

Fading out of Local Government Ownership: Recent Ownership Reform in China's Township and Village Enterprises*

Laixiang Sun

CeFiMS

SOAS, University of London

and

International Institute for Applied Systems Analysis, Laxenburg, Austria

Local government ownership had dominated China's township and village enterprises (TVEs) and made significant contribution to the TVE growth miracle for many years. However, since the mid-1990s, TVEs have conducted a series of radical and successful restructuring in their ownership and governance arrangements. The most striking feature of the restructuring is the fading out of local government ownership. This paper discusses why local government ownership could dominate private ownership in the first two decades of China's transition and identifies what factors have driven the fading out of local government ownership over TVEs in recent years. It then characterizes an emerging new ownership form called "joint-stock cooperative" (*gufen hezuozhi*) and shows the adaptive efficiency feature of the new form. By this way, the paper also sheds light on the roles that an alternative form of ownership and governance can play in an alternative institutional environment.

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CORRESPONDING ADDRESS:

1. 1 July to 30 August 2002: Dr. Laixiang Sun, International Institute for Applied Systems Analysis (IIASA), A-2361 Laxenburg, Austria. Tel. +43-2236-807-345, Fax. +43-2236-71313, Email: SUN@IIASA.AC.AT
2. Other periods: Dr. Laixiang Sun, Centre for Financial and Management Studies (CeFiMS), SOAS, University of London, Thornhaugh Street, Russell Square, London WC1H 0XG, UK. Tel. +44-20-78984821, Fax. +44-20-76377075, Email: Laixiang.Sun@soas.ac.uk.

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"It is not the strongest species that survive, nor the most intelligent, but the ones most responsive to change."

— Darwinian proverb

1. Introduction

The rising of rural enterprises and especially township and village enterprises (TVEs) has been the most striking feature of China's impressive development since the late 1970s. By 1995, industrial TVEs had become the number one producer in China's industrial production and thus taken over the position of state owned enterprises (SOEs) in the sector. During 1995-2000, they produced over 30 percent of the national totals of industrial value-added, profits, and output, and all TVEs across non-agricultural sectors created more than 15 percent of China's GDP (Sun, 2000; *Yearbook of China's Township and Village Enterprises*, 2000, p.113, 2001, pp. 3-5, 95).ⁱ

TVEs are either collectively established by or initially based on and closely associated with rural communities such as townships and villages. A typical TVE before the recent ownership restructuring can be best characterized as a community enterprise with a governance structure in which the community government has control (Che and Qian, 1998a; Perotti *et al.*, 1999; Che, 2002). In the recent wave of large-scale ownership restructuring, although most small TVEs have been outright privatized by selling them to their managers or other private owners, the restructured ownership of a typical larger TVE has been characterized by a joint ownership across its employees, the community government, and outside equity-holders. The local government has continued to be involved in the governance of the restructured TVE via the community assets management body and the Party branch. However, its role in governance has been increasingly transformed from the sole owner and supervisor of the TVE to one more similar to that of a major institutional shareholder. It might take a long time for local government ownership to fade out completely, nevertheless the process has been proceeding well on this way and the trend has become widely accepted.

Of various joint-ownership arrangements, the most popular one is the "joint-stock cooperative" (*gufen hezuozhi*).ⁱⁱ The stylized features of joint-stock cooperatives (JSCs) can be spelled out as follows.ⁱⁱⁱ (a) Managers and employees own a majority of the total share of the firm and share-holdings among them differ on the basis of paid subscriptions. (b) The firm is closely held, implying that ownership shares are typically not freely marketable, although subscribed shares can be transferred within the community. (c) The local government may hold a large part of shares in the name of community citizens. (d) In addition to the shares held by the insiders and local government, there usually exist some (or even large) shares of outside equity which carry one vote per share. (e) A representative form of governance is usually employed based on "one-person-one-vote" or "one-share-one-vote" or a combination of both voting principles. (f) The layoff of the cooperative members is common, and the layoffs may continue to hold their shares or may sell their shares back to the cooperatives.

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

While the performance of JSCs may widely differ across individual enterprises, their average performance has been outstanding. The adoption of JSCs well meets the urgent need for TVE capitalization. In those provinces such as Zhejiang, Jiangsu, and Anhui, where have been the leading areas for TVE development, this adoption leads to an intermediate reduction of the debt/asset ratio by 10 percentage points at average. More importantly, it is widely reported that those TVEs having transformed themselves into JSCs have typically shown a significant improvement in performance, exhibited more dynamic features, and played the leading role in maintaining the TVE miracle (*Yearbook of China's TVEs*, 1997: 299-306, 1998: 271-280; 1999: 4; Wang *et al.*, 1997).^{iv} According to a recent survey of TVEs in 16 townships conducted by Beijing Municipal Government (Beijing Survey Group, 2000), among all restructured TVEs in the sample, those adopted JSCs have clearly over-performed all others including outright privatized ones.

There has been a large body of literature analyzing why and how it is the local government-owned TVEs instead of the more conventional private firms that had contributed the most to China's impressive economic growth during the first two decades of the reform (see, among others, Che 2002; Che and Qian, 1998a, 1998b; Chen and Rozelle, 1999; Li, 1996; Tian, 2000). The core insight from this literature suggests that local government ownership can be a second-best arrangement when there are few constraints on the government's predatory behavior. In other words, local government ownership can act as a commitment mechanism to limit rent-seeking activities of the local government itself and to constraint the predatory behavior of the national government. Nevertheless, little attention has been paid to the recent fading out of local government ownership and to the newly emerging joint-ownership forms.

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

The Western literature indicates that the relative scarcity of worker cooperatives in the industrial sector lies in their disadvantages in collective decision making and capital financing (Bonin *et al.*, 1993; Craig and Pencavel, 1995; Hansmann, 1996). The transition literature shows that the employee-owned firms have paid more attention to rents or other firm-specific surpluses in one way or another due to the lack of fair competition and contract enforcement mechanism. It is relatively easy to argue that China's JSCs have little political power to maintain some kind of firm-specific rents simply because the market within a township or village community is both too small and limited. Whereas what deserve special attention are the mechanisms that are developed by China's JSCs to avoid high costs of collective decision making, to check insider control, to mobilize internal and external finances, to diversify risk, to harmonize labor-management relations, and to facilitate further evolving.

Because of the sharp contrast between the promising dynamics of China's JSCs and the conclusions suggested by the existing literature, a better understanding of how these JSCs actually work will bring new insights into the ongoing debate over the advantages and disadvantages of employee ownership, and into the discussion on the possible evolving paths of JSCs in the future. It will also reveal the roles that an alternative form of ownership and governance can play in an alternative institutional environment.

When a new ownership arrangement emerges, much attention is often given to the question whether it is transitory or enduring. This paper puts emphasis on the nature of the ownership *evolving process* and raises a more important and relevant question: Whether this arrangement is able to facilitate both institutional transition and socioeconomic development, or not? While we have already had so many lessons on the huge development costs of institutional transition, a new ownership arrangement that is capable of simultaneously facilitating smooth transition and creating impressive growth certainly deserves attention and investigation.

The rest of the paper is organized as follows. Section 2 summarizes the theoretical justifications for the dominance of local government ownership in China's rural industrialization based on a literature review. Section 3 identifies what factors have driven the fading out of local government ownership over TVEs in recent years. Section 4 analyzes the major functioning mechanisms of JSCs. Section 5 discusses the remaining challenges to the ongoing TVE ownership reform and development. Finally, Section 6 concludes the paper with an emphasis on the notion of adaptive efficiency.

2. Justifications for the Dominance of Local Government Ownership

In the literature analyzing when local government ownership may dominate private ownership in the context of China's transition, the majority of works have focused on the underdevelopment of input markets and the productive cooperation between the local government that controls various critical inputs and entrepreneurs who initiate and manage the TVE. The critical inputs include not only material inputs such as land, electricity, water, and key materials, but also accesses to bank loans, business licenses, official distribution channels, and political favor and support. Given the superior ability of local governments in obtaining these critical inputs, local government ownership would bring in significant political and economic advantages to TVEs in comparison with private ownership. Although local government ownership compromises managerial incentives, both theoretical and empirical works in this strand of literature indicate that the advantages of local government ownership well outweigh its disadvantages.

A key implicit assumption in this strand is that local governments themselves have incentives in production and have willingness to cooperate with private entrepreneurs to achieve certain government goals. In the context of rural China, increasing community government's revenue, creating non-farm employment, and raising per capita income have been the top objectives of local community governments. Against this background, the assumption of benevolent local government seems plausible. Consequently, the normative explorations in these researches focus on how to best make use of the efforts of local governments.

However, in a society where there is a lack of adequate checking and balancing mechanisms to hold governments accountable, so much privileges enjoyed by local government often form the institutional basis for government excessive rent-seeking and corruption. By further having control over firms, the manager of a TVE may never be absolutely sure about how the local government will interfere in the management. Given this commitment problem, the *ex ante* effort level of the manager may be seriously undermined. In this sense, the role of the local government may be quite counter-productive. More importantly, this strand of literature does not answer the typical question of Coase: Why cannot the critical inputs controlled by local government officials be bought from market (i.e. through bribery)?

To answer this question, Che (2002) analyzes TVE ownership arrangement trade-offs under the institutional condition of local government rent seeking. By examining the incentive trade-offs in three stages (*ex ante*, interim, and *ex post*), Che demonstrates that under certain plausible conditions local government ownership can act as a commitment mechanism to limit rent-seeking activities of the local government

itself. A simplified story of the paper can be presented as follows. A manager needs to make an effort to initiate an investment project. After the project is initiated, it needs an input and the government agency is a body that is in charge of the allocation of the input (e.g., a license, or a piece of land). The government agency is not held accountable and may collect a fee in addition to the regulated price for the allocation of the input. Once this critical input is allocated to the project, the manager goes on to make another effort for the project to yield revenue. If the firm is privately owned, after the initial effort is sunk, the government agency would charge a fee that equals the manager's net *ex post* payoff. Anticipating this predatory behavior, the manager would not initiate the project in the first place.

Under the local government ownership, however, the government agency may become less predatory towards the project it owns than one the manager owns. As a result, government ownership would encourage the manager to initiate the project. Two aspects of government ownership are modeled in Che (2002), first the government agency gets an exogenous share of revenue and second, the agency has the right to interfere in the firm's operation to decide on the number of excessive workers to hire, which undermines the firm's revenue. The agency derives benefits from three sources: the fee linked to the allocation of the critical input, the revenue share, and the political benefits from excessive employment. There are two types of government agencies: one pro-business and the other pro-politics, dependent on how much weight the agency gives to the political benefits of over-staffing. The weight selected is the agency's private information.

The fee charged for the allocation of the key input can potentially signal the type of the government agency. A pro-business agency has incentives to charge a lower fee and to hire a smaller number of excessive workers. This sends a signal to the manager that the agency is not pro-politics. As a consequence the manager will have greater incentives to make more efforts in production, which will also benefit the agency. Due to that in a separate equilibrium, pro-politics agency always fully exploit its bargaining power and charges a fee equal to the manager's net *ex post* payoff, the pro-business agency would charge a lower fee as a signal of its type, which is strictly less than the manager's net *ex post* payoff. Anticipating that on average, the project would bring positive benefits to the manager, the manager would have the *ex ante* incentive to initiate the project.

This analysis indicates that under the local government ownership, the government would subject its interest to the performance of firms under its control and thus to the incentives of private entrepreneurs managing these firms. To motivate these private entrepreneurs and ultimately advance its own interest, the government may become less predatory towards these managers and in some cases may voluntarily provide helps such as subsidies and tax breaks to these firms. In contrast, with regards to the private firms, it is in the government interest to extract rents from them as much as possible. As a result, TVEs under local government ownership would suffer less from government rent-seeking activities than private firms and therefore would have a larger room for development.

In a society with the authoritarian power structure, the national (central) government can be major rent-seeker or predator against the non-state sector as well. Could local government ownership act as a commitment mechanism to limit the predatory behavior of the national government? Che and Qian (1998a) develop a theory to answer this question. Their major arguments are as follows. In an environment without secure property rights against state predation, private ownership leads to excessive revenue hiding, which includes choosing short-term or liquid projects, and state ownership (i.e., the national government controls firms) fails to provide incentives for both managers and local governments in a credible way. In contrast, local government ownership integrates the local government activities of providing local public goods and the busi-

ness activities of controlling TVEs, which would better serve the interests of the national government.

Local community governments are more likely to invest revenue in local public goods than private entrepreneurs would be because their ownership rights give them access to the future revenue in a credible way, which will benefit the national government in the future. Knowing this, the national governments will leave bigger budgets to local governments and rationally prey less on TVEs than on private enterprises. This in turn makes local governments less worried about revenue confiscation and reduces TVE revenue hiding. In summary, local government ownership can not only benefit both local and national governments, but also be efficiency improving due to more secured property rights and more local public goods provisions.

With regard to the prediction on the evolving of TVE ownership structure, both strands of the literature suggest that the gradual exit of local government ownership would take place following the substantial progresses in the marketization of the critical inputs and the establishment of rule of law. When an increasing number of inputs become available on markets, government-regulated inputs will become increasingly irrelevant. This will help to reduce the bargaining power of local governments vis-à-vis private entrepreneurs. The establishment of rule of law means to replace ad hoc arrangements by public codes with transparency, predictability, and uniformity. This will reduce idiosyncratic risks of government predation and corruption. Following this prediction, before a meaningful marketization of the two most important inputs, land and bank financing, and before a meaningful replacement of the ad hoc bureaucratic ruling on business licensing and regulating by rule of law, the advantages of local government ownership would outweigh its disadvantages and local government ownership would continue to dominate in the TVE sector. Also following this prediction, once these two conditions become present, local governments would still have no incentives to voluntarily give up their control rights over TVEs.

However, the real development as briefed in the introduction section is that the evolving process of TVE ownership has gone far ahead than what the theoretical prediction has suggested. The fading out of local government ownership has taken place far before a meaningful marketization of land and bank financing, and far before a meaningful presence of rule of law in the areas of business licensing and regulating. More interestingly, the TVE ownership reform has been largely initiated and led by local governments. The fading out of local government ownership has been widely regarded as a means to promote, rather than a result of, marketization and rule of law. It is worth exploring what forces have driven this new development, especially, what have motivated the local community governments to voluntarily give up a large set of their ownership and control rights over their TVEs. Clearly, a better understanding of these driving forces would make important contributions to the literature, in both terms of theoretical advancement and policy improvement.

3. Why Local Government Ownership Needs to Fade out

Both supply-side factors arising within the community and demand-side factors emerging from the society have led to the radical ownership reform. We suggest that the supply-side factors may be more critical because they provide the incentive-based reasons that motivate the major players, whereas the demand-side factors provide favorable external conditions and social support to the reform.

Incentive Compatible Reason I: Capitalization Urge

By the end of 1995, when comparable data are available across major ownership forms, township-run TVEs had the highest debt-assets ratio (68 percent), then industrial SOEs in second (66 percent), village-run TVEs in third (55 percent). Debt-asset ratios in the

private sector were very low, 35 percent for joint-households-run firms and 25 percent for individual household-run firms.^v Although industrial SOEs are typically more capital intensive and have enjoyed more equity investment from the state, making the direct comparison unfair for TVEs, the comparison indicates that both industrial SOEs and township-run TVEs were highly leveraged on average in 1995. Village-run TVEs started to have excessive debts as well. Comparable time-series data on debt-assets ratio are not available at the national level. However we do have an illustrative example at the prefecture-level, Suzhou city in Jiangsu Province. TVEs in Suzhou have been regarded as representative of the well-known Southern Jiangsu Model, in which all rural firms have kept pure community ownership until very recently. TVEs in Suzhou had the debt-asset ratio of 61.9 percent in 1994, very similar to the corresponding national average of 62.8 in 1995. In the first half of the 1980s, TVEs in Suzhou had a quite healthy debt-equity structure (between 37 and 51 percent). However, along with their success and take-off over the next decade, their debt-asset ratios increased rapidly and have reached over 60 percent since 1992 (Xu and Zhang, 1997).

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

Casual media reports and official documents also indicate that the leverage-state of TVEs worsened rapidly in the late 1980s and has remained at the unhealthy level in the 1990s. Two reasons may contribute the most to the worsening of TVE leverage-state. First, the continuous entry of a large number of TVEs, international joint ventures, and private firms intensified competition, eroding the exceptional profits available early on. As a result, the ratio of profits after taxes over assets for TVEs steadily decreased from more than 30 percent in the early 1980s to about 7.5 percent in 1995 and 1996 (*Statistical Yearbook of China*, 1993, pp. 396-397; *Yearbook of China's TVEs*, 1996, p. 100, 1997, p. 122). The steadily declining profitability has significantly reduced the capital accumulation capability of TVEs and pushed them to increasingly depend on credit financing. Second and more importantly, following the rapid expansion of community conglomerates, the financial capability for the community government to cross-subsidize its TVEs and to guarantee more loans for them has increased rapidly as well. This makes it feasible for TVEs to increasingly rely on debt financing. At the same time, information asymmetry problem becomes increasingly severe due to the speedily expanded scale of the community conglomerate and the accompanying bureaucratization. As a consequence, individual TVEs take the advantage of softening budget constraint to borrow more, choose higher risk, but reduce their efforts (Zou and Sun 1996, Proposition 1).

Because the budget constraint for the community as a whole has been and will continue to be hard, the implication of opportunistic activities by individual TVEs for the community government is clear and straightforward. That is, the community government has to ultimately bear the unlimited liability for its TVEs. The increasingly softening budget constraint to individual TVEs may finally induce the bankruptcy of the whole community. In order to get rid of the unlimited liability it holds for its TVEs and avoid the threat of community bankruptcy, the community government with many highly leveraged TVEs has strong incentive to initiate ownership reform programs. For the interest of the community government, the first purpose of the reform is to capitalize community TVEs and to reduce its own paternalistic responsibilities towards community TVEs.

Before the ownership reform, profitable TVEs have had to follow the orders from the community government to lend money in scarce to fellow TVEs with poorer performance. The opportunity costs of such lending is high, because the likelihood of repayment is low and the lenders can use the money more efficiently. In this sense, they are losers *ex post* under the community government ownership. *Ex ante*, if the probability is high that a TVE will be profitable, the perceived value of the cross-subsidy for this TVE will be negative (Zou and Sun 1996). Therefore managers in profitable TVEs will have strong incentive to seek more autonomy, to improve asset structure, and to strengthen their competitive ability through ownership reform. Although loss-making TVEs can benefit from the cross-subsidies and from the loans guaranteed by the community government, they have faced the pressure of lowering reputation and the threat of liquidation and closing-down by the community government. Once the firm is closed down, both managers and workers will lose their non-agricultural jobs thus the sources of higher income and more respected social status. When the firm continues its business, the compensation for both managers and workers is typically low because the firm has to pay the interest and part of principals of its debt first. Therefore, managers in loss-making TVEs also have strong motivation to avoid closing-down and to increase their equity capital through ownership reform.

Although the major terms and conditions of the reform are typically set by community governments and TVE managers, employee stock ownership has played a prominent role in the reform of larger TVEs, thanks to the greater need to raise large amount of capital and to bolster support for the reform. There seem to be two types of support from workers towards the employee stock ownership. General support comes from all TVE workers whether owning shares or not, because the increase of equity capital in their TVEs will strengthen their job security and bring them more income in terms of wage, bonuses, and social welfare provision. Specific support comes from employee share-holders because the paid subscription of shares is often immediately compensated in part by the distribution of the "matching shares" (*pei gu*). The matching shares are free of charge, in the proportion of one subscription to one or two matching shares, and correspond to the original collective equity. These shares together will bring dividends in the future and the subscribed shares can be transferred within the community and in some case out of the community. In addition, these shares bring the TVE workers certain control rights over their TVEs. Therefore, TVE workers who have rights to subscribe shares often strongly support the employee stock ownership (Dong *et al.*, 2002). Nevertheless the half of those workers who have no such rights (mainly, temporary workers from other communities) feel dissatisfied with such restructuring (Wang *et al.* 1997: 233-244).

Incentive Compatible Reason II: Development Urge

Almost all TVEs have been initiated in rural areas and based on local social and economic conditions. To survive and expand their businesses in the highly competitive products markets, TVEs have to employ all means available to overcome their comparative disadvantages inherent in the general backwardness of a developing rural economy like the rural China. There have been two major constraints that TVEs constantly face. They are (a) the shortage of qualified professional managers and technicians and skilled workers; and (b) the shortage of financial capital in general and equity capital in particular.

Traditionally, TVEs pay competitively high salary and bonus to attract professionals and skilled workers. Given the increasing competition in labor market and constant liquidity constraints, the provision of competitively high salary and bonus has become increasingly unaffordable for an increasing number of TVEs. In comparison, incorporating share distribution into the compensation and bonus package would not only circumvent the hard liquidity constraint, but also bring in the benefits of improving work incentives, enhancing the loyalty of employees in general and the skilled in particular, and developing better relations between management and employees (Dong, *et al.*, 2002; Liu and Zhang, 2001). In this sense, the equitization and employee stock owner-

ship have been regarded as an effective institutional arrangement to promote TVE human capital development and accumulation.

The equitization is also regarded as an effective means to simplify and clarify the relationship between the local government and TVEs it owns. This clarification is important for attracting external equity investment. Once the governmental rights over TVE residual benefits and residual control become clearly defined in forms of concrete share numbers and capital proportions, external equity investors will have more credible assurance to get adequate returns proportional to their investment shares. External equity investors will also have adequate negotiation power proportional to their investment shares in corporate governance. External equity investment helps not only to alleviate capital shortages, but also to break through the relative closeness inherent in traditional TVE governance. The closeness means that there is a lack of outside interests in the community firms, once owner-managers fail to recognize emerging growth opportunities or pitfalls in some cases, there would be an absence of knowledgeable outsider's intervene. This happens more often when there are changes in marketplace or in technology. This type of governance failure has been typical among numerous failed TVEs (*China Information Daily*, August 2, 1993; Ministry of Agriculture 1997). The bitter lesson may have greatly contributed to the increasing popularity of equitization and stock ownership in the TVE sector.

Demand-side Reason: "Mechanism Degeneration"

TVE "mechanism degeneration" refers mainly to increasing bureaucratization in communities with successful TVEs, softening budget constraints across TVEs in the same community, and other trends towards the mechanisms often seen in SOEs. The phenomenon was not new and was in fact common among those emerging rich communities with a number of profitable TVEs even in the second half of the 1980s (Byrd and Lin, 1990). It has become widely reported since the early 1990s (*China Information Daily*, August 2, 1993; Ministry of Agriculture 1997). The increasing public attention on this phenomenon also indicates that the public in China has become less and less tolerant of the lasting SOE and SOE-like syndromes. Many aspects of mechanism degeneration have the roots in TVE ownership and governance structures. Among them, two are most decisive.

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

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

Although there has been supervisions from county governments as highlighted in Che and Qian (1998b), this type of monitoring is bound to be limited due to the problem of asymmetry in incentives and information. The restraints from county governments are mainly based on the discipline of the Communist Party. This may not make sense for most officials at grassroots level, because the probability that they will be promoted to the status of a formal bureaucrat is small. Indeed, compared with the economic and social rents they enjoy from the TVEs, the career of being a low-rank bureaucrat is not that attractive. In addition, this monitoring is further undermined by the communication difficulties in rural areas and the fact that there are usually a large number of community-run TVEs, townships and villages in a county.^{vi} To solve the problems of who and how to monitor the monitors, equity democratization via both joint-stock ownership and employee stock ownership has been increasingly regarded as the core of the solution.

4. Functioning Mechanisms of Joint-Stock Cooperatives

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

Mechanisms to Restrain Insider Control

In order to highlight the restraint mechanisms to insider control in China's JSCs, we present a sharp comparison among the JSCs, China's SOEs with autonomy in the transition, and large public companies in the USA (Table 1). As well documented in the literature, SOEs under the contract responsibility system obtain effective *usus fructus* – the rights to control state assets and to enjoy the incomes so generated, but do not carry the downside risk borne by state assets. In order to restrain opportunistic behavior and self-dealing of the SOE insiders, the government agencies have reasons to intervene in SOE operations and Party organizations have the reasons as well to control personnel; but this in turn brings high bureaucratic and political costs. This dilemma results in the inefficiency of the state sector as a whole (Jefferson, 1998; Perotti, et al., 1999; Qian, 1996).

In American publicly held corporations, insiders, particularly managers have effective rights to control the assets of outside shareholders. Because of the dispersion of shareholdings in the US, the managers of many large public companies have long been essentially self-appointing and self-policing. The mechanisms which function in keeping the accountability of the managers to their company's owners are mainly competitive capital, product, and managerial labor markets and well-established legal and institutional constraints as listed in Table 1. Although shareholders have a chance to vote in the shareholders conference, a more effective and less expensive way for them to exercise ownership rights is to sell or keep their holdings, or buy new shares in the market.

Table 1. Comparative Models of Insiders' Control: Understanding the Features of Joint Stock Cooperatives

Insiders control whose assets	Model identification and performance	Restraint mechanisms
State assets	<ul style="list-style-type: none"> • SOEs in the transition • Privatised profits and socialised losses 	Government inspection and intervention
Assets of outside shareholders	<ul style="list-style-type: none"> • Large corporations in USA • Competitively strong 	a) Competitive markets of capital, products, and managerial labour <ul style="list-style-type: none"> • performance comparison and managerial reputation • threats of take-over, bankruptcy, and exit b) Shareholders' votes (by hands or by feet) c) Legal and institutional constraints <ul style="list-style-type: none"> • rigorous accounting standards • extensive mandated disclosure • prohibitions on insider dealing • procedural rules facilitating shareholder litigation • a well-developed financial press
Insiders' assets plus outsiders (insiders hold a majority of the total shares)	<ul style="list-style-type: none"> • Joint stock cooperatives in China • Competitively strong 	a) Competitive product markets: Continue or exit b) Hard budget constraint: Threats of liquidation, bankruptcy, and exit c) Shareholders vote by hands (both inside and outside shareholders) d) Benefits from smallness: Information problems are largely internalised e) The local government acts as a major venture capitalist f) Revaluation of share is based on book value, profitability, and collective discussion g) Portfolio risks are diversified by share-holdings in other community firms and by holding contracting rights over farm land

Compared with both SOEs operating under “transitional” conditions and the normal times in large American public corporations, insider control in China’s JSCs is less problematic. Highly competitive product markets and hard budget constraints have constantly put the “survival urge” before them and forced them to reduce various costs and improve their efficiency. Both groups of inside and outside shareholders have had long-term co-operative relations and geographic proximity. Their interests in the firm have now become measurable and clearly defined in terms of shares. When facing tough market competition, the better strategy for them is to acknowledge, safeguard and promote their common interests and to choose co-operation rather than conflict. The community government by acting as a major institutional share-holder may become more helpful, because it acts now in a less predatory manner while continuing to mediate market transactions and to resolve disputes among parties involved, particularly between insiders and outsiders.

For China’s JSCs, the most challenging issue is deciding who will monitor the monitors in general and the community government in particular. The community government has typically held a large stake in most of JSCs in terms of either financial capital, land or both. In the ownership reform process, the government often plays triple roles of “coach”, “referee”, and “athlete”. In raising equity capital and mediating credits the role of community government seems irreplaceable at least in the near future. In most of the townships and villages with JSCs, the community government has acted as

the *de facto* representative agency of local shareholders in the exercise of shareholders' residual control rights over the local JSCs. Together these patterns indicate that the proper behavior of community governments has been and will continue to be crucial for the success of the local firms. Although inter-jurisdictional and market competition can function as an alternative governance mechanism to discipline local officials through putting pressure on and placing survival urge before the community, it cannot replace the internal governance structure within the community. In order to directly promote the most competent persons to the key positions and to prevent some officials from opportunism and corruption, political democratization within the community becomes equally, if not more, important than the equity democratization promoted by JSCs.

Structures to Avoid Excessive Costs of Collective Decision Making

In comparison with the state ownership of SOEs and collective ownership of TVEs before the ownership reform, the ownership form of JSCs reduces the costs of both monitoring and collective decision making. Investing part of personal savings in the firm and in exchange for getting some control rights will certainly increase employee commitment to the firm (Dong *et al.*, 2002). This may encourage self-monitoring and peer-group monitoring. Since employees now have a measurable and larger personal stake in the fortunes of the firm from which most of their income comes, they can be more easily assembled for consolidated collective actions when facing market competition. Employees already know a great deal about the firm simply as a by-product of their employment and moreover they now have a stronger incentive to acquire information about the effectiveness of management. The improved flow of information and communication between workers and managers may avoid some needless conflict. They can appoint and hold accountable representatives who in turn act to monitor management accountability for the fortunes of the firm. This will reduce the costs of managerial opportunism. The reduction of government intervention will enable the firm to focus on its business criteria, which will contribute to the reduction of the costs induced by conflicted criteria.

However, because workers act as both equity owners and employees in exercising their control rights over the JSCs, the interest differences induced by the dual role may bring high costs of collective decision making if desired mechanisms for resolving interest conflicts are not put in place. Generally speaking, employees may disagree about their relative wages. They may have quite different opinion about the distribution of firm's earning between capital and labor because they may differ substantially in the amount of equity capital they have invested in the firm. They may fail to reach agreement on the firm's investment decisions due to their different stakes in the investment projects. There may be different attitudes toward technical updating between unskilled, skilled, and white-collar workers, and between younger and older workers. In order to avoid some of these conflicts appearing in the decision-making processes and limit other costs to a tolerable level, some institutional and social mechanisms need to be put in place.

The institutional and social mechanisms which facilitate avoidance or limitation of the costs of interest conflicts that are emerging in China's JSCs include representative form of governance, formal charter limitations on voting procedures and voting outcomes, review by outside agencies, and the shared norms and survival urge imposed by competition.

The representative form of governance is analogous to that employed in large corporations with dispersed shareholdings and also in large cooperatives such as Mondragon in Spain (Cheney, 2000; Hansmann, 1996, pp. 98-103). Under this form both inside and outside owners elect representatives to a board of directors. The board, in turn, is responsible for appointing, overseeing and dismissing the firm's managers. The direct employee participation in governance is largely confined to annual meetings and

to major “constitutional” changes such as mergers or splits of the firm, changing the firm’s statutes (e.g. to a limited liability company), issuance of bonds, and increasing or decreasing the number of shares. The members on the board of directors and the managers serve for a minimum of three to five years. The members on the board of directors cannot be removed during their term except for cause. This arrangement would serve to secure professional management and to avoid inefficiently biased decisions and high costs induced by a highly participatory governance form.

Formal charter limitations on voting procedures and voting outcomes means that there are formalised limitations on the substantive decisions that may be vulnerable to the conflicts of heterogeneous interests. For example, the distribution of profits is largely defined by the firm’s charter that is based on government regulations. According to the regulations issued by the Ministry of Agriculture on 12 January 1990 (article 15), the rural JSCs should retain 60 percent of their profits after taxes for investment and capital accumulation. The remaining 40 percent can be used for dividends, bonuses, and employee welfare funds, and the distribution of dividends is suggested to be no more than 20 percent of the total profits after taxes.^{vii} Relative wages are largely determined by piece-rate, contracting (for managers) and sub-contracting (for teams in workshops). The wage level is subject to the firm’s performance in the previous year and local government approval, and is flexible in order to accommodate the needs of market competition. The strong delegation of decision-making power to management and the charter attenuation of employee’s rights to earnings and control have appeared to effectively mute the play of political forces among the firm’s employees, preempting opportunities for costly conflicts. In fact, criticisms in China have focused on the weak role of employees in controlling management. While agreeing that employees should play a more active role in the exercise of the equity democracy, our analysis suggests that it is better to let employees play more politics in the process of community democratization rather than in the firm.

At present the outside review function is still performed by the agencies of county government, mainly, state asset administration bodies, financial bureaus, and the local branches of state banks at county level, and by the community government itself. Although there continue to be certain bureaucratic and political costs, their review and oversight seem to bring more benefits and less cost than before. In addition to the roles of major institutional shareholder, market intermediaries, and dispute arbitrators analyzed above, another role they play is quite similar to that of the “social council” in Spanish Mondragon. The members of the social council are elected by local constituencies and the council serves as a major venue for discussion and negotiation which smooths the relations between employees and management.

The effectiveness of above listed mechanisms is subject to a hard budget constraint and the extent of market and inter-jurisdictional competition. Without competitive pressure and a hard budget constraint, they may not function in a positive way. Competition and the hard budget constraint make profits sensitive to the performance of the firm and put the same survival urge before all of the inside and outside owners and managers. As a consequence, profitability and the survival urge may become the shared norms among stakeholders. This competition also disciplines local government agencies to promote and secure better ownership arrangements and to function as a “helping hand” rather than a “grabbing hand”.

Channels to Raise Capital and to Diversify Risk and the Flexibility to Evolve

Apart from the costs of collective decision making, theoretical worries over employee-ownership include also the concentration of risks and difficulty of raising capital. The risk concentration argument indicates that when employees invest a significant portion of their wealth in the firm that employs them, they will bear much more risk than that born by pure employees. They not only reduce the diversification of their investment

portfolio, but also reduce the diversification between their financial portfolio and their human capital, the source of earning income. If the firm fails in business, they will lose not only their jobs but also their savings (Hansmann, 1995, p. 76; Putterman, 1993). The argument about the difficulty of raising capital indicates that because of the asymmetric information and interest differences between employee-owners and outside investors, predominantly employee-owned firms may be less attractive to the outside investors, resulting in under-capitalization (Craig and Pencavel, 1995; Earle and Estrin, 1996).

However, as pointed out by Earle and Estrin (1996, p. 12), the risk concentration argument ignores the point that human capital risk may be reduced due to reduction in the risks of layoff and in loss of firm-specific investment or rents, once it becomes clear that investing personal savings in the firm also brings employees some control rights. This point is much more relevant for SOEs in transition economies, where capital markets are severely underdeveloped and the highest risk for employees is layoff and for the society is a large-scale of layoffs. In addition, if outside funds are rarely available, employee ownership may help to form a modest pool of savings for the firm's survival and capitalization.

For JSCs in the TVE sector, there is a mechanism for risk diversification that has existed since the time of the TVE takeoff. From the very beginning, the township and village communities were diversified producers. They engaged in manufacturing, agriculture, commerce, construction, and transportation activities, whether intentionally or not diversifying risk (Sun, 1997: Section 4).^{viii} Some of the JSCs are directly based on the community conglomerate, meaning that households and employees hold the shares of the community conglomerate rather than in a single firm. For firm-based JSCs, local employees and their households typically hold shares in other community firms as well and in addition they continue to possess contracting rights to use farmland (Table 1).

As documented in Sun (1999, 2000), the establishment of JSCs has greatly strengthened capitalization of these restructured firms rather than the opposite. For small and medium-sized firms, even in an economy with well-developed capital markets, the possibility of raising equity capital from markets is usually very low and the cost is often unbearably high. For them, a feasible and efficient way of raising equity capital is to issue shares to the employees of the firm, community members and their relatives and to attract external equity capital through the assistance of community governments.

The above analysis seems to suggest that for numerous small and medium-sized enterprises in the TVE sector at least, there is no *ex ante* reason to assume that the ownership form of JSC will be a transitory arrangement. Some may grow into limited liability and openly held companies, and some may be closed down due to business failure. However, many of them may continue to enjoy the advantages of this ownership arrangement and many new firms may adopt this ownership arrangement due to its cost-benefit advantages. In fact, by the end of 2000, there were 28,168 firms that directly employed JSC form at their startup and 48,542 JSCs that were formed by the cooperation of household and private firms (*Yearbook of China's TVEs*, 2001, p. 166).

The JSC form may facilitate the smoother and speedier fading out of community government ownership as well. On the one hand, the equitization of those ownership stakes held by local governments make it possible to transfer the equitized government stakes to other investors or specialized assets management institutions. This transfer helps local governments to get rid of the paternalistic responsibilities for their TVEs and to focus on their due role of administrators and regulators. On the other hand, the continuous presence of local government stakes in JSCs in the short- and medium-run may help to release financial and other constraints the firms face and to reduce tensions between employees and management as we discussed before.

4. Remaining Challenges to JSC Development and TVE Reform

Although TVE ownership reform in general and the emergence of employee stock ownership in particular has been effective in curing TVE mechanism degeneration and in improving TVE capitalization, the reform is still in a middle way. The development is uneven, and in particular there are great difficulties at present stage to make consistent, unified, and rigorous legal provisions for standardizing the establishment and operation of various joint ownership forms and JSCs. The uneven development of political democratization at the grass-root level also hinders the healthy evolving of joint ownership forms and JSCs and the further fading out of local government ownership in those communities where the political democratization has lagged behind. Apart from these remaining challenge to TVE reform, many other problems which are closely linked with the features of development in a developing economy like rural China have surfaced and constrained the further development of TVEs. The four major development challenges can be summarized as follows.

First, enterprise management is in general still far from professional and proficient. The major managers are typically from the local community and have a relatively poor educational background. They have strong desires to develop their business but lack of management skills to deal with market competition and to improve internal efficiency. The development of tools for market-based economic decision-making has lagged behind the general growth of the TVE sector. For example, the enterprise accountant usually functions as a bookkeeper rather than an integral part of management mainly due to the severe shortage of professional accountants. As a consequence, many TVE managers have no access to the information flows generated by modern accounting practices, which in turn hinders them from making rational and timely business decisions (*China Daily*, 26 October 1995, p. 2). The shortage of competent engineers and technicians has also undermined the improvement of TVE technological management.

Second, there is an obvious conflict between risk diversification, which implies small scale, and existing technical economies of scale in production. TVEs are typically locally initiated and locally based. In order to diversify business risks, it is rational for a township or village to set up several small-scale TVEs that diversify into different sectors. However, on the other hand, in many industries, small-scale production has no profitable potential at all in the medium- or long-term. This conflict casts a shadow over the long-term prospects of many small-scale TVEs.

Third, the entry of TVEs in many cases is local-resource-driven rather than market-demand-driven. In the past they had no marketing problems due to the widespread supply-shortages. From the mid-1990s onwards, the demand-constraint appears to have become dominant in Chinese economy. Confronted with the increasing demand-constraint, they have to adjust their product structure and update their products so as to meet market demand and maintain their market shares. How to conduct such adjustment and updating has become an urgent challenge to many local-resource-based TVEs.

Fourth, almost all TVEs have been initiated by township governments, village governments, households, and joint-households (so-called "four-wheel driven"), and based on local resources and conditions. The comparative benefits include very low TVE entry costs into non-agricultural sectors and sufficient exploitation of local resources and comparative advantages. However, the comparative costs are significant as well. Rural industrialization has not yet induced meaningful urbanization. As a consequence, TVEs in general will continue to miss the great benefits created by urbanization for a long period. In other words, the further development of TVEs will be increasingly restricted by the lack of infrastructure, market information and strategic services and by poor transportation and communication networks. Furthermore, human capital development of TVEs will be increasingly constrained by localized and kinship-based vested interests and by dual role of their employees as both workers and peasants.

At the macroeconomic level, the widespread pattern of TVE distribution suggests three negative consequences: (a) the uses of scarce land and existing infrastructure are inefficient; (b) the development of the service industry is restricted by the absence of demand for its products, meaning that the strong job-creating capability of the service industry, which is urgently needed in China, would not be sufficiently exploited; and (c) there is the risk that environmental pollution may go unchecked in certain localities. In order to tackle these problems the Chinese government has started to pay greater attention to the establishment of industrialized small cities and towns since early 1990s. Some experiments have been conducted and some supporting policies have been issued. The role of both central and local governments in this area is certainly critical.

The challenges linked with the general development problems cannot be solved by ownership reform alone, though ownership reform will create a sound institutional environment for tackling these problems. Ownership reform is only one of the major subjects in the process of TVE development. Management modernization, creation of forms of urbanization which are compatible with TVE growth, human capital development, and catching up modernized corporations are all critical challenges faced by TVEs and Chinese government. The challenges from both reform and development dimensions will continue to place pressure on all of the players in this competition field, providing them with strong incentives and stimulating them to look for innovative and adaptive solutions one after another.

5. Concluding Remarks

In this paper we have briefed the major progresses in the recent radical and successful TVE ownership reform in China. We highlight that the most striking feature of the reform is the fading out of local government ownership through the transitional arrangement of joint-stock ownership across the local government, TVE employees, and external equity investors. We discuss why local government ownership could dominate private ownership in the first two decades of China's transition and then identify three leading factors that have driven the fading out of local government ownership in TVEs in recent years. We present the stylized features of China's joint-stock cooperatives (JSCs), which have been widely adopted in China's TVE sector. To show the distinguished features of China's JSCs from those of industrial cooperatives and closely held employee stock ownership in the West and various employee-owned firms in transitional economies in Europe, we identify and investigate the core mechanisms that developed by China's JSCs. They include those mechanisms that have facilitated to avoid excessive costs of collective decision making, to check inside control, to mobilize internal and external financial resources, to diversify risks, to harmonize labor-management relations, and to provide flexibility for the JSC's further evolving.

The most striking feature of China's joint ownership forms in general and the JSC mode in particular is that it intends to combine the incentive of individual ownership on internal capital accumulation with the strength of the existing institutional and social capitals embedded in the township or village community. In a comparative perspective, they can be regarded as a hybrid mode between the closely held joint-stock firm and the preceding collective TVE, and it represents both development continuity and dynamic adaptation. These modes could be transitional in the case where a joint-stock firm or JSC firm grows out of the community and becomes an openly held company. However, the realization that the closely held firm is and will continue to be the dominant form in China's rural economy suggests that the institutional and social capitals embedded in a rural community would continue to be valuable in the future for most community enterprises. When the firm is closely held, its corporate governance problem is fundamentally different from one in the openly held firm. For the closely held firms, the paradigm of the competitive stock market has little to do with them, and their

governance problems typically involve the use of mutual class shares and managerial networks, re-designing ownership and control via multilateral negotiations, and influence-seeking among different stakeholders. In all these interactive fields, the vesting of social and institutional capital within the community would provide information advantages and cost-saving potentials (Aoki, 2001).

While it has become widely acknowledged that the transition is not an immediate replacement of the old institutional structures by the new ones and that the transition process might be quite long, it is highly desirable to search for transitional ownership and governance mechanisms that are adaptively efficient. Adaptively efficient mechanisms are characterized by their capability to provide economic and political flexibility for people and organizations to adopt to new opportunities. They accommodate to the sequences of progressive levels in know-how and provide incentives for the acquisition of knowledge and learning. They encourage risk-taking and creative activities. They also encourage trials and eliminate errors in a world of uncertainty. If one path does not work, they are able to initiate organizational responses to try new paths until successful outcomes are achieved. Judged by these criteria, this paper suggests that the essential mechanisms of China's employee stock ownership and JSCs in the TVE sector can be qualified to be adaptively efficient. They might be transitional but also have good chance to go beyond the transition. What is certain is that they will continue to pursue adaptive efficiency and catch advantages from more than one institutional and social channel so as to strengthen their competence and to meet new challenges. Pursuing adaptive efficiency via hybrid mode may be the most instructive lesson China's TVE reform has offered to decision-makers and entrepreneurs in transition and developing economies.

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Notes

ⁱ In official statistics, rural enterprises are classified into four categories: township-run (*xiangban*), village-run (*cunban*), owned by a group of households (*lianhu*, mainly partnerships), and owned by an individual household (*geti*, i.e., a sole proprietorship employing less than eight employees). TVEs in this paper refer to the first two categories. Although household-run and jointly owned private enterprises accounted for about 42 percent of value-added and 56 percent of employment in the rural non-agricultural sector in 1996, they tend to be much smaller in scale (*Yearbook of China's TVEs*, 1997, p. 121). In addition, a large number of them are subcontracted subsidiaries of larger TVEs.

ⁱⁱ By the end of 2000, of total about 802,000 TVEs that remain in the "collective ownership" category, 163,000 (20.3%) were JSCs, 25,000 (3.1%) were joint-stock companies, and all others either maintained more conventional collective ownership (with leasing or management responsibility contract arrangements) or registered themselves as limited liability companies (*Yearbook of China's TVEs*, 2001, p. 3).

ⁱⁱⁱ The property rights arrangements across JSCs are not uniform as well, with variations across regions, industries, and the SOE, TVE and private sectors. In China's official statistics, the various forms of JSCs have not yet been clearly brought together in a single category.

^{iv} During 1992-1998, the TVE sector continued its growth miracle. TVE value added increased from 299 billion yuan in 1992 to 997 billion yuan in 1998, implying a real growth rate of 13.6 percent per annum. In 1999, the growth rates of TVE value-added were still around 9 percent although many small TVEs being transformed into private ownership and there continuously being the negative impact of deflation and export difficulties caused by East Asian economic crisis. (Ministry of Agriculture, 1997; *Statistical Yearbook of China*, 1999 and 2000: Table 9.2; *Yearbook of China's TVEs*, 1996, pp. 102-108).

^v Data sources: "Selection from the 1995 National Industrial Census", in *People's Daily*, July 25, 1998. *Yearbook of China's TVEs*, 1996, pp. 100-101.

^{vi} In 1996 each county had on average 21.2 townships, 345.5 villages, and 723.2 community run TVEs (*Statistical Yearbook of China*, 1997, pp. 3, 21, and 399).

^{vii} In August 1997, This same norm for profit distribution was adopted for urban JSCs by the State Commission for Restructuring the Economic System, which issued the "guiding suggestions" (*Zhidao yijian*) for urban JSCs (*Economic Daily*, 7 August 1997).

^{viii} At the end of 1996, China had 45,500 townships and 740,100 villages. On average, each township, with a population of about 24,000, possessed 9 township-run non-agricultural firms; and each village, with a population of about 1,200, had 1.54 village-run non-agricultural enterprises.