members.

The members have ownership rights only collectively. These rights are not individually appropriable or transferable. The member cannot sell her rights; she cannot liquidate her anticipated future benefits into a present lump sum; and she cannot continue to enjoy her rights after she has left the collective. At the same time, these rights are subject to strong accumulation restraints that typically mandate strict equality in control and limited inequality in financial distribution.

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40. Yingyi Qian has offered the following legal positivist elucidation of the distinction between state and collective property: "The central government reserves the ultimate rights of reallocation of residual cash flow and the assets in state-owned enterprises, even if the control rights have been delegated to and the residual income has not been assigned to local governments, while it has no such rights [with respect to] collectively-owned enterprises." Yingyi Qian, *Issues of Enterprise Reform in China 3* (1994) (unpublished manuscript, on file with author).

41. WALDER, *supra* note 33, at 43-48.

42. See generally XUE MUQIAO, *CHINA'S SOCIALIST ECONOMY* 45-66 (1981).

The members similarly cannot appropriate collective capital as a group by, for example, agreeing to liquidate it and sharing the proceeds. In Western legal rhetoric, they might be characterized as trustees of the enterprise's capital for future members. The law requires that enterprise capital be maintained through depreciation charges (and also frequently in China, augmented through mandatory earnings retention) and restricts distributions to what American lawyers might call earned surplus.

Although the collective form often puzzles American observers of China (and of Yugoslavia, where prior to 1988 it received its most ambitious implementation), there are Western analogues to it. In its worker control and profit appropriation it resembles a cooperative; in its restraints on capital appropriation it resembles a charitable trust. In its combination of these features it resembles the "limited equity cooperative," a form occasionally found in the United States in publicly subsidized housing ownership and in worker cooperatives in Europe.<sup>43</sup>

Although the collective form is fairly well-defined, a distinctive ambiguity recurs in the usage of the term. Sometimes the Chinese speak as though each enterprise were itself a collective and its workers, the member-owners. At other times, they speak as if the local government units associated with the enterprise were the collectives and all the members of these units were the owners of the associated enterprises. And in still other instances, somewhat contradictorily, they refer to individual enterprises as collectives "owned" by the government units.

Part of the ambiguity arises from the fact that, while urban districts and neighborhood associations and rural townships and villages perform governmental functions, they are not considered part of the "state," but are themselves collectives.<sup>44</sup> Unlike their urban counterparts, the townships and villages (and their predecessors, the communes and brigades) have played strong roles in economic management. While in the urban sector the collective is often identified with the enterprise and its workers are considered owners, in the rural sector the relevant collective has been the entire community.<sup>45</sup>

From the beginning of the reform period in 1978, the leadership has encouraged the development of both urban collectives and rural industrial enterprises, or TVEs. Both sectors, especially the rural one, have grown dramatically. In 1981, the collective sector accounted for about twenty percent of the PRC's industrial output; and rural industrial production was twenty-seven percent of collective output. By 1993, the collective sector accounted for about thirty-eight percent of industrial output and TVEs accounted for sixty-nine percent of collective output.<sup>46</sup>

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43. See generally William H. Simon, *Social-Republican Property*, 38 UCLA L. REV. 1335 (1991).

44. The situation of the townships became more ambiguous in the 1980s when they were given a variety of administrative functions previously performed at higher levels and their budgets were integrated with those of higher level units. Notwithstanding the change, townships are still considered essentially self-governing units rather than agencies of the state.

45. See Jianzhong Tang & Laurence J. C. Ma, *Evolution of Urban Collective Enterprises in China*, CHINA Q., Dec. 1985, at 614 (discussing urban collectives).

46. STATISTICAL YEARBOOK 1994, *supra* note 7, at 351; STATISTICAL YEARBOOK OF CHINA 1981 212 (1981).

Because of their institutional novelty and their phenomenal growth, the TVEs have attracted the most attention, and this Article focuses on them here. The central government's policy has been to leave broad discretion to townships and villages in shaping industrial development.<sup>47</sup> TVEs have developed in almost every area of industrial activity except natural resources extraction, including highly capital intensive forms of manufacturing and processing. They have taken a variety of legal forms.<sup>48</sup>

Some TVEs are organized as private—typically family proprietorships or partnerships. In the Wenzhou area of Zhejiang province, south of Shanghai, a booming economy of mostly small-scale manufacturing is organized largely as private firms. On the other hand, just north of Shanghai in southern Jiangsu county, another booming TVE economy consists almost entirely of local government owned enterprises. Other areas show more of a mix, but the "Southern Jiangsu model" is the more dominant. Most large TVEs and many small ones are public.<sup>49</sup>

The institutional structure of the TVEs is notoriously amorphous, and crude classifications can be misleading. The practical distinction between public and private enterprises is often not what the name suggests. Some private entrepreneurs choose to designate their enterprises as public so as to qualify for subsidies or avoid popular hostility to private wealth.<sup>50</sup> Such "red hat" enterprises may be functionally indistinguishable from private businesses.

At the same time, private enterprises are often extremely dependent on local government and subject to extensive collective controls. Even in areas of intense private entrepreneurialism, both governments and quasi-public industrial associations play important roles in providing technical and marketing assistance, facilitating transactions, allocating credit, and providing land, buildings, and infrastructure. Though these activities are often initiated and controlled by entrepreneurs, they are typically conducted through government agencies. The success of the small private household industries producing buttons and badges in Wenzhou depends in part on collectively run "main factories" that furnish supplies to households and certify the quality of their output. The factories are owned by the household "branches" in conjunction with the village and township collectives.<sup>51</sup>

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47. Although populations vary widely, a typical township has 30,000 to 40,000 people; a typical village has 1,000 to 2,000. CHINA'S RURAL INDUSTRY 3 (William Byrd & Lin Qingsong eds., 1990) [hereinafter RURAL INDUSTRY].

48. See *id.* at 129-218.

49. Official 1993 statistics show about 95% of rural industrial employment in collective enterprises. CHINA STATISTICAL YEARBOOK 1994 65 (1994). A World Bank study of 1985 data estimated that 92% of the output of the rural industrial sector came from public TVEs, with 45% coming from township enterprises, 38% from village enterprises, and 9% from production team enterprises. RURAL INDUSTRY, *supra* note 47, at 195.

50. Prior to 1988, there was no clear legal sanction for private business organizations with more than seven workers. ("Individual" business organizations—defined as businesses employing no more than seven people—had been recognized in the 1982 Constitution and subsequent legislation.) See Conner, *supra* note 6, at 1-8. During this period, the temptation was especially strong to adopt the collective form in the hope of acquiring more legal security. Some observers of the urban scene at this time interpreted the collective form as simply a fig leaf for unabashedly capitalist enterprise. *E.g.*, Howard Chao & Yang Xiaoping, *Private Enterprise in China: The Developing Law of Collective Enterprises*, 19 INT'L LAW. 1215 (1985).

51. PETER NOLAN & DONG FURENG, MARKET FORCES IN CHINA: COMPETITION AND SMALL BUSINESS-

Private ownership is nominally the norm in Nanhai county in booming Guangzhou province. However, sociologists studying Nanhai county have recently described a "new collective economy." In this relatively advanced economy, where enterprises produce a quarter of China's aluminum output, collective enterprises play important roles in keeping enterprises abreast of technical developments and soliciting and allocating orders.<sup>52</sup>

Some firms have explicitly hybrid structures. For example, some township enterprises are leased to managers for fixed rental payments. The lessee has control and the short-term residual interest. The township has the reversionary interest, though in practice, if the enterprise is successful, it will often sell out to the lessee. In some areas, joint ventures between collective and private firms are common.

Another hybrid variation arises when a small private business grows to substantial size and then converts to a collective. Such a move might be attractive because it would improve access to capital and thus reduce the risk for both managers and workers. Moreover, managers sometimes receive improved compensation when they become public officials. Upon conversion, the managers retain control, as well as some vaguely specified residual interest. The township's control and residual rights increase, but only incrementally.

At the township level, the most characteristic structure involves enterprise supervision by a Township Industrial Commission, which is often analogized to a holding company or a conglomerate.<sup>53</sup> The latter seems more apt since the Commissions appear more activist than holding companies, but many TVEs seem to have more autonomy than American conglomerate enterprises, particularly with respect to raising capital. Like a conglomerate, the Township Industrial Commission chooses and monitors management of the operating enterprises, allocates capital (and often land and workers), and participates in major strategic decisions, while leaving routine operations and moderate scale decisions to the enterprise itself. Capital allocation takes the form of either direct investments by the township or, more commonly, recommendations or guarantees to the national banking system. Local government also controls land and infrastructural services.<sup>54</sup>

The Township receives three revenue streams from the enterprises. First, the enterprises within the township pay taxes. In accordance with China's elaborate hierarchical fiscal system, these revenues must be shared with upper levels of government and their local uses are extensively mandated by the central and provincial governments. Second, the Townships receive some or all of the profit distributions of their publicly owned

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THE WENZHOU DEBATE 97-125 (1990); Dong Fureng, *Shareholding Cooperative Enterprise—Reform in Enterprise Organizational Form*, JPRS Rep. China (JPRS), at 14-15 (Dec. 3, 1991) (discussing "main branch" factories in Wenzhou).

52. See generally WANG YING, SHICHANG JINGJI YU ZHONGGUO SHEHUI ZUZHI JIEGOU DE BIANQIAN [CHANGES IN THE MARKET ECONOMY AND STRUCTURES OF CHINESE SOCIETAL ORGANIZATION] (1994).

53. See RURAL INDUSTRY, *supra* note 47, at 339-87.

54. Another analogy that seems relevant in areas with extensive private ownership is a venture capital investment company. Like a conglomerate, a venture capital firm provides capital, monitoring, and expertise, but has a smaller stake and less control. At the point where the firm becomes successful, the investment firm facilitates diversification of finance by taking the firm "public." The process by which private firms convert to collectives is in some respects analogous to that by which Western firms "go public" by selling shares on the stock market. Here, however, diversification takes place only within the local capital market.

enterprises. These revenues are considered "extrabudgetary" and thus need not be shared and can be spent locally within the Township's discretion.<sup>55</sup> Third, the Township Industrial Commission receives a management fee from the Township enterprises.

Two sorts of explanations exist for the predominance of public TVE ownership.<sup>56</sup> One suggests that the government uses its monopoly power over property rights protection, finance, and land to discriminate against private enterprise. The other explanation emphasizes the important productive functions that local government is distinctively equipped to perform and that require close relations with the enterprises. First, local governments are well situated to conduct financial intermediation. They have better information than outside institutions about local investment prospects, and they are better able to collateralize debts than private entrepreneurs. They can collateralize better because the townships have more capital and because township officials have career and reputational interests that support honest dealings more than typical private entrepreneurs. Second, public ownership involves risk pooling that may be quite desirable in a community with little private wealth, and in doing so, it also constrains inequality. Third, the townships may be well-situated to provide technical or marketing assistance to enterprises that are too small to procure it individually in an economic manner. Fourth, community ownership reduces the conflict of interest over tax collection and payment for public goods that arises with private ownership. Private owners have an interest in hiding and understating income which has made effective tax collection difficult.

Observers have had difficulty discerning the internal structures of the TVEs. Two characteristics that everyone agrees on are that the structures are highly informal and that they often do not correspond to familiar Western models of private or state enterprise. However, with the help of an excellent empirical study by the World Bank in the mid-1980s and the Regulations on Township and Village Collective Enterprises promulgated by the central government in 1992, we can get a general sense of at least one important model for such enterprises.<sup>57</sup> The three distinctive themes noticed in the SOE structure are again evident.

*Authority.* The law provides that TVEs are part of a "socialist economy based on public ownership;"<sup>58</sup> that the enterprise's property is owned "by the residents [of the township or village] as a collective;" and that the local resident's assembly exercises the rights of ownership.<sup>59</sup> It specifies as rights of ownership the election of the director and decisions regarding major business policies, dividend distributions, major structural

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55. See Jean C. Oi, *Fiscal Reform and the Economic Foundations of Local State Corporatism in China*, 45 *WORLD POL.* 99, 103-05 (1992).

56. Both explanations can be found in *RURAL INDUSTRY*, *supra* note 47, at 129-218. The positive explanations are emphasized in Zheyuen Cui, *China's Rural Industrialization: Flexible Specialization, Moebius-Strip Ownership, and Proudhonian Socialism* (1994) (unpublished manuscript, on file with author).

57. *RURAL INDUSTRY*, *supra* note 47, at 134-218, 339-88; Xiangcun Jiti Suoyouzhi Qiye Tiaolie [Rural Collective Enterprise Regulations] (State Council 1990) (P.R.C.) [hereinafter TVE Regs]; see also Weitzman & Xu, *supra* note 3, at 131-36.

58. See TVE Regs, *supra* note 57, art. 3.

59. *Id.* art. 18.

changes such as mergers, and bankruptcy. However, the law cautions that “[t]he owner shall respect the autonomy of the enterprises.”<sup>60</sup>

The latter qualification reflects the concern that local officials may interfere in corrupt or economically short-sighted ways. Complaints are common in some areas that officials demand personal favors,<sup>61</sup> treat enterprise revenues as available to cover fiscal shortfalls, or insist that they expand employment to absorb local excess labor beyond the point that would be efficient for the enterprise. Perversely but understandably, such practices are most common in the poorest areas.

Language in the law suggests that local congresses elect managers. In practice, however, party cadres usually appoint managers. With the encouragement of the national government, some localities have experimented with auctioning off managerial jobs or subleasing entire enterprises through auction processes in which aspirants bid competitively by promising to remit specified levels of return to the township.<sup>62</sup>

The juxtaposition of strong managerialism and worker participation is again striking. The enterprise powers associated with the status of “legal person” (contracting, holding and conveying property, initiating and defending lawsuits) are to be exercised by the director (though presumably he or she can delegate).<sup>63</sup> The law provides that “[t]he director will have full responsibility in management,” and that “[t]he director has full authority regarding the affairs of the enterprise.”<sup>64</sup>

The grant of “full” responsibility and authority has to be read in the light of the local government’s ownership control over major policy decisions. Still, the law seems to give the manager at least as much power as a Western board of directors has formally. Although the practical role of the board in the West is less than the formal one, its oversight role is significant, and the collective legal model provides no internal organizational counterpart. However, the Township government and its Industrial Commission have the practical ability to engage in potentially intense oversight.

Again, the managerial theme co-exists with a worker control theme. The Constitution mandates that collective enterprises practice “democratic management.”<sup>65</sup> The regulations elaborate:

Workers have the right to participate in democratic management and to criticize and accuse managers and their staff. The enterprise workers’ congress or the representatives of the workers are entitled to voice criticisms and opinions regarding problems to managers or members of his staff and to protect the legal rights of the workers.<sup>66</sup>

60. *Id.* art. 19.

61. The practice of *tampai*—free products for government officials—is specifically condemned in the Collective Law, which encourages enterprises to denounce officials who demand such favors. *Id.* art. 40.

62. The idea is to force choice of the manager on the basis of economic productivity, but as a practical matter it seems doubtful that auctions can function impersonally in these contexts. Prospective managers have limited abilities to collateralize their promises and, even if they could do so fully, would not be plausible risk bearers, so the critical factor in the decision will be the subjective assessment of the competence and trustworthiness of the aspirant.

63. TVE Regs, *supra* note 57, art. 11.

64. *Id.* art. 22.

65. *Id.* art. 17.

66. *Id.* art. 26.

Most observers are skeptical that worker participation amounts to much in practice. As with the state enterprises, even highly satisfied workers seem to feel they have little power.<sup>67</sup>

Nevertheless, some areas have experimented with an important form of worker power not contemplated in the statute—election of managers. The motivation for this reform seems not to have been democratic ideals so much as a belief that elected managers would be better able to resist government fiscal predation. It is also suggested that elected directors would be in a better position to make necessary layoffs without compromising morale. Since a substantial portion of worker compensation amounts to bonus and profit sharing payments, workers as a body are hurt by overstaffing. The experiment has reportedly been successful in at least one jurisdiction—Shaxi township in Jiangxi province—and despite the narrowness of its initial motivation, it may prove a step toward giving substance to workers' participatory rights.<sup>68</sup>

*Membership.* The membership notion—the second recurring theme—is not explicit in the collective law, but it is prominent in the practical arrangements surrounding the TVEs, some of which are codified in other law. Considered as separate entities, neither the TVEs nor the individual worker's status in them has the permanence long associated with (though perhaps eroding in) the state enterprises. The TVEs operate on relatively hard budget constraints; there is no explicit or implicit public commitment to keep them going regardless of profitability. Bankruptcies are common.

The worker tenure norm of the state-owned enterprises does not apply even in the larger, more successful TVEs. The worker's relation is contractual,<sup>69</sup> which means workers are subject to dismissal and layoff. As noted above, some township governments pressure managers not to layoff or to hire unneeded workers, but in theory no workers have the type of tenure associated with the state-owned enterprises.

Compensation practices vary. Some workers are paid piece rates. However, many operate on quite egalitarian standards. The 1990 guidelines of the Ministry of Agriculture recommend that the director's salary should normally not exceed three times that of the average worker and never five times.<sup>70</sup>

The in-kind, collective consumption associated with the SOE occurs in the TVEs, but to a lesser degree. The State Council regulations require that an unspecified fraction of profits be devoted to employee welfare expenditures. Ministry of Agriculture regulations specify that amounts equal to at least ten percent of total wages be used for welfare expenditures (health, sickness, culture, and recreation) and one and a half percent of total wages be used to fund employee education.<sup>71</sup>

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67. *But see infra* notes 118-19 and accompanying text (discussing recent experiments in village level democracy).

68. RURAL INDUSTRY, *supra* note 47, at 380.

69. TVE Regs, *supra* note 57, art. 28.

70. MINISTRY OF AGRICULTURE, XIANGZHEN QIYE CHENGBAO JINGYING ZERENZHI GUIDING DI SHI JIU TIAO [REGULATION OF CONTRACT RESPONSIBILITY SYSTEM OF TOWNSHIP AND VILLAGE ENTERPRISES], reprinted in NONGMIN GUFEN HEZUO QIYE [RURAL SHAREHOLDING COOPERATIVES] 241 (1990) [hereinafter SHAREHOLDING COOPERATIVES].

71. TVE Regs, *supra* note 57, art. 32; MINISTRY OF AGRICULTURE, XIANGZHEN QIYE CAIWU ZHIDU [TOWNSHIP AND VILLAGE ENTERPRISE ACCOUNTING SYSTEM], reprinted in SHAREHOLDING COOPERATIVES, *supra* note 70, at 241.

However, the most important dimension of membership associated with the TVEs is membership in the *community*. This dimension appears in two salient respects: first, the dependence of eligibility for the core workforce on lawful permanent residence in the community, and second, the distribution of benefits in the form of collective consumption by residents.

The Communist regime has severely restricted its citizens' geographic mobility. The "household registration" system restricts each individual's lawful residence to a specific locality—presumptively the mother's residence—that can be changed only with official permission. Moreover, until recently, all housing was publicly owned and allocated, and basic food and cooking goods were publicly rationed. Housing and ration coupons were available only in the jurisdiction of a person's registered residence.

These controls have loosened during the reforms. Reregistration is easier. Permission to leave one's current jurisdiction of residence is no longer essential. Permission from the new jurisdiction is necessary, however. This is not easy to get, although some jurisdictions grant it to people with job offers in the locality, sometimes on payment of fees (or bribes). Moreover, the abolition of food rationing and the emergence of a private housing market have reduced the practical importance of lawful residence.

TVE development has occurred in a geographically uneven way, with most of the successful activity in areas of the coastal provinces of the South and East. This success has generated demand for labor that has induced massive migration to the booming townships. By and large, however, the new workers have not been accepted as legal residents of the townships. They are, to use the European term, "guest workers."

These workers are a major presence in most townships that have experienced industrial development. For example, in Nanhai County in Guangzhou, where the local labor force numbers 600,000, there are 300,000 guest workers. An extreme example is the notorious Daqiu Zhuang, near Tianjin, where a few years ago there were about 4,400 villagers and 30,000 guest workers.

Some localities regulate immigration intensely, bringing workers in under contracts that limit their stay to fixed periods. Some have built special housing for them. Typically the arrangements do not permit them to bring family members. In other areas, there is less formal regulation.

The government generally prohibits discrimination in compensation between resident and guest workers.<sup>72</sup> But other types of discrimination are lawful. The best jobs typically go to residents. Guest workers can be expelled when there is no work for them. They may be denied the right to bring their families to live with them. And they are denied access to a broad range of public goods provided residents.

In the collective sector, the most salient locus of collective consumption is the township or village, rather than the enterprise. Compensation of workers within the enterprise is "lower than their marginal productivities, lower than wages of state enter-

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72. See MINISTRY OF AGRICULTURE, ZHONGHUA RENMIN GONGHEGUO XIANGZHEN QIYE FA (CAO AN SONG SHEN GAO) DI SHI JIU TIAO [TOWNSHIP AND VILLAGE ENTERPRISE LAW OF THE PRC] (draft for review), reprinted in ZHONGGUO XIANGZHEN QIYE NIANDU XUESHU LUNWENJI [COLLECTED MATERIALS ON CHINESE TOWNSHIP ENTERPRISES] 145 (Zhang Yi ed., 1991) [hereinafter MATERIALS]. Although my informants asserted that wage discrimination against nonresidents was uncommon, there are reports of it. ANITA CHAN ET AL., CHEN VILLAGE UNDER MAO AND DENG 304 (1992).

prises, and . . . not correlated with the profitability of the enterprises."<sup>73</sup> A large part of the resident worker's effective compensation comes from public goods provided by the township or village with revenues collected from successful enterprises. These public goods take myriad forms—schools, public utility services, recreation, ceremonies, and festivals. In prosperous localities these benefits can be lavish, and the exclusion of nonresidents makes salient the value of community membership.

*Reinvestment.* The national regulations provide that forty percent of profits be paid to the local government. The enterprise retains the remaining sixty percent for reinvestment, bonus payments, and employee welfare expenditures.<sup>74</sup> Local regulations typically provide that a substantial portion of the enterprise's portion of its earnings—often fifty percent—be reinvested.<sup>75</sup>

### III. CORPORATIZATION

The pace of reform slowed after the Tiananmin Square massacre of 1989, but only briefly. When the reform movement regained momentum, reformers proposed new legal models and began to implement them in both the SOE and TVE sectors. In the SOE sector, reformers moved toward the "shareholding system"; in the TVE sector, they pushed the "shareholding cooperative" structure.

In both sectors, corporatization was proposed as a means of "clarification of property rights"—a constantly recurring phrase in Chinese discussions of enterprise reform in recent years. The leadership's most recent major statement on reform—the 1993 "Decision of the Chinese Communist Party Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economic Structure"—describes as the first "basic feature" of a "modern enterprise system" that "the property rights relations are clearly defined" and then proceeds to recommend "experimentation with the corporate system." Turning collectives into shareholding cooperatives is also urged in order to "strengthen property rights."<sup>76</sup> Though the idea of "clarification [or strengthening] of property rights" is itself far from clear, the term has unmistakably managerial implications. Property rights become clearer the more readily we can identify a single actor (or small group) who has unilateral dominion over the enterprise.<sup>77</sup>

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73. Weitzman & Xu, *supra* note 3, at 133.

74. TVE Regs, *supra* note 57, art. 32.

75. Oi, *supra* note 55, at 117.

76. Decision of the CPC Central Committee, *supra* note 2, at 24-25.

77. Several Chinese economists discussing the idea of clarification of property rights on my 1994 visit referred to work by Harold Demsetz. *See, e.g.,* Harold Demsetz, *A Theory of Property Rights*, 57 AM. ECON. REV. 354-59 (1967) (suggesting that efficiency will usually require the concentration of ownership in a small group); Harold Demsetz & Armen Alchian, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 787-88 (1972) (recognizing that financial ownership claims on public corporations are widely dispersed, but could be read to suggest that control rights are and should be concentrated). Later literature, less well known to the people I met, rejects these views in favor of a vision of the firm as a "nexus of contracts" in which financial and control rights are diffused among myriad constituencies. *See, e.g.,* Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290 (1980) ("In this 'nexus-of-contracts' perspective, ownership of the firm is an irrelevant concept."). The trend of this literature has been quite different from the inferences drawn in China from the early pieces. The later articles renounce any idea of specifying the optimal ownership structure generally and instead insist that, as long as a firm's shares are

The developments in both SOE and TVE areas involved appeals to Western corporate models. Both represented steps toward more conventionally capitalist forms of organization and away from the distinctive features of authority, membership, and reinvestment. Although these themes were attenuated in the new models, they persisted.

#### *A. State-Owned Enterprises*

Despite some major successes, a sense of crisis has surrounded the SOEs during the 1990s. Two problems have been most salient. First, one-half to two-thirds of the SOEs remain dependent on subsidies which in turn are a major component of a growing state deficit. Although many reasons are given for the failure of these enterprises, the reason considered the most important and least tractable is the SOEs' continued inability to shed workers or drastically cut compensation.

Second, the decapitalization of the enterprises by managers and workers is troublesome. The softer forms of decapitalization take the form of excessive compensation. The incentive features of the "contract responsibility system" encourage the enterprise to overstate its income—for example, by underestimating depreciation—and to forego maintenance expenses in order to finance current compensation. The harder forms of decapitalization take the form of managerial self-dealing. Managers sell stock to themselves and cronies at unduly low prices. They transfer assets without adequate compensation from their SOE to enterprises they have interests in. They commit their SOEs to joint ventures with affiliated entities on terms skewed toward the latter. At the same time, managers have continued to complain of unprincipled or outright corrupt interference by state officials.

The focus of debate over legal reform has now shifted to corporatization. A large body of literature has emerged; though some of it is skeptical, most writers have argued that some form of corporatization would improve the SOEs. The appeal of the corporate form seems to rest for some on little more than the glamour of its perceived association with economic modernity. Others favor it as a means of facilitating foreign investment or the development of a domestic capital market.

But the strongest emphasis has been on the potential contribution of the corporate form to balancing official and managerial power and limiting state economic responsibility. The Central Committee's program document argues that "corporations can effectively accomplish the separation between the ownership of investors and the rights of enterprise" and are "conducive to . . . enabling enterprises to get rid of reliance on administrative organizations and enabling the state to get rid of its unlimited responsibility

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widely traded, the capital markets will find the right structure for each firm. Of course, it would be more difficult to make this argument in a society in which state ownership remains the "mainstay" of the economy.

for enterprises."<sup>78</sup> In fact, however, the literature is not very specific as to how corporatization is to contribute to these goals.

The rhetoric of the "separation of ownership and control" in the modern corporation, popularized in the 1930s in the West by Adolph Berle and Gardner Means, has played a distinctive role in recent discussions in China. For Berle and Means, the separation of ownership and control represented a problem—managerial unaccountability—that called for imposing responsibility on management. Some recent Chinese reformers have seized on Berle and Means's rhetoric as if "separation" were a *solution* to an entirely different problem—the interference of government officials in the operation of enterprises. Thus, ironically, Berle and Means's rhetoric is identified in some recent Chinese debates with proposals that tend to enlarge managerial discretion to degrees they would have considered implausible.

The closest thing to a comprehensive picture of what a corporatized SOE would look like is the Company Law enacted in late 1993.<sup>79</sup> The Company Law represents the convergence of the corporatization project, focussing primarily on corporate governance, with a partially distinct "securitization" project, focussing primarily on finance.

During the 1980s, central and provincial governments permitted a few enterprises to experiment with issuing securities. Local markets for the exchange of these securities were permitted in several areas. In 1990 Shanghai opened a stock exchange listing securities in a few state enterprises; in 1992 Shenzhen opened its exchange, listing a few more SOE securities.

Though these securities were sometimes called "shares," most looked more like bonds, with fixed payment guarantees and no control rights. In 1992, however, the State Council endorsed limited experimentation with corporatization, contemplating the issuance of shares with control rights. It also published proposed company legislation, and Shanghai and Guangdong province (where Shenzhen is located) enacted provincial com-

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78. Decision of the CPC Central Committee, *supra* note 2, at 24. A sampling of the literature on corporatization in English translation includes State Commission for Restructuring Economic System, Production System Department, *Properly Run Joint-Stock System Pilot Projects According to Standardized Requirements*, JPRS Rep. China (JPRS), at 34-39 (Aug. 3, 1992); Liu Guoliang, *Market Economy: State Enterprises Facing Serious Tests*, JPRS Rep. China (JPRS), at 9-10 (Jan. 22, 1993); Liu Hongru, *Probe for a Correct Path—Questions on the Experiments in Joint Stock Companies and the Stock Market*, JPRS Rep. China (JPRS), at 20-27 (Oct. 21, 1993); Chao Qian & Xin Yi, *Some Thoughts on Overhauling Enterprise Operating Mechanisms*, JPRS Rep. China (JPRS) (Sept. 23, 1992); Sun Xiaoliang, *A Contradiction in Continuing Enterprise Reform*, JPRS Rep. China (JPRS), at 21-23 (Sept. 15, 1992); Zhan Zhongde & Ma Ping, *Use Shareholding System to Revitalize State Enterprises*, JPRS Rep. China (JPRS), at 30-33 (Jan. 8, 1993). An influential early work by the leading academic proponent of corporatization is Li Yinning, *A Conception of Reform of the Ownership System of Our Country*, Daily Rep. China (FBIS), at K5-11 (Oct. 22, 1986). For a well known article by a lawyer expressing skepticism about corporatization, see Wang Liming, *Lun Gufen Z: Qiye Shuoyouqian De Erchong Jiegou [On the Dual Structure of Stock Enterprise Ownership]*, 1 ZHONGGUO FAXUE [JURIS. CHINA] 47, 47-56 (1989). Some of the literature is cited and summarized in Jianfu Chen, *Securitisation of State-Owned Enterprises and the Ownership Controversy in the PRC*, 15 SYDNEY L. REV. 59 (1993).

79. Company Law, Daily Rep. China (FBIS), at 27-48 (Jan. 26, 1994).

pany laws.<sup>80</sup> These were pre-empted the following year by the national Company Law, which applies to SOE stock companies, as well as private ones.

The 1993 Central Committee policy statement authorized reformers to “experiment with the corporate system.” It cautioned, however, that only a “small number” of SOEs should have publicly traded shares.<sup>81</sup> Several thousand SOEs have since been converted to stock companies, though only a few hundred have had their shares traded on exchanges. In most of the new corporations, shares not held by the state directly are held by other enterprises and organizations (“legal persons”), most of which are themselves state-owned, or by managers and workers of the enterprise itself. Typically, “legal person” shares can be traded only among organizations; two organized national markets for trading “legal person” shares now operate. Manager and worker shares typically cannot be traded outside the enterprise (though some transfer restrictions lapse after a period of time).<sup>82</sup>

The Company Law is a more or less wholesale importation of a European, notably German, model. This cross-cultural borrowing reflects the prestige of the economic institutions of the pioneer capitalist countries. It also represents a desire to encourage foreign investors by providing a legal regime familiar to them.

The choice of the German model over competing capitalist ones probably reflects historically embedded intellectual affinities. China’s legal system was strongly influenced by civil, especially German, law in the late Qing and Republican periods, and the influence survived in the system the Guomindang developed on Taiwan. Moreover, the Soviet Union, which remained the dominant foreign intellectual influence on China until well into the reform period, had incorporated extensively civil law principles and rhetoric in its legal system. In adopting the Principles of Civil Law in 1986, PRC law makers had signalled an attraction to civil law models.<sup>83</sup>

It comes as no surprise to Western lawyers that a corporation code adopted wholecloth from the West leaves many key questions about Chinese enterprise structures unanswered. Few European or American lawyers would argue that their corporation statutes are functionally well-adapted to their own practical circumstances, much less to China’s. In both Europe and America, much of the most important corporate law

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80. See Chen, *supra* note 78, at 60-64; see also, Pitman B. Potter, *The Legal Framework for Securities Markets in China: The Challenge of Maintaining State Control and Inducing Investor Confidence*, 7 CHINA L. REP. 61 (1992).

81. See Decision of the CPC Central Committee, *supra* note 2, at 24.

82. Transfer of legal person shares was previously restricted by general regulation. The Company Law now provides in article 143 that all “shares may be transferred in accordance with law.” Transfer restrictions now take the form of charter provisions or contracts specific to the particular enterprise.

83. The Qing Company Law of 1904 was influenced by Germany by way of the German-influenced Japanese Code. The Republican Company Law of 1929 was directly influenced by the German model, and this influence survived in the 1949 revision. William C. Kirby, *China Unincorporated: Company Law and Business Enterprise in Twentieth Century China*, 54 J. ASIAN STUD. 43, 47, 49, 54-55 (1995). On Russia’s reliance on civil law principles, see Andrei Baev, *Legal Mechanisms of Monitoring State Property in Russia* 27-58 (1995) (unpublished Ph.D. dissertation, Stanford University).

Taiwan’s Company Law is also said to have specifically influenced the PRC’s. See REPUBLIC OF CHINA MINISTRY OF ECONOMIC AFFAIRS, *COMPANY LAW* (1995); NORBERT HORN ET AL., *GERMAN PRIVATE AND COMMERCIAL LAW: AN INTRODUCTION* 251-79 (Tony Weir trans., 1982).

is nonstatutory—for example, fiduciary duties—and many preoccupations of the statutes seem anachronistic—for example, the legal (registered) capital regimes.

Moreover, recent Western scholarship has suggested that the key issues of corporate governance are largely outside corporate law, as conventionally defined. Corporate codes are largely devoted to regulating the interaction of shareholders, managers, and creditors. But the most important practical distinctions now seem to depend on how shares are allocated among different types of investors, which in turn depends on a variety of rules outside the corporate code. In Germany and Japan, financial intermediaries holding substantial blocks of shares deal directly with management. In the United States, where shares are more dispersed and intermediaries more constrained, the stock market (and the takeover) play more important roles.<sup>84</sup> Like its Western counterparts, the PRC Company Law is silent about to whom shares in large corporations will be allocated. The leadership's commitment to state ownership as the "mainstay" of the economy would seem to imply that the state own at least a controlling block of the shares in most enterprises, which most proposals seem to contemplate.<sup>85</sup>

How will the state's shareholder rights be exercised? Surprisingly, the corporatization experiment was launched before any definite answer to this question was reached, and apparently even before much thought had been given to it. For the moment, a large fraction of state shares are held by the industrial ministries or, in some instances, the holding company structures that have taken their places. Most of the rest are held by the National Administrative Bureau of State-Owned Property, created in 1988 as an arm of the State Council to superintend the state's interest in the reformed enterprises.

Few regard the current arrangements as satisfactory, however. The industrial ministries often try to continue their old ways of commanding enterprise management. The National Administrative Bureau of State-Owned Property is primarily an auditing agency; it has neither adequate staffing nor expertise to participate actively in corporate governance.

Recent discussions of institutionalizing the state's shareholder role appear to be converging on a structure that, if implemented successfully, would constitute a new form of market socialism. The structure has three tiers. The corporatized operating companies are the bottom tier. The middle tier would consist of intermediaries of various types holding the operating company shares. The intermediaries would include holding companies, investment companies, charitable foundations, and pension funds. Most of

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84. See generally MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994).

85. Li Yinning's influential proposal suggested that the state should retain a controlling interest but that "one-third, two-fifths, or even less" of outstanding shares would be sufficient for control. Yinning, *supra* note 78, at K7.

According to Shanghai officials I spoke to in 1995, in the 92 listed companies formed from former SOEs controlled by the Shanghai government, the government holds on average 53% of the shares.

The Central Committee program document says, "Companies that turn out special-category products and those producing armaments should be held by the state alone. In key enterprises in 'backbone' and basic industries, the state should have controlling shares and at the same time bring in non-state capital . . ." Decision of the CPC Central Committee, *supra* note 2, at 24. The implication that the state might take a minority position in other industries is unelaborated.

these intermediaries would in turn be owned wholly or in part by state agencies forming the top tier, perhaps by an expanded National Administrative Bureau of State-Owned Property, or perhaps as some would prefer, a new agency accountable directly to the National People's Congress and its Standing Committee.

One promising feature of the model is that it would make possible competition among intermediaries in monitoring. As long as intermediary managers are given incentives to maximize returns and many intermediaries are free to invest or disinvest in any given enterprise, competition might induce effective monitoring of the operating companies.

Competition at the top level would not be possible, but it should be possible to specify a set of fairly simple rules for officials at the top that would make it easy for a separate government agency to audit performance. In essence, top level officials would be instructed to move capital into and out of the intermediaries in accordance with their relative performances.<sup>86</sup> This approach presupposes that the government will pursue social goals distinct from profit maximization through the regulation and the tax-transfer system, rather than through ownership. Many reformers are quite clear about this, fearing that social goals are too vague to permit monitoring and accountability through corporate institutions. A compromise would be to set up a separate set of investment and monitoring institutions for "social" investing.

At the moment, the banking system plays no role in corporate monitoring. The law forbids banks to hold shares. But many proposals contemplate an important role for banks. Banks have a substantial fraction of China's economic expertise. Moreover, banks hold massive debt claims on the SOEs that are uncollectible in their current forms and need restructuring. One alternative popular with reformers is a swap of debt for equity, which would give enterprises more flexibility and turn banks into major shareholders.<sup>87</sup>

The few publicly traded SOE corporations typically have dispersed individual shareholders. However, there is little expectation that they will play any direct role in corporate monitoring. (The Company Law does not provide for cumulative voting or derivative suits, nor does it give majority shareholders duties to minority ones.) On the other hand, some reformers have expressed the hope that the share prices in the public

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86. Many experiments with intermediary structures for managing state enterprises have been tried in recent decades, though they have generally not contemplated competition among the intermediaries. See generally ANJALI KUMAR, *STATE HOLDING COMPANIES AND PUBLIC ENTERPRISES IN TRANSITION* (1993). China's size and the fragmentation of its government structure offer a distinctively auspicious setting for trying to achieve a competitive structure.

87. Qian, *supra* note 40, at 33; *Financial System Reform in China: Lessons from Japan's Main Bank System*, in *THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES* 552, 575-78 (Masahiko Aoki & Hugh Patrick eds., 1994). A 1985 World Bank report on China focused attention on the idea of exercising corporate control through multiple independent public intermediaries. WORLD BANK, *CHINA: LONG TERM DEVELOPMENT ISSUES AND OPTIONS* 165-66 (1985). See also the interesting interpretation of "socialism with Chinese characteristics" by Bo Yibo, an elder of the revolutionary generation, which does not mention clarifying property rights and suggests that the "initial conditions for developing joint stock enterprises on the basis of public ownership" have been created by the diffusion of SOE control among different public institutions. Bo Yibo, *Correctly Handle the Relationship Between Planning and the Market*, Daily Rep. China (FBIS), at 28, 39 (Feb. 3, 1993).

market of these companies will provide an important signal to controlling shareholders of how well management is doing. Others doubt that the market in the near term will become sufficiently informationally efficient to perform such a role.

The Company Law represents a dilution of the three distinctive themes of the 1980s rhetoric, but the themes are still notably present.

*Authority.* For the reformers, the greatest appeal of the corporate form is as a model for the "separation of administration and management." Corporatization converts the state from a sovereign with plenary powers to a corporate shareholder. In this way, corporatization purports to limit the state's power of unprincipled or ad hoc intervention in the affairs of the business.

Managers of a corporation are not agents subject to the general authority of the shareholders. Under the new Company Law, as under its Western counterparts, shareholders have the power to elect and remove the senior managers (directors) and to veto certain fundamental alterations of the business, such as mergers, revisions of the share structure, or liquidations. Aside from this limited class of decisions, however, while they are in office, managers have general authority to run the business. Moreover, though shareholders can remove directors with whom they are displeased, the Company Law permits removal during their terms only for "proper justification."<sup>88</sup>

On the other hand, though corporatization is vaunted as a way of constraining state power, some aspects of the Company Law in theory represent steps back from the extreme managerialism of the Enterprise Law. The meeting of shareholders is declared the "highest power organ" in the enterprise.<sup>89</sup> Furthermore, managerial power is fragmented among, first, a "manager" with responsibility to "take charge of the company's operation [and] management"; second, a chairman of the board of directors, who is the "company's legal representative"; third, a board of directors charged with formulating the company's operating and strategic plans and hiring, firing, and supervising senior management; and, fourth, a board of supervisors charged with "monitoring" managers and directors to insure they "perform their duties to the company."<sup>90</sup>

Whether the statute gives management more or less power than its Western counterparts is debatable. On the one hand, the statute gives the shareholders several powers that American (and to a lesser extent, German) shareholders normally do not have. In addition to the power to elect directors and veto major "strategic" transactions, the statute prescribes shareholder power over the fixing of director's compensation, issuance of bonds, and dividend payments.<sup>91</sup> It also gives shareholders the right of "approval" of the board of directors' business plan, which if construed as a right to veto it, is a power

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88. Company Law, *supra* note 79, art. 115. The Company Law authorizes three separate types of corporations: (1) limited liability companies, which have relatively smaller capital requirements, simpler governance structures, and less readily tradable shares; (2) limited liability stock companies, which are generally large companies with broadly traded stock; and (3) wholly state-owned companies, which have a simpler governance structure—since there is only a single shareholder, they dispense with shareholders' meetings. The focus above is on limited liability stock companies, which seem to be the most important variation for SOE reform.

89. *Id.* art. 110.

90. *Id.* arts. 126, 119, 112.

91. *Id.* art. 103.

not normally enjoyed by Western shareholders. From this perspective, the Company Law is less managerial than Western ones.

On the other hand, if we understand "management" to include not all members of both boards, but primarily the Board of Directors, which typically consists of senior full-time management, then arguably the PRC Law is more managerial. In the German system, the shareholder-elected members of the supervisory board, who are part-timers meeting only a few times a year, are usually thought of as "outside" directors acting (though not necessarily effectively) as watchdogs on management. German law gives to the supervisory board the power to appoint the managing board.<sup>92</sup> But the PRC Law gives this power to the shareholders. Thus the PRC supervisory board is weaker. If, as is often assumed, shareholders have more difficulty monitoring than supervisory directors, full-time management is stronger under the PRC Company Law.

Inevitably, the statute (even if we assume it will be enforced in good faith) is not a guarantee against either official or managerial abuse. Although shareholders have no right to instruct managers directly on a broad range of matters, their power to remove them (even if, in the absence of cause for midterm removal, they must wait until the end of their terms) may give them sufficient leverage to enforce their will on managers continuously. On the other hand, while they are in office, managers have great power to dispose of the corporation and its assets. In particular, given the concern about managerial asset stripping, it is surprising that the Company Law constraints on managerial self-dealing are as brief and vague as they are.<sup>93</sup>

Despite all the ambiguity and the retreat from some of the managerial rhetoric of the Enterprise Law, Yingyi Qian reports that managers are wildly enthusiastic about corporatization.<sup>94</sup> The dominant popular connotation of corporate status is managerial independence. At least in the absence of a developed system for the exercise of the state's rights as majority shareholder, the monitoring provisions of the Company Law do not seem threatening. Another benefit of corporatization is to avoid constraints on wage levels and dispersion; the constraints do not apply to dividend payments.

The worker theme remains salient in the Company Law. Two sections of the Law require the company to "invite" or "heed" worker opinions, and to allow worker attendance at management meetings on issues of "immediate concern" to workers and "important issues relating to production and operation."<sup>95</sup> The Board of Supervisors must include an "appropriate" number of "democratically elected" worker representatives.<sup>96</sup>

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92. 84 Aktiengesetz I (1965) (F.R.G.); HORN ET AL., *supra* note 83, at 260.

93. The Law forbids directors and managers to "use their positions and powers in the company to seek personal gains" and to "sign contracts or conduct transactions with the company." Company Law, *supra* note 79, arts. 123, 61. These provisions could be interpreted to forbid all conflict-of-interest transactions, but it seems more likely that they will be construed to permit transactions that are fair and provide benefits to the corporation, even if managers benefit too, so long as managers do not contract in purely personal capacities with the corporation (as opposed to through affiliated entities or relatives). If the latter interpretation is likely, then a plausible procedural safeguard would have been a provision requiring conflict-of-interest transactions to be ratified by independent directors or shareholders.

94. Qian, *supra* note 40, at 43.

95. Company Law, *supra* note 79, arts. 121-22.

96. *Id.* art. 124. Somewhat different norms apply to companies that are wholly state-owned and to limited liability companies (the presumptively smaller type of corporation with less readily transferable shares)

(The number is to be decided by promoters or shareholders.) This is a substantial step back from the German model which prescribes that half the supervisory positions must go to workers,<sup>97</sup> but most other Western countries prescribe no worker board representation at all.<sup>98</sup>

*Membership.* The membership theme survives explicitly in the Company Law principally in the requirement—foreign to American and German law—that a company set aside five to ten percent of its profits in a “common welfare fund” to be used for “collective welfare programs of the company’s workers.”<sup>99</sup> As mentioned above, the 1994 Labor Law provides for tenure, but only after ten years of employment.

In fact, SOEs continue to be encompassing communities with a reduced but substantial range of collective cultural and consumption responsibilities. Nevertheless, there is a trend, particularly in SOEs converting to stock companies, to try to spin off housing and other consumption activities into separate organizations. These separate organizations operate on a fee-for-service basis.

One aspect of corporatization that bears on the membership theme is worker shareholding. Together with managers, workers hold substantial blocks in most corporatized enterprises. In some respects, the shareholder relation is the opposite of the membership relation. Corporate shares are typically individual financial interests that can be traded like commodities. However, worker shares in corporatized SOEs function a little differently. They typically cannot be sold outside the enterprise and have to be relinquished on departure. The reformers see their purpose as to counter worker pressures for short-term income distribution by giving them a capital stake designed to reflect long-term enterprise performance.<sup>100</sup> On the other hand, shareholding weakens

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formed wholly or “primarily” by state-owned investors. First, these companies must practice “democratic management.” *Id.* art. 16. Though the meaning of the term is far from clear, it could be construed to require a more ambitious measure of worker participation than the consultation procedures mandated for limited liability stock companies. Second, these companies must include elected worker representatives on their boards of directors. (These companies need not have supervisory boards.)

97. The German requirement of one-half worker members applies to companies with more than 2,000 employees; in companies with more than 500 but fewer than 2,000, a third of the supervisory seats go to employees. HORN ET AL., *supra* note 83, at 277.

98. See, e.g., Terence L. Blackburn, *The Societas Europea: The Evolving European Corporation Statute*, 61 FORDHAM L. REV. 695, 749 (1993) (noting that of EC states, only Germany and Netherlands require employee board representation).

99. Company Law, *supra* note 79, arts. 177, 180.

100. A significant step away from the membership theme is the Company Law’s rejection of “enterprise shares.” Some commentators had urged that major blocks of stock in corporatized shares should be held by the enterprise itself in its corporate capacity. Some pre-Company Law corporatization experiments had involved this, and two commentators suggested that the “enterprise shares” were “the essential difference between the system of shares in China and stock corporations in the West.” Gu Peidong & Liu Xirong, *Study on Turning State-Owned Enterprises into Stock Companies*, 9 SOC. SCI. CHINA 25, 36-40 (1988).

To Western lawyers the notion of “enterprise shares” begs the question of who within the enterprise is to have the financial and control rights of the shares and invites confusion and sharp practice. Thus, Western codes typically forbid voting or distributions on shares held by the issuing enterprise. However, the appeal of enterprise shares to some of the commentators might be interpreted as a desire to preserve a larger role for more informal and collective modes of decision-making and distribution. The Company Law rejects such ideas by providing that the corporation cannot issue stock to itself and must cancel repurchased shares. Company Law, *supra* note 79, art. 149.

norms of internal egalitarianism reflected in the constraints on wage dispersion since shares and dividends are typically distributed much more unequally than wages.

*Reinvestment.* The reinvestment constraints of the Company Law are much weaker than under the Enterprise Law, but they remain stronger than the Western counterparts. As under the Western models, amounts paid for the company's stock become the measure of its "registered capital," and distributions to shareholders that would reduce its assets below this sum are prohibited. In addition, the company is obliged to contribute ten percent of its profits annually to a reserve fund until the fund equals fifty percent of its registered capital, and distributions that would impair the reserve fund are also prohibited.<sup>101</sup> The company can invest in other companies, but such outside investments are not supposed to exceed fifty percent of its net assets.<sup>102</sup> In the West, the reserve fund is understood as a safeguard for creditors rather than a commitment by owners to develop the enterprise. Nevertheless, the unusually demanding requirement of the Company Law may partly reflect a commitment to internal reinvestment as desirable in itself.

### *B. Township and Village Enterprises*

Despite the phenomenal aggregate success of the rural industrial sector, the idea that reform of the legal structure of the TVEs is needed became popular in the 1990s. Legal reform proposals are most strongly associated with the areas of successful TVE development. The problems of the less developed areas are usually attributed to factors other than legal structure, such as low skill levels, poor access to capital, and incompetent cadres.

But in the more successful areas, it was widely asserted that enterprises were constrained by outmoded legal structures, especially "unclear property rights." In a few areas, especially near Shenzhen and Shanghai, with capital intensive enterprise and access to outside capital markets, there was a desire for a legal structure that would facilitate investment from outside the community.

However, by far the most prominently expressed goal of reform has been to limit the abusive powers of government officials. Complaints are widespread that government officials siphon off enterprise income for their personal benefit, force enterprises to hire cronies or political allies, or induce enterprises to undertake business commitments that indirectly benefit the officials. In many townships outside of the most developed areas, a single person holds the offices of party chief, head of the township government, and director of the township investment corporation—a situation popularly referred to as the "holy trinity." Even where these offices are separated, government officials retain great power to hold up enterprises.

These complaints are quite similar to those made about SOE managers, but discussion of abuse in the TVE sector differs in that the corresponding danger of managerial abuse is thought to be much weaker. Whether because of the harder budget constraints and more competitive environment of the TVEs or the better information and incentives

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101. *Id.* art. 177. In Germany, the reserve fund need be only 10% of basic capital. 57 Aktiengesetz I (1965) (F.R.G.); HORN ET AL., *supra* note 83, at 268.

102. Company Law, *supra* note 79, art. 12.

in a smaller scale environment, managerial performance in the TVE sector is more highly regarded. The national Ministry of Agriculture officials charged with TVE reform consider local official abuse the critical problem. "We're trying to protect managers, not control them," one told me.

Again, the reformers see the solution to the problems in corporatization. The model that has emerged from experimentation in areas such as Wenzhou and Nanhai and has been promoted by the Ministry of Agriculture since 1992 is the "shareholding cooperative." By 1994 perhaps as many as ten percent of the TVEs had been converted to some variation of this model. Again, the "separation of administration and ownership" is a major goal. The state's authority for ad hoc intervention (as opposed to regulation and taxation in accordance with laws of general application) is to be reduced to that of a shareholder and limited by the extent of its shareholdings.

To encourage the move to "shareholding cooperatives," the Ministry proposed a revision of the Township and Village Collective Enterprise regulations that redefines TVE ownership. While the 1990 regulations locate ownership in the "whole people of the locality," the revision provides that enterprises belong to "the whole people of the locality *and* outside investors."<sup>103</sup> Interpretive guidelines describe the underlying principle as "he who invests, owns."<sup>104</sup>

The basic idea of the model is to apportion ownership rights among shares. The Ministry's Model Articles of Organization provide simply that "people who invest in the enterprise become shareholders," and place no restrictions on who may invest.<sup>105</sup> In practice, however, corporatization generally has not represented a major step toward private ownership. In most shareholding cooperatives, the majority of shares are held collectively by the township or the enterprise itself. Based on interviews in Guangdong and Hebei provinces, Weitzman and Xu estimate that eighty percent of shares in a typical enterprise are collectively held.<sup>106</sup> Moreover, township or enterprise rules often preclude resale of individually held shares outside the enterprise or township.

Collective institutions, such as the township industrial commission, typically hold a substantial block. When a collective enterprise is converted to a shareholding cooperative, these shares are intended to compensate the township or village for its prior ownership interest. (In a reversal of the pattern of private appropriation of public capital widely noted in the SOE sector, "red hat" entrepreneurs who have argued that since their companies are only nominally private they should not have to give shares to the public when they convert, have generally lost.) And the township or village will get shares in a new enterprise if it invests in cash or in kind—for example, by providing land.

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103. MINISTRY OF AGRICULTURE, ZHONGHUA RENMIN GONGHEGUO XIANGZHEN QIYE FA (CAO AN SONG SHEN GAO) DI SHI JIU TIAO [TOWNSHIP AND VILLAGE ENTERPRISE LAW OF THE PEOPLE'S REPUBLIC OF CHINA] (draft for review), *reprinted in* MATERIALS, *supra* note 72, at 142.

104. Ministry of Agriculture, Xianzhen Chanquan Zhidu Gaige Yijian [Recommendations for the Reform of the Township and Village Enterprise System] (Apr. 1, 1994) (unpublished manuscript, on file with author).

105. MINISTRY OF AGRICULTURE, NONGMIN GUFEN HEZUO QIYIE SHIFAN ZHANGCHENG [MODEL ARTICLES OF INCORPORATION FOR RURAL SHAREHOLDING COOPERATIVES], *reprinted in* MATERIALS, *supra* note 72, at 168 [hereinafter MODEL ARTICLES].

106. Weitzman & Xu, *supra* note 3, at 135.

Another block of shares is commonly held in the name of the enterprise. The notion of "enterprise shares" was rejected for the urban sector in the Company Law, but many insist it is vital in the TVE sector. The arguments for it are typically abstract and assert that the shares acknowledge the organic nature of the enterprise—the extent to which it is a whole independent of its constituents. Such claims seem implausible, not because enterprises are not organic wholes, but because, in practice, the voting rights of the enterprise shares are exercised by a single constituency: management.

Managers and workers hold another substantial block individually. Some shares are typically given to them free; some are sold to them. The Ministry's Model Articles require that workers be offered shares at bargain prices.<sup>107</sup> In some areas, local enterprises hold shares in each other.

Finally, shares are sometimes held by individuals outside the enterprise. These are most commonly individuals within the locality, but some large TVEs sell shares outside the locality. At the extreme, a few are listed on the Shanghai and Shenzhen stock exchanges.

While the significance of the move toward corporatization is again to dilute the three distinctive themes of authority, membership, and reinvestment, the dilution is less than in the case of the SOEs.

*Authority.* In the Ministry's Model Articles of Organization for Shareholding Cooperatives, the enterprise director has the power to legally represent the company, hire and fire junior managers and workers, and organize production.<sup>108</sup> The body of workers, whose relation is said to be "contractual," nonetheless has rights to participate in "democratic management" through a workers' congress.

What is new is that the roles of manager and worker are now mediated by the shareholders' meeting, which is empowered to choose, monitor, and remove the director, and the Board of Directors, which is supposed to hire, monitor, and if necessary, remove the manager. Voting rights are allocated in proportion to shares.<sup>109</sup> Thus, the critical determinant of authority is the allocation of shares, and what links the new model to the older one's insistence on exceptional (from a Western point of view) managerial *and* worker authority is the assumption (unstated in the regulations but reflected pervasively in practice) that managers and workers will also be substantial shareholders.

*Membership.* In the TVE context, membership connotes relatively thick ties of participants to both the enterprise and the community. As between managers and workers on the one hand and the enterprise on the other, the basic legal relation is contractual,<sup>110</sup> which connotes an absence of tenure, and as noted earlier, the TVEs operate on hard budget constraints that put many out of business. Nevertheless, in viable enterprises the worker-enterprise relation has dimensions beyond the labor contract.

First, the worker is usually also a shareholder, and at least some of her shareholder rights are contingent on working in the enterprise. Shares the worker receives without payment usually revert without payment to the enterprise if and when the worker

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107. MODEL ARTICLES, *supra* note 105, art. 15.

108. *Id.* art. 12.

109. *Id.* art. 7.

110. *Id.* art. 14.

leaves. Shares the worker purchases sometimes must be sold back to other workers on departure.

In addition, where there are "enterprise shares," they involve another variation on the shareholder relation. In theory these shares are owned by all participants, including the workers. In practice, managers exercise the control rights, but in doing so, they should in principle take account of employee interests. Dividends paid on "enterprise shares" are divided within the enterprise among managers and employees.

Second, the practice of collective consumption remains securely institutionalized in practice and rule. The Ministry's Model and local regulations require a fraction of after-tax profits to be remitted to a welfare fund for employee benefits.<sup>111</sup> This fraction of after-tax benefits is commonly ten or twenty percent.

The ties between the enterprise and the community remain strong. Share ownership remains concentrated within the community, usually entirely so. Regulations sometimes restrict trading of shares outside the community. Government institutions hold large blocks, and their receipts continue to fund collective benefits for residents. Lawful residence remains a *de facto* requirement for the better jobs.

*Reinvestment.* Provincial or local regulations typically mandate reinvestment of a substantial portion of income. The Ministry suggests that sixty percent of annual income should be devoted to "enlarging capital."<sup>112</sup> The Zhejiang requirement, which is more typical, is forty percent.

Strikingly, such regulations typically mandate that a portion—the Ministry recommends half<sup>113</sup>—of retained earnings be committed to a "public accumulation" fund that may never be distributed to shareholders or workers. In the event the enterprise has no use for further capital or ceases to exist, the "public accumulation" fund is to be spent on some community benefit or turned over to a collective institution providing public benefits. Although anomalous in conventional corporate terms, this kind of nonappropriable reserve is very much in the spirit of the notion of the collective. Members of a collective are entitled to share in the income of collective property, but they have custody of the property in trust for the institution, including its future members, and cannot therefore appropriate it individually.

#### IV. THE ORIGINS AND PROSPECTS OF THE SOCIALIST MARKET ENTERPRISE

How important and durable are the distinctive themes in the new enterprise laws? Consider two views of the nonappropriable "public accumulation fund" prescribed in the shareholding cooperative regulations of Wenzhou. Liu Wenpu of the Rural Development Institute in the Chinese Academy of Socialist Sciences, singles it out with approval as one of the distinctively "socialist elements" of a structure he describes as a "transition" to a more fully socialist economy. He suggests that it will endure while the more conventionally capitalist elements of the structure wither away as the economy develops.<sup>114</sup> On the other hand, Dong Fureng of the Economic Research Institute of the

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111. *Id.* art. 13.

112. MODEL ARTICLES, *supra* note 105, art. 19.

113. *Id.* art. 20.

114. Liu Wenpu, *Socialism and Peasant Property Ownership Rights*, JPRS Rep. China (JPRS), at 19, 22

Chinese Academy of Social Science, complains that the funds suffer from “ambiguity about property rights” and suggests that *this* is the type of feature likely to wither away as enterprises evolve toward models standard in the West.<sup>115</sup> It is a reflection of the current disjunction in China between general ideology and informal policy discourse that, while Liu’s view is clearly implied in the official doctrines of the leadership, Dong’s reflects the operating premises of most of the reforming cadres, managerial professionals, and academics.

Certainly the moves toward corporatization represent steps toward more conventionally capitalist models. Nevertheless, there is a substantial probability that corporatization will disappoint the articulated aspirations of its proponents, and there are reasons to think that some of the conventionally capitalist elements of the corporate enterprise structures will prove unstable. All that can be done here is to offer some reasons for regarding the question as open.

#### A. Authority: Governance and Property Rights

To the extent that we take at face value the claim that Western corporate forms have been adopted in order to “clarify property rights,” the project seems misguided. In fact, property rights in the 1980s structures were not distinctively unclear, and corporatization is unlikely to clarify them further.<sup>116</sup> Sometimes the claim of lack of clarity seems to be associated with organizational features that are clear enough, but are anomalous by mainstream Western standards. In both the SOE and TVE structures of

(June 11, 1992).

115. Dong Fureng, *Shareholding Cooperative Enterprise-Reform in Enterprise Organization Form*, JPRS Rep. China (JPRS), at 14-15 (Dec. 3, 1991).

116. There are at least two different ways to think about “clarity” of legal rights. First, we might understand clarity to imply rules that are fully specified *ex ante*. Such rules maximize clarity about how a decision-maker will apply them in a given case, but since we do not know what circumstances future cases will involve, they do not necessarily maximize clarity about what the concrete effects of the decision will be for us. A rule that says a majority can always mandate a merger is clear in the sense that we know how the judge will decide if a merger has been approved by the majority. How it will affect *us*, though, depends on whether we end up in the majority or the minority, and we may not be clear about that *ex ante*.

Second, we might understand clarity to mean a rule under which decisions tend strongly to correlate with expectations. Rules that reflect this understanding may be minimally specified in advance. For example, we might have a rule that says that a majority can mandate a merger “if it’s fair.” We are less clear about exactly how a judge will apply this rule; on the other hand, we might feel more clear that we will be adequately protected under it.

American corporate law has generally (though not uniformly) evolved toward the premise that the second type of clarity is more important and, thus, toward acceptance of relatively unspecified norms of fair treatment. Note, however, that it is misleading to speak of this type of norm as “clarifying” rights. Such norms do not specify entitlements; they are parasitic on a pre-existing sense of entitlement. A general “fair dealing” standard presupposes some pre-existing shared views of what is fair. Thus, arguably the quest for clarity through legal reform is misguided. The first type of clarity may not be economically valuable; the second is unattainable through rules.

Xun Yang, an economist in Liaoning University, makes an analogous point when he writes in an article expressing skepticism about corporatization: “The shareholding system is not a premise for clarifying property rights, it requires the clarity of property rights as its premise.” Xun Yang, *The Shareholding System Cannot Solve Operating Mechanism Problems Within State-Owned Enterprises*, JPRS Rep. China (JPRS), at 7 (Oct. 15, 1992).

the 1980s, managers and workers had strong control and income rights but relatively weak capital rights. They had rights to substantial portions of enterprise income but were obliged to preserve the capital for the benefit of some larger community. In the SOEs (though not in the TVEs) this appears to have resulted in overstating income and running down capital. The problem arose not from lack of clarity, but from difficulty of enforcement of property rights, in this case the community's difficulty in enforcing its asset rights.<sup>117</sup>

Similarly, the problems of official interference and managerial abuse have more to do with enforcement than definition of rights. In such instances, the real need is not for better definition of property rights, but for the development of state capacity to enforce public rights and citizen remedies for official abuse. It is difficult to avoid the conclusion that many reformers prefer to talk about property rights reform as a way of avoiding more politically sensitive discussions of state structure reform.

*Managers.* As with the *nomenclatura* privatization in Eastern Europe, China's enterprise reform has occasioned the looting of state assets by ex-cadres. On the other hand, it seems possible that China may succeed in developing public enterprise structures that have better results in terms of both enterprise efficiency and distribution of benefits. These results may be better than could have been achieved through broad scale explicit privatization programs like the ones being tried in Eastern Europe.

The corporatization process and enterprise law have been largely peripheral to this process and have been based on dubious analogies to corporatization in the West. The main goal of the corporate form in the West was to facilitate participation in large-scale enterprise of large numbers of dispersed investors. The two key moves were limited liability and a control structure that allowed investors some hold over management but left management a broad range of discretion over most business decisions.

These moves involved *changes* in property rights, not clarification of them. The inauguration of limited liability involved a global transfer (or expropriation) of property rights away from creditors to investors. The creation of the internal control structure made available a form of conducting business that was not previously generally available. In each case, however, the prior regime—the rules of unlimited liability and the unavailability of corporate control structures—was clear.

In the PRC, facilitating the participation of dispersed small investors is neither the major articulated rationale for corporatization nor a likely practical effect. In the SOE sector, the regime remains officially committed to public ownership, and despite the occasionally articulated hopes of some reformers, it seems unlikely that dispersed individual shareholders could play a significant role in corporate governance. The public share markets are not informationally efficient; the collective action problems that plague shareholder monitoring in the West are at least as severe in China, and the rights of individual minority shareholders remain weak and unclear even after the Company Law.

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117. The one important area where it seems appropriate to speak of unclear property rights is in connection with the capital rights in the TVE sector of individual founders of collective firms. Such individuals are often considered to have capital rights, but absent corporatization, the extent of these rights is vague. While it may be desirable to clarify such rights, there is no evidence that the absence of clarity has impeded development.

In China, the practical goal of balancing state and managerial power does not involve, as it did in the West, facilitating participation by dispersed stakeholders. Rather, it involves the narrowing of the participation of a single concentrated state stakeholder (while maintaining effective checks against managerial abuse). For this purpose, Western enterprise models are not helpful for two reasons.

First, to the extent they limit state power at all, they do so in a categorical way that constrains responsible supervisory efforts as much as corrupt ones. Any effort to distinguish the two would probably require resort to difficult distinctions under fiduciary-type standards that would have the effect of making rights less clear (though perhaps fairer and more efficient). Second, corporate statutes in fact do little to constrain shareholder power *in the presence of concentrated holdings*. The power to elect and remove officers on short notice would usually be enough to compel managerial obedience over decisions the law purports to leave to management.

In the TVE sector, the explicit arguments for corporatization seem insubstantial as well. The interest in corporatization seems strongest in the areas with the most successful TVEs. As Weitzman and Xu point out, the success of these enterprises under ambiguous property regimes is powerful evidence that “clear” property rights are not vital to development. This success also suggests that a substantial amount of official abuse and corruption can be compatible with development.

Thus, it seems likely that the most important stakes in the corporatization proposals are different from the ones explicitly advanced. On the one hand, managers in the SOE sector like the symbolic and rhetorical associations of the corporate model with managerial independence and appeal to it to legitimate greater autonomy from state control. On the other hand, especially in the TVE sector, popular concerns about political accountability of state officials are being sublimated into the much safer technocratic rhetoric of economic efficiency.

Despite the irrelevance or ineffectuality of many aspects of the corporatization project, China does appear to have at hand promising approaches to corporate monitoring. The first approach arises from the dispersion of public ownership among a variety of institutions with significant independence from each other. If ownership could be held in blocks large enough to provide incentives for monitoring but small enough to impede the formation of looting or self-dealing coalitions, China might have the makings of the kind of institutional monitoring that appears to have been successful in Japan and about which American corporate theorists now dream.

Achieving such a system, recent scholarship suggests, depends less on enterprise or company law and more on the rules that constitute the stakeholder institutions, presumably primarily (though not exclusively) intermediaries. While the Company Law could certainly accommodate such a structure, arguably a model drawn more from partnership—with greater informality and stronger minority rights—would have been more appropriate. Within the corporate structure, measures such as cumulative voting that facilitate minority representation, which the Company Law does not provide, might be desirable. Facilitating minority representation impedes the formation of predatory coalitions and makes it less likely that management can control the elections in the absence of a majority shareholder coalition.

The second approach is political democracy. In many respects, governance rights are a substitute for private property rights. They have a stronger tendency than property

rights to be unclear and to depend on post hoc assessment rather than ex ante specification, but as has been suggested, that is not necessarily a disadvantage. So instead of protecting against official abuse by insulating enterprise management, a society could try to do so by making officials more accountable to citizens generally. The current state of debate on corporate governance is a reflection of the fact that Chinese leaders are far more comfortable with capitalist economic institutions than with democracy.

Nevertheless, at least in the TVE sector, there may be reason to take seriously democratic political solutions to problems that are more often treated as matters of corporate governance. Beginning in 1987 with the passage of the national Organic Law on Villagers' Committees and continuing with subsequent provincial legislation, there have been efforts to give real power to village representative institutions and limit party control of them. Implementation has been slow and erratic, but in some villages local government has become a serious engine of official accountability.<sup>118</sup>

Susan Lawrence recently reported on one such village in Hebei province. The concerns on which the Village Representative Assembly focused were precisely the types of economic abuse on which the literature on enterprise reform has focused. Officials run up excessive personal expenses ostensibly on public business; they give jobs to unqualified friends and relatives; they cause enterprises to execute contracts with cronies; they walk off with property that belongs to the collective; and they exercise patently bad business judgments. The assembly Lawrence studied was able to get effective redress for such misconduct, including reimbursement and return of property, discharge of offending officials, and reversal of unfounded decisions. The people held accountable included senior party leaders.<sup>119</sup>

*Workers.* That the PRC legal structures express comparatively strong commitments simultaneously to managerial power and to worker participation is only superficially paradoxical. The explanation lies partly in the fact that participation usually does not involve real control or democracy. The fact that the leadership continues to pay homage to worker participation reflects both ideological continuity and ambivalence about basic problems.

The attempt to combine managerial power and worker participation recalls the principle of "democratic centralism" that was central to Maoism.<sup>120</sup> Centralism implied control of policy by the Party elite. On the other hand, democracy implied implementation, but also participation in formulating policy, by small groups at the grass roots.

So conceived, "democracy" was a means of keeping the Party in touch with the masses by surfacing information about grass roots sentiments and by enabling the Party to recruit as cadres able people who demonstrated their abilities in small groups. Of course, the small groups were also a means of keeping the masses in touch with the Party by facilitating co-optation and monitoring. The most prominent participatory right (which remains codified in the new enterprise laws) was the right to "criticize" elite conduct. This right may have sometimes helped ordinary people redress grievances but

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118. Kevin J. O'Brien, *Implementing Political Reform in China's Villages*, AUSTL. J. CHINESE AFF., July 1994, at 33-60.

119. Susan Lawrence, *Democracy-Chinese Style*, AUSTL. J. CHINESE AFF., July 1994, at 61-70.

120. See Franz Schurmann, *Organizational Principles of the Chinese Communists*, in CHINA UNDER MAO: POLITICS TAKES COMMAND 87-98 (Roderick MacFarquhar ed., 1966).

often clearly helped officials identify deviants or (when manipulated and staged) punish out-of-favor local leaders. Within the enterprise, the institutions of worker participation (the trade union, the workers' congresses, small work groups) continue to play important roles in inducing worker consent to enterprise goals and surfacing information of use to management. In comparison to the past, however, the goals and the information are now less encompassing and political, more focused on productivity and economic concerns.<sup>121</sup>

SOE workers and many resident TVE workers have strong enough informal claims to membership in their enterprise that managers are constrained in using the dismissal threat arbitrarily to motivate cooperation. Moreover, as enterprises strive to achieve more flexibility in their production processes, they depend more on workers' skill and initiative and a kind of performance not easily monitored. We know from studies of industries elsewhere that such circumstances can motivate managers to allow more serious forms of worker participation.<sup>122</sup>

In addition, we should take note of the most important "unclear" property right in the Chinese enterprise system—the right of SOE workers to have their jobs protected, if necessary, by subsidies to their enterprises. This "right" is unmentioned—even denied—in promulgated law,<sup>123</sup> but so far has been recognized significantly in practice and is perceived by many as a critical constraint on policy. Unlike the managerial authority issue, this is an area where lack of clarity really does create problems.

On the one hand, the sense that there is such a right induces the kind of laxness associated with soft budget constraints. On the other hand, the fact that the right is vague and insecure leads to counter-productive behavior, such as an emphasis on short-term gains (ranging from demands for higher compensation to outright looting of enterprise assets). Moreover, being unclear, the right is not transferable (as might be accomplished through an unemployment insurance system or retraining program), so the re-allocation of labor from less efficient to more efficient enterprises is impeded. That the effort to "clarify property rights" largely ignores this issue must be a reflection of political impasse.

Some reformers have entertained the idea that governance rights—serious worker control—might substitute for property rights to subsidies. Workers given serious control over the production process might see enterprise failure as a consequence of their own decisions and hence more acceptable. This seems naive, stated so baldly. It is interesting, however, that in the few rural areas where workers were permitted to elect TVE managers, some officials explain the practice as a way of making workers feel more responsible for performance and more willing to accept the consequences of failure.<sup>124</sup>

The salience of democratic centralism was in part a reflection of the fact that the Chinese Communist dictatorship has always taken a relatively nonbureaucratic form; it

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121. See WALDER, *supra* note 33, at 222-41.

122. See, e.g., MICHAEL J. PIORE & CHARLES SABEL, *THE SECOND INDUSTRIAL DIVIDE: POSSIBILITIES FOR PROSPERITY* 133-64 (1985).

123. The Labor Law gives workers with 10 years seniority tenure in the enterprise. Labor Law, *supra* note 35, art. 20. But the Enterprise Law denies that there is any right to subsidization of the enterprise. Enterprise Law, *supra* note 13, art. 2.

124. RURAL INDUSTRY, *supra* note 47, at 380.

has tended to be relatively informal and personalistic. This style of organization seeks to enlist cooperation and initiative through controlled participation. But the more ambitious its efforts to secure cooperation and initiative, the more risk that participation will escape the bounds of control. Thus, one should not discount the possibility that the participatory forms the law provides perfunctorily might someday be meaningfully exercised.

### *B. Exit Constraints and Enterprise Form*

Weitzman and Xu explain the success of TVEs without the benefit of clear property rights as a function of high-trust, collaborative dispositions, which they treat as a matter of culture. Although this could be right, institutions that are themselves creatures of deliberate policy choices are also an important part of the explanation. Certainly the recent explosion in China of both entrepreneurialism and corruption, and various noneconomic forms of self-assertion, raises some questions about the stereotype of Chinese culture as fundamentally more cooperative than others. On the other hand, it seems undeniable that there are important institutional structures in the rural sector that create strong expectations of repeated dealings among potential collaborators and powerful collective incentives for collaboration.

The membership and reinvestment themes in the legal structures of the SOEs and TVEs are small-scale instances of a broad set of policies to restrain capital and labor mobility. This policy represents a point of continuity between the Maoist and reform eras. Although China's product markets have been as fully marketized as those of many capitalist economies, its labor and capital markets remain highly constrained.

The household registration system continues to make migration from one's place of birth difficult. The capital market is dominated by the People's Bank of China and its affiliates, which have a monopoly over formal banking. Though stock markets and a variety of intermediaries have emerged, their roles remain limited. In these circumstances, capital tends to be relatively immobile both because the branch offices of the official banking system are sensitive to local political interests opposed to capital migration and because, in the absence of a fully developed national system of intermediation, people are compelled to rely on internal finance.<sup>125</sup>

These policies are in some respects echoes of the Maoist idea of "self-reliance."<sup>126</sup> If "democratic centralism" was an effort to achieve dictatorship without bureaucracy, "self-reliance" was an effort to achieve economic decentralization without markets. The Maoist vision prescribed strongly encompassing local communities with minimal exit and entry and largely internal finance. In a way that has some resemblances to the contemporary "flexible specialization" theme, it sought to foster economic diversification and the development of general skills. This rhetoric seems discredited

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125. Ronald McKinnon argues that it is desirable in the early stages of economic liberalization to rely strongly on internal enterprise finance. He suggests this is necessary to harden the budget constraints of the state enterprises and curb the inflationary potential of lax credit. He also suggests that in the early stage, the formerly socialist banking system is unlikely to have the skills of credit evaluation needed to prudently play a major role in enterprise finance. RONALD MCKINNON, *THE ORDER OF ECONOMIC LIBERALIZATION* 6-8, 120-61, 187-216 (2d ed. 1993).

126. See CARL RISKIN, *CHINA'S POLITICAL ECONOMY* 11-37 (1987).

now even in China because of its association with the catastrophes of the Great Leap Forward and the Cultural Revolution, but it in fact seems consistent with many aspects of successful current practice. Moreover, Philip Huang has suggested that the much-maligned Maoist effort at rural industrialization provided the initial basis for the TVEs. The TVEs started out with capital that might not have accumulated at the township and village (commune and brigade) level but for the Maoist industrialization efforts. And a large number of prosperous TVEs trace their origins back before the reforms to the Maoist era.<sup>127</sup>

The “self-reliance” idea appears at the level of the firm in both the Communist notion of collective ownership and those of various forms of market socialism, including those of Proudhon and his disciples, the American Farmers’ Alliance, and pre-1988 Yugoslavia.<sup>128</sup> A basic idea is to trade ease of “exit” for opportunities for “voice” or participation. Individuals who cannot easily withdraw from an enterprise are more likely to struggle to improve it through participation, at least if they are likely to benefit from improvement. An economic interest in the enterprise that cannot be transferred or liquidated potentially penalizes exit and gives the holder incentives to participate productively. The paradigmatic form of this type of interest is a nonappropriable capital stake conditional on membership, such as the “public accumulation fund” in the shareholding cooperative regulations. The participants benefit from the stake during their tenure but cannot liquidate it or carry it with them on departure. Employment benefits in excess of the worker’s alternative employment opportunities function in a similar way. Personal satisfactions associated with fulfilling membership in a community do so as well. There is both a political and an economic logic here that has been rediscovered recently in various fields outside the socialist world. The political logic is that local self-governance and workplace democracy requires that participants have a kind of property interest that links their personal fortunes to the fate of the community.

The economic logic is that certain valuable long-term investments require that firm and worker bond to each other. In particular, if the worker is to invest in the acquisition of skills distinctively valuable within the firm or if the firm is to invest in the worker’s acquisition of skills that would also have value elsewhere, then the worker needs assurances of tenure or the firm needs assurances that the worker will remain for the long-term. Such investments are especially important when firms adopt the mode of “flexible specialization” that aims to produce a changing array of at least moderately sophisticated products with general purpose technology. Zheyuen Cui suggests that many TVEs fit the “flexible specialization” model well.<sup>129</sup> Ministry of Agriculture officials indicated to me that long-term incentives for investments in skill acquisition have been an important consideration in the design of TVE enterprise structure.

The type of enterprise organization with illiquid long-term relations and internal finance seems to complement important practical features of the Chinese economy, particularly the limited development of labor and capital markets. One might anticipate that labor and capital markets will gradually liberalize to resemble conventional Western

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127. PHILIP HUANG, *THE PEASANT FAMILY AND RURAL DEVELOPMENT IN THE YANGZI DELTA 1350-1988* 253-87 (1990).

128. See generally Simon, *supra* note 43.

129. Cui, *supra* note 56.

ones, and that the distinctive features of enterprise structure will then erode. Nevertheless, an important measure of constraint on labor and capital mobility may prove to be a relatively enduring feature of Chinese society.

It is widely believed that a strong and immediate liberalization of labor and capital markets would prompt massive migrations of labor and capital from country to city, north to south, and interior to coast. Common belief also holds that this migration would be costly both in terms of the loss of personally satisfying and potentially productive relations in the areas that would lose population and crowding externalities (overuse of public goods) and social control problems in the receiving areas. Constraints on capital and labor movement, in particular movement out of the rural and interior areas, are thought necessary in order to avoid these costs.

Some believe that if movement of capital *into* undeveloped areas could be induced, constraints on labor outmigration would be unnecessary. However, it is far from clear that a market-based national financial system in a relatively under-developed country is capable of identifying efficiently viable investment opportunities in less developed rural areas.<sup>130</sup> Thus, some combination of capital and labor controls may continue to seem necessary.

In this context, the membership and reinvestment aspects of the TVE structure may be valued as constraints on capital and labor migration. These constraints are likely to be seen as considerably less coercive than those of the household registration system, and at some stages of development, might become a plausible alternative to them.

Of course in the long run, one could imagine China developing toward fully liberalized labor and capital markets. Would the distinctive "socialist market" aspects of its enterprise structures survive then? It is hard to say, but it is certainly possible. There are some examples of comparable structures that are currently successful in advanced capitalist environments—the industrial cooperative networks of north central Italy, for example. If China develops through a path that induces these characteristics in the short-term, they might prove viable in the long run, even though alternative paths would also have been viable.

## V. CONCLUSION

The Chinese "socialist market" enterprise is socialist in more than name. It involves extensive public ownership and three themes that link it structurally and functionally to pre-reform ideologies and structures—a simultaneous commitment to managerialism with worker control, a definition of ownership in terms of community membership, and strong reinvestment commitments. These characteristics remain strong even in corporatized enterprises. The stakes involved in corporatization seem more symbolic and ideological than practical. Corporatization is unlikely to solve either the problems invoked to support it or the deeper political concerns that seem to motivate some of its proponents.

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130. See GUNNAR MYRDAL, *RICH LANDS AND POOR* 27-29 (1957); Thomas Hellman et al., *Financial Restraint: Towards a New Paradigm* (Feb. 1995) (unpublished manuscript, on file with author).

The distinctive characteristics of the “socialist market” enterprise are strongly linked both to long-standing characteristics of Chinese organizational and economic life. The key organizational characteristics are informal hierarchy and controlled rank-and-file mobilization. The key economic characteristics are constraints on labor and capital mobility. The durability of the distinctive “Chinese characteristics” of the current SOEs and TVEs will depend on the development of these broader conditions. They could well erode in favor of institutions with a more thorough going resemblance to those in the mainstream West, but alternative logics of political and economic development make it possible as well that the distinctive features could remain important defining features of the Chinese enterprise.