Brooklyn Journal of International Law

Volume 21
Issue 1
Symposium: Comparative Models of Privatization: Paradigms and Politics

Article 4

9-1-1995

The Cat That Catches Mice: China's Challenge to the Dominant Privatization Model

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ARTICLE

THE CAT THAT CATCHES MICE: CHINA'S CHALLENGE TO THE DOMINANT PRIVATIZATION MODEL

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I. INTRODUCTION

One of the most extraordinary dramas of our century has produced one of the most compelling paradoxes of our time. Communist rule in Eastern Europe and the former Soviet Union has ended, and the Berlin Wall has collapsed. Market-oriented economic reforms and political democratization have been introduced to the region, conforming with popular notions of the paradigm for reform.[1] Yet, the transformation from to-

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1. The idealized paradigm consists of simultaneous political and economic liberalization, or at least one followed in rapid succession by the other. In the case of transitional economies, the virtues of immediate and rapid privatization of planned economies have received widespread approval from Western institutions and economists. *See, e.g.*, John R. Guardiano, *Exploding the Myths About Economic Reform in Russia*, Heritage Foundation Rep. (Heritage Foundation) No. 930, (Mar. 9, 1993), *available in* LEXIS, EXEC Library, HFRPTS File ("The solution to Russia's economic problem is not less reform, but more reform. The government should press ahead quickly with a comprehensive and full-fledged economic reform program that would include continued mass privatization of state industry . . . . Economic reform, moreover, should be carried out in a wholesale and not piecemeal manner."); Jeffrey Sachs, *Accelerating Privatization in Eastern Europe: The Case of Poland, in* PROCEEDINGS OF THE WORLD BANK ANNUAL CONFERENCE ON DEVELOPMENT ECONOMIES 1991 (1991).

Political transformation to democracy is also deemed indispensable to economic transformation. *See, e.g., U.S. Policy Toward the Former Soviet Union: Hearings of the House Foreign Affairs Comm.*, 103d Cong., 2d Sess. 3 (1994) ("Our talitarianism to political democracy has also wreaked economic chaos and disillusionment, and in the Soviet Union, disintegration from central authority into centrifugal conglomerates euphemistically called the "Commonwealth of Independent States."

On the other side of the globe, the antithesis to Eastern Europe and the former Soviet Union can be found in China. There, Tiananmen Square and political repression coexist with an economy currently experiencing one of the most rapid growth rates in the world. Nominally socialist but steadfastly market-oriented, China is embarking on a strategy of slow but steady economic transformation.

"Privatization" is a term used to describe the means by which a centrally planned economy can effectively make the transition to a market economy.[2] While there are critical dif-

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approach in assembling last year's foreign assistance program was to reinforce those trends in Russian political and economic life that together, we believe, constitute the essence of the great transformation underway in that country. Those trends are democratization and privatization.") (testimony of Strobe Talbott, Deputy Secretary of State) (hereinafter Talbott Testimony).

Eastern Europe fits the Western paradigm for reform because it emphasizes both political democracy and immediate privatization of the state sector.

2. For a more in-depth discussion of the evolving meanings associated with the term "privatization," see discussion *infra* part II.A.

While the privatization debate, at least in the context of emerging market economies, usually centers around the transformation of an economy from centralized to more decentralized arrangements, its subtext is also about political liberalization. For the view that political and economic liberalization go hand in hand, see Michael Hirsh, *The State Strikes Back*, INSTITUTIONAL INVESTOR, Sept. 1993, at 123, 127 ("[U]ltimately the development debate is also about how best to achieve democracy."); Cass Sunstein, *Constitutionalism, Prosperity and Democracy*, 2 CONST. POL. ECON. 372, 372 (1991) ("A constitution designed to promote economic development and democratic reform could provide an important stimulus in both directions.").

For the view that economics and politics are more often sequentially or causally rather than simultaneously linked, see MARSHALL I. GOLDMAN, WHAT WENT WRONG WITH PERESTROIKA (1991). "The simultaneous introduction of the economic reforms associated with perestroika and the political reforms referred to as glasnost all but guaranteed that chaos would follow . . . . [A]s early as 1987, it was apparent that combining perestroika and glasnost was like mixing sulfuric acid and water—it would set off sparks." *Id.* at 124-25; Samuel Huntington, *Challenges Facing Democracy: What Cost Freedom*, CURRENT 22, 25 (1993) ("[E]conomic development promotes democratization . . . . Transitions to democracy are heavily concentrated among countries at the upper-middle income level of development."). It has also been argued that one should be given priority over the other. "One of the bitterest lessons of the 'transition' is: You can have bread without freedom, but you cannot enjoy freedom forever without bread." Shlomo Maital & Ben-Zion Milner, *Russia and Poland: The Anatomy of Transition*, CHALLENGE, Sept. 1993, at ferences between privatization processes employed by China and Eastern Europe, both regions have produced a set of common transitional dilemmas. Hidden traps beneath the path of reform have become an increasingly volatile and disruptive force. The initial euphoria associated with change has given way to a host of sobering concerns: how to dismantle an obsolete system of bureaucratic central planning,[3] construct a new economic order grounded on institutions of a fledgling market economy, and at the same time, create economic growth and increased productivity with some semblance of order, or at least with minimum disorder.

There are generally two exits for countries previously organized under the principles of full public ownership of the means of production and compulsory state economic planning.[4] First, the dramatic "Big Bang" exit, characterized by radical "shock therapy" prescriptions adopted by many of the Eastern European countries, involves immediate privatization of the state sector, including the swift transfer of assets from public to private hands. Second, the more gradual, less explosive form

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3. For a compelling presentation of the view that it is not socialism per se that has been rejected but rather Soviet-style socialism, see John Elliott, *Challenges Facing Social Economics in the Twenty-First Century: A Radical Democratic Perspective*, 51 REV. SOC. ECON. 504 (1993); Paul M. Sweezy, *Socialism: Legacy and Renewal*, MONTHLY REV., Jan. 1993, at 1-9.

4. The race to depart from Marxist economic orthodoxy to embark on a market-oriented path of reform has begun for almost all countries organized under the principles of central planning. *See, e.g.*, Barbara Bradley, *Burma Capitalism is Half-Baked but on the Rise*, CHRISTIAN SCI. MONITOR, Jan. 25, 1995, at 8 (The government has abandoned "'the Burmese Road to Socialism'" in favor of a free market by privatizing farming and other industries); *Cuba*, COUNTRY REP. (Walden Pub.), (Jan. 30, 1995), *available in* LEXIS, World Library, COUREP File (By the end of 1994, various concessions to a mixed market were made allowing farmers to sell above-quota surplus at market prices and local state industries to sell manufactured products to the public at market rates); Irja Halasz, *Mongolia to Open Stock Trading to Foreigners*, Reuter Asia-Pac. Bus. Rep., Feb. 5, 1995, *available in* LEXIS, News Library, NONUS File (Mongolian privatization of its state companies have resulted in about half of its 2.2 million people becoming shareholders of former state enterprises); Daniel Southerland, *Mongolia Takes a Hard Road*, WASH. POST, June 13, 1992, at G1; *Vietnam Halves Number of State-Owned Firms*, Reuters World Service, Feb. 5, 1995, *available in* LEXIS, News Library, NONUS File (Communist Vietnam has reduced the number of its state-owned firms to approximately 6000, half the 1990 figure. The government has dissolved 2000 money-losing state enterprises, restructured others into shareholding companies to improve their performance and currently has plans to open a pilot stock exchange to trade in government bonds).

of disengagement pursued by China, involves the initial creation of a nonstate sector followed by limited privatization of the state sector. This path has been called "socialism with Chinese characteristics,"[5] and more specifically, "privatization with Chinese characteristics."[6] This method of privatization is characterized by a strategy which eschews the current Eastern European wholesale transfer of state enterprises from the state to the private sector.

Although there are two generally recognized exits—gradual extrication from the central plan or a quick leap to private ownership—it has been assumed that all exits lead to the same common destination: a Western style economy based on full private property rights. This Article explores the more uncommon and seemingly less dramatic approach favored by China, an approach gradual in speed and different in orientation from the Eastern European approach. The Chinese model is based on carefully orchestrated sequences[7] designed to create a two-track economic system consisting of parallel state and nonstate sectors. Thus, the Chinese model makes an inherent distinction between privatizing the state sector and creating a nonstate sector. Additionally, within this separate

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5. Deng Xiaoping first coined this term in a statement about China's attempts to deal with its exploding population growth. "[T]he problem of China is its excessive population . . . . [O]nly a socialist system can solve this problem . . . . The socialism we are talking about is one with Chinese characteristics." *China Can Only Go the Socialist Road*, PEOPLE'S DAILY (overseas ed.) June 24, 1989, at 1.

6. Matthew Bersani, *Privatization and the Creation of Stock Companies in China*, 3 COLUM. BUS. L. REV. 301, 302 (1993).

7. This description does not suggest that the central authorities in Beijing have always been successful in prescribing reform from above. As a popular Chinese saying goes, "Those above propose a policy; those below implement their own." Gerrit Gong, *China's Fourth Revolution*, 17 WASH. Q. 26, 32 (1994). China's reformers themselves describe the process as one of trial and error, similar to "groping for stones to cross the river." Carl Riskin, *Where is China Going?*, *in* THE CHINESE ECONOMY AND ITS FUTURE 41, 52 (Peter Nolan & Dong Fureng eds., 1990).

Indeed, Beijing has often been surprised by renegade initiatives undertaken by commercially minded provinces without the capital's prior blessings. For example, officials of the Shenzhen Special Economic Zone, located across the border from Hong Kong in one of China's most prosperous regions, Guangdong Province, unilaterally decided on December 18, 1990, to open its own stock exchange without asking for Beijing's approval. Beijing's response to this open act of defiance was not to shut down the exchange, but rather to allow it to exist if Shenzhen in turn agreed to a postponement of a few months. *See* Orville Schell & Todd Lappin, *China Plays the Market*, 1992 THE NATION 727.

nonstate sector, the Chinese model has also spawned unorthodox economic organizations founded on hybrid, nontraditional concepts of ownership. As this Article will argue, the success of these unorthodox entities not only challenges conventional prescriptions for economic reform but also calls into question the traditional dichotomy between centrally planned and market economies.

Beyond the inherent distinctions it draws between the state and nonstate sectors, the Chinese model is particularly interesting for two primary reasons. First, its very success poses a serious challenge to the conventional view that the only effective reform package is the one offered by the "shock therapy" school.[8] Although proponents of "shock therapy" reform argue that only the faint-hearted will reject this route, because anything less will result in distorted economic development, the "anti-shock" model has been adopted quite successfully by China.

The Chinese model is also interesting for a second and perhaps more significant reason. Its success challenges many of the implicit and fundamental assumptions that have remained buried in the privatization debate. It has been assumed, for example, that the objective of transitional economies is to privatize in order to arrive at the same inevitable destination, namely a full and unfettered market economy founded on clear, transparent and unambiguous private property rights. With so unquestioned a goal, the only thing left to be worked out is the speed with which this goal can be accomplished. Thus, even though there may be hares and tortoises on this transitional path, it is supposed that both will aim towards and arrive at a common end point modeled on the advanced industrial economies.

With this goal in mind, it is no wonder that the debate has

8. As the term itself suggests, "shock therapy" conveys an image for how to cure a body politic of what ails it economically. It suggests attaching electrodes to the body and putting quite a bit of voltage through that body. It suggests, in other words, pain. Talbott Testimony, *supra* note 1, at 19. Some of the characteristics of shock therapy include introducing free prices, eradicating subsidies, allowing inefficient state enterprises to go bankrupt, saving the salvageable by mass privatization, and laying off excess workers. Shock therapists typically promise that the pain will only be temporary, and its short-term effects (unemployment, higher prices, social dislocation, and economic instability) will be more than offset by the long-term benefits of a swift and unequivocal transition.

been narrowly framed in terms of revolution versus evolution. In fact, the term "transitional economy" itself takes for granted not just the fact that the economy in question is making a "transition," but also the fact that it is making a transition to a self-fulfilling prophecy, an all-too-certain logic embodied in the "acceptable" economies of the United States, the European Union, and Japan.

This Article will examine the Chinese model and explore why, despite its shortcomings, it still presents a feasible and plausible alternative to the more dominant model that inspired reforms in Eastern Europe. China's unique transitional path as well as its unique institutional arrangements present a wholly different alternative. This Article will argue that while economic growth has certainly been fueled by the creation of a market-oriented, nonstate economy, such nonstate growth has also been generated by unorthodox market entities, such as collectives, with vague private property rights. Moreover, the retention of the state sector and the concomitant creation of a nonstate sector consisting of multiple property arrangements presents an additional challenge to the conventional prescription that state sector privatization is always required. According to conventional prescription, because clear property rights are a prerequisite to producing efficient markets and generating economic growth, and because privatization is the best means with which this end can be achieved, state sector privatization is an absolute imperative for ailing transitional economies.

Yet China departs from the dominant prescription for three reasons. First, it rejects immediate privatization of the state sector and encourages the initial creation of a new, nonstate sector. Second, it is making a transition to an economy with different concepts of property rights and ownership. Third, the strategy it has adopted to arrive at that point is not complete state sector privatization but rather a gradual model consisting of three phases of reform, only the last of which involves some privatization of the state sector. Even then, the Chinese approach is limited state sector privatization which is diametrically opposed to the Eastern European model of mass privatization. In this context, Chinese privatization has evolved over time into three manageable sequences: the creation of a new, nonstate sector, the reformation of the existing state sector, and the privatization of the state sector.

Part II of this Article describes the general framework of the privatization debate, and compares the dominant Eastern European model with the more novel Chinese model. It also examines the ideological and economic contexts in which both models were undertaken, focusing on the Chinese model and its theoretical underpinnings. Particular emphasis is placed on the economic benefits generated by the Chinese model and the economic rationale for deferring state sector privatization.

Part III examines the first sequence of reform. Instituted since 1978, this sequence involves the creation of a nonstate sector coexisting on a parallel track with the state sector and consisting of multiple property arrangements: private enterprises, collective enterprises called township-village enterprises (TVEs),[9] and foreign invested enterprises. Because the most significant and economically productive enterprises within this nonstate sector universe are the TVEs, Part III focuses on these unorthodox entities and the implications to be drawn from their economic success. As decentralized state enterprises under the ownership and control of the local provincial or village governments, their success is directly contrary to conventional dogma on privatization. Part III will conclude that the success of TVEs demonstrates that clear private property arrangements are not always required to generate economic growth and that markets can function without private ownership as that term is traditionally understood.

Part IV explores and assesses state sector reform in China. It first examines state sector reform in the absence of state sector privatization. These were reforms undertaken to improve public sector efficiency and productivity in state enterprises without altering the foundation of the state's ownership rights. In this regard, this Article will examine the measures China took to induce its state enterprises to reorient their behavior, to favor innovation over routine and marketization over central planning. Part IV also examines the creation of a dual pricing system for state enterprises and the transfer and assignment of property use rights under a wide variety of contracts. These property rights were transferred progressively from the state to the enterprise in order to allow the latter

9. While "collective enterprises" are not private enterprises, they are not considered state enterprises either. *See infra* text accompanying notes 109-13.

greater autonomy over management, marketing, and other decisions relating to the business. At the same time, managerial reforms, including profit retention schemes and bonus plans adopted in the late 1970s and early 1980s, have also led to greater public sector efficiency and productivity.

The second section of Part IV analyzes the current stage of Chinese state sector privatization, which is the gradual transformation in ownership of state enterprises into a shareholding system by private equity participation. It is only in this last phase of reform that China has finally pursued privatization as it has been traditionally employed by transferring state ownership rights to private interests. Part IV will also demonstrate that state sector privatization in China is wholly different from state sector privatization as adopted by Eastern Europe for the following reasons. First, state sector privatization in China is implemented only *after* a full-fledged nonstate sector has been created, so that transfer of ownership from state to private hands occurs in the context of an already highly-marketized framework. And second, state sector privatization in China is intended to be circumscribed, not widespread, in the number of enterprises to be privatized, the percentage of shares that can be privately owned, and the trading of those shares on the stock exchanges.

Part IV will use as an example the recent securities issues of Chinese enterprises and examine how the development of a securities market in China is a reflection of the carefully calibrated choices of the Chinese government to engage in rather limited privatization of the state sector. In this regard, Part IV argues that state sector privatization has been uneven and that the government's preoccupation with remaining majority shareholder has created a securities market insufficiently responsive to the needs of other shareholders. The prescription for this ill, however, lies not in more or faster privatization, but in better privatization. Thus, if state sector privatization is to be instituted, it should include among its goals more than just the objectives of capital fundraising and state control of the securities market.

Although it is a paradigm that currently dominates the privatization discourse, full, immediate and clear-cut privatization is not desirable for all economies. The relative success of China's two-track model of privatization should invite serious consideration of alternative forms of privatization, as well as economic diversity in so-called transitional economies. In addition, as the success of the TVEs show, if a market can be constructed and market oriented behavior induced, then uninhibited privatization of existing state institutions, given the social costs, may not be the prescription required or desired.

II. Friend and Foe; Contrasting the Importance of the State Sector in Chinese and Eastern European Privatization Economics and Ideology.

A. *Introduction*

Since the collapse of the Berlin Wall, the term "privatization" has made a dramatic entrance into the emerging legal orders. Privatization has been accorded almost mystical status, as if its incantation will dissolve all difficulties inherent in reform and transition.[10] However, despite its popular usage, the term "privatization" alone is so generalized as to be devoid of meaning if not grounded in the context of where and when it is employed.[11] For example, within the context of just one re-

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10. Not only must reformers "move on all fronts at once—or not move at all," Lal Jayawardena, *Preface to* OLIVIER BLANCHARD ET AL., REFORM IN EASTERN EUROPE at vii, ix (1991), all fronts must additionally share one common goal—to reassign state ownership to private hands as quickly as possible. "The need to accelerate privatization is the paramount economic policy issue facing Eastern Europe. If there is no breakthrough in the privatization of large enterprises in the near future, the entire process could be stalled for years to come." Sachs, *supra* note 1, at 15; *see also* INTERNATIONAL MONETARY FUND, ET AL., THE ECONOMY OF THE USSR: SUMMARY AND RECOMMENDATIONS 26 (1990) ("the ultimate goal of ownership reform is to privatize almost all enterprises"); WORLD DEVELOPMENT REPORT 1991: THE CHALLENGE OF DEVELOPMENT 144 (1991) ("Privatization is necessary and highly desirable, even though difficult and time-consuming."). CATHERINE MANN ET AL., POLITICAL AND ECONOMIC CONSEQUENCES OF ALTERNATIVE PRIVATIZATION SCHEMES 8 (Conference on Markets, States, and Democracy: The Political Economy of Post-Communist Transformation, sponsored by the Center for German and European Studies at the University of California, Berkeley and the Friedrich Ebert Stifftung (Feb. 11-13, 1993) Working Paper No. 5.14, 1993) ("Speed is important, since proceeding slowly risks allowing political opposition to develop that could weaken and perhaps unravel progress achieved to date.").

11. On the other hand, at the other end of the spectrum of too general is too specific. Too much specificity can also cause one to throw up one's hands and conclude, simply, that "the French experience of privatization is unsuitable for Russia and Mexican lessons are useless for Eastern European, Cuban, Chinese and Vietnamese enterprises." Andrei Baev, *Civil Law and the Transformation of State Property in Post-Socialist Economies: Alternatives to Privatization*, 12 PAC. BASIN L.J. 131, 139 (1993). Thus, "we cannot push into the Procrustean bed all the different historical, legal, and economic forms of privatization." *Id.* Indeed, this ap-

gion or country, the definition of privatization is evolving continuously.

> [A]t its broadest level, the term 'privatization' refers merely to the introduction of some private enterprise into the economy. For example, enacting a law which allows an artisan to become self employed is a form of privatization . . . . This meaning of privatization was relevant to developments in Eastern Europe less than three to five years ago. Now, however, for the most part Eastern European economies have moved far beyond these initial stages.[12]

Indeed, at the current stage of the transformation process, "in the context of Eastern Europe, privatization means the transfer of state owned enterprises to private ownership . . . . For example, in Czechoslovakia, Poland and Hungary, the term privatization is generally used to refer to a specific program for the wholesale divestment of state enterprises."[13]

Moreover, privatization in emerging economies will be different from privatization in developed, market economies. For example, privatization in the more highly developed market economies of Western Europe only entailed a sale of state assets to a more efficient private sector. It did not necessitate the restructuring or reconstruction of the economy.[14] By con-

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proach, if stretched to its limits, can result in the conclusion that unless initial conditions and structures were identical, the experience of one country is analytically meaningless if applied to another country. *See, e.g.*, Jeffrey Sachs & Wing Thye Woo, *Understanding the Reform Experiences of China, Eastern Europe and Russia, in* FROM REFORM TO GROWTH: CHINA AND OTHER COUNTRIES IN TRANSITION IN ASIA AND CENTRAL AND EASTERN EUROPE 23 (Chung H. Lee & Helmut Reisen eds., 1994).

12. Richard M. Phillips & Marian G. Dent, *Privatizing Eastern Europe: A Challenge for the Nineties, in* JOINT VENTURES AND PRIVATIZATION IN EASTERN EUROPE, at 445, 448 (PLI Commercial Law & Practice Course Handbook Series No. 575, 1991).

13. There are, of course, differences within Eastern Europe itself. "In other states, which have not progressed as far towards a Western style economy (for example Romania and Albania), privatization may merely refer to the efforts of individual SOEs [state-owned enterprises] to introduce an element of private ownership or to create a joint venture with private firms." *Id.* at 448-49.

14. ROMAN FRYDMAN & ANDRZEJ RAPACZYNSKI, PRIVATIZATION IN EASTERN EUROPE: IS THE STATE WITHERING AWAY 21 (1994). Sales of British Airways, British Steel, British Telecom took place in a "fundamentally market environment dominated by private property." *Id.* Moreover, "prior to their privatization, state enterprises in . . . Great Britain had to operate in competition with other private companies and their managerial system (even if often less efficient than that of their private analogues) was basically a product of the surrounding capitalist busi-

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> privatization, in the environment of the transitional economies, is not a simple transfer of ownership from the state to private individuals. It is rather a process by which the very institution of property, in the sense in which lawyers and economists employ the term, is reintroduced into East European societies.[15]

Thus, for all transitional economies, questions have arisen concerning not just the optimal pace of reform or the sequence of reform but also the type of property that reform is supposed to create. Should privatization of state enterprises be implemented first? Or should a framework designed to induce market-oriented behavior be adopted before state enterprises are transferred to private hands?

In these two very basic aspects alone, the Eastern European and Chinese models of privatization represent two unmistakably disparate strategies of reform. The Eastern European model favors quick privatization of state enterprises and invests significant capital and resources into the conceptualization and implementation of this process. The premise of the Eastern European model is that clear-cut private property rights are not just an inherent good but also a necessary precondition for economic growth and efficiency. Because privatization clarifies muddled property arrangements and transfers ownership rights from the state to private hands, privatization is considered necessary for the institution of a dynamic market economy.

By contrast, the Chinese model favors retention of state enterprises and encourages the creation of a new set of firms in a distinct nonstate sector. A basic premise underlying the Chinese model is that the fundamentals of a market-oriented economy must be established before state sector privatization can be successfully pursued, if it is to be pursued at all. Thus, China's goal for many years has been the creation of a nonstate sector oriented towards the maximization of profits and the efficiency of production.

Different ideological as well as economic considerations

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ness culture." *Id.*

15. *Id.* at 10.

underlie the decision to adopt one model over the other. A political motive was fundamental to the decision by Eastern European countries to pursue a model founded on speedy and mass privatization of state owned enterprises. In a similar vein, an equally fundamental political impulse caused China to adopt a model that insulates the state sector from change and preserves, to the extent practical, vestiges of social ownership.

This next section will focus on the ideological and economic means by which China has sought to privatize its economy, and as a point of contrast, compare the Chinese experience with the Eastern European model.

B. Ideological Considerations: China and Eastern Europe

To underscore China's shift from ideological purity to pragmatism, Deng Xioaping once noted that yellow cat or white cat, it's a good cat if it catches mice.[16] This paradigmatic shift allowed China to adopt a series of reforms intended to reduce the role of central planning and extend the role of markets. While pragmatism has allowed China to create and use the market in a way that could not have been contemplated before 1978, ideology has also ensured that such reforms will be kept within doctrinally acceptable parameters and will not displace the centrality of the state sector. Thus, a nonstate sector separate from public ownership of the means of production was created and the state sector itself was retained.

Public ownership of the means of production is still a cen-

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16. Schell & Lappin, *supra* note 7, at 730. Addressing the seventh Plenum of the third Central Committee of the Chinese Communist Youth League on July 7, 1962, Deng Xiaoping said:

> As to what kind of relations of production is the best mode, I'm afraid we shall have to leave the matter to the discretion of local authorities, allowing them to adopt whatever mode of production that can facilitate quickest recovery and growth of agricultural production. The masses should also be allowed to adopt whatever mode they see fit, legalizing illegal practices as necessary. These are all tentative ideas, not final decisions, so they will not necessarily come to pass in the future. When talking about fighting battles, Comrade Liu Bocheng often uses this Sichuan popular saying: "It does not matter if it is a yellow cat or a black cat, as long as it catches mice."

DENG XIAOPING, *How to Recover the Agricultural Production, in,* SELECTED WORKS OF DENG XIAOPING (1938-1965) 292, 293 (1992).

This speech was used by Party conservatives to charge Deng Xiaoping with "going capitalist" and Deng was subsequently purged during the Cultural Revolution.

tral tenet of Marxist theory. After the Communist revolution in 1949, mass rural collectivizations and the restructuring of all businesses into state enterprises owned by all of the people were carried out under the banner of Marxist ideology.[17] It was not until 1978 when Deng Xiaoping initiated an open door policy that China took the first of many incremental steps toward what has been called a "fourth revolution."[18] This revolution is characterized by a process of limited and controlled privatization with an "increasing market orientation . . . in ownership, production, investment, and demand[.]"[19]

This fourth revolution is not characterized by any singular defining moment or violent shift along ideological fault lines on the scale of the Great Leap Forward or the Cultural Revolution. Rather, it is marked by subtle but persistent threads of reform which are revolutionary in implication but evolutionary in approach, designed to avoid disillusionment with change or pendulum politics and backlash.[20] Thus, China's quest to em-

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17. *See* Howard Chao & Yang Xiaoping, *Private Enterprise in China: the Developing Law of Collective Enterprises*, 19 INT'L LAW. 1215, 1217 (1985) for a description of the process effected by the Chinese Communist Party between 1949 and 1956, in which "nationalist capitalist enterprises" underwent "social transformation."

See also ZHONGHUA RENMIN GONGHEGUO XIANFA [Constitution] [XIANFA (1982)]. Article 6 of the Constitution provides that "[t]he basis of the socialist economic system of the People's Republic of China is socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people." *Id.* art. 6. Article 7 further states that "[t]he state economy is the sector of socialist economy under ownership by the whole people; it is the leading force in the national economy." *Id.* art. 7.

18. Gong, *supra* note 7, at 34.

19. *Id.* at 30.

20. By contrast, backlash in Eastern Europe has been occurring in recent months:

> In Russia, shock therapy had a backlash in December's parliamentary elections, giving an antireformist, ultranationalist party a quarter of the vote. In Poland . . . the former Communists—standing for a slower reform platform in elections—became the largest party in Parliament. Similar results are expected in Hungary's spring elections, and in Romania and Bulgaria, the former Communists are gaining.
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> Everywhere, the slow track to reform has an increasing appeal as more jobs disappear, prices rise, and living standards go on falling.

Eric Bourne, *East Europeans Feel Duped by the West's Promises of Aid*, CHRISTIAN SCI. MONITOR, Jan. 26, 1994, at 3.

Because "poorly planned privatizations have done more harm than good," Eastern European governments have begun to question whether privatization is "a reform they can afford to skip." *Tired of Capitalism? So Soon?*, ECONOMIST, Jan. 21, 1995, at 61.

bark on its fourth revolution and to construct the workings of a "socialist market economy" have been guided by the defining criteria of "balancing growth with stability, order with dynamism, change with constancy."[21]

"Socialism with Chinese characteristics" or "market socialism" thus accommodates both of China's stated objectives: to achieve economic growth through market reforms, and to balance growth with stability in order to generate change without rupture. Hence, there emerges the ideologically pragmatic mantra of "market socialism," controlling the hurly-burly of market within the familiar parameters of socialism. Not surprisingly, ideological pragmatism has become the guiding principle for China's reformers,[22] who emphasize economic growth, increased efficiency, production before distribution,[23] and mar-

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21. Gong, *supra* note 7, at 35.

China pledged to continue market-oriented reforms at the Communist Party Third Central Committee Plenum, but rejected shock therapy in favor of the "China model," based more along the line of the "four little dragons," Hong Kong, Singapore, South Korea and Taiwan, than on American or European economic models. Daniel Kwan, *Third Plenum's Agenda Revealed*, S. CHINA MORNING POST, Oct. 5, 1993, at 8, *available in* LEXIS, ASIAPC Library, SCHINA File.

22. Under Deng Xiaoping, "practice [is] the sole criterion of truth." Gong, *supra* note 7, at 35.

Deng Xiaoping's ideological pragmatism has percolated throughout Chinese society as well. A Chinese agriculture specialist recently asserted that Karl Marx had "'fully affirmed [the] viewpoint'" held by Adam Smith that supply and demand should be regulated through the "invisible hand" of the market. H. Lyman Miller, *Holding the Deng Line*, CHINA BUS. REV., Jan.-Feb. 1993, at 22. Nowhere is this ideological pragmatism more freely exhibited than in China's embryonic but developing stock exchanges. According to Wei Wenyuan, chief executive of the Shanghai Stock Exchange, "when we think about the development of our economy, we have stopped thinking about whether it is socialism or capitalism." Michael Hirsh, *China's Financial Revolutionaries*, INSTITUTIONAL INVESTOR (int'l ed.), July 31, 1993, at 43, 51. As Huang Guixian, an executive at Shanghai Shenyin Securities, said, "'We used to decide first if something new was socialist or capitalist . . . . Now we see whether it works, then decide whether it is socialist or capitalist.'" *Id.*

23. Under "market socialism," emphasis shifted from distribution of resources to production of resources. As Winston Churchill so succinctly noted before the House of Commons, "the inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries." Maital & Milner, *supra* note 2, at 46.

As early as 1978, the third plenary session of the 11th Chinese Communist Party Central Committee declared: "'To realize the four modernizations, it is necessary to raise productive forces dramatically, and it is thus also necessary to change from various aspects the productive relations and superstructure which are incompatible with the growth of productive forces, and to change all unsuitable management styles, operational styles and ideological styles.'" *Dissent, Official* ket incentives, all within the ideologically comforting confines of central planning.[24]

To date, market socialism has produced a marked shift towards the market in a country that, as recently as 1978, depended on its public sector to produce 78% of its industrial output.[25] As discussed more fully in Part III, a nonstate sector was created and by 1992 alone was responsible for 52% of gross industrial output and more than 57% of nonagricultural employment.[26] In addition to creating a booming nonstate sector and a shrinking state sector,[27] China has also managed to

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Journal Closed for Publishing Pro-Democracy Articles, British Broadcasting Corporation Summary of World Broadcasts, Jan. 8, 1993, *available in* LEXIS, News Library, TBBCSW File.

24. In defending "market socialism," Deng Xiaoping stated, "'A planned economy does not equal socialism, because planning also exists in capitalism. A market economy does not necessarily equal capitalism because the market also exists in socialism. In order to make socialism superior to capitalism, we must boldly take heed of and absorb all the accomplishments of civilization that the human race has achieved,' including 'all the advanced modes of operation and management developed by other countries.'" Schell & Lappin, *supra* note 7, at 729-30.

25. Gong, *supra* note 7, at 31. By contrast, in 1979, the small-scale Chinese private sector provided only 23% of total industrial output. Guardiano, *supra* note 1.

26. Gong, *supra* note 7, at 31. If agricultural production and the service sector are counted, the private sector could be said to account for 75% of total economic output in China. Guardiano, *supra* note 1. By contrast, the state sector accounted for only 35% of the output of goods and services, a figure slightly above the government share in many European countries. Sir Alec Cairncross & Cyril Z. Lin, *The Private Sector that Is Driving China*, FIN. TIMES, Jan. 8, 1993, at 13.

But it is not just the public sector that has shrunk. Beijing's financial dominance over the provinces has as well. For example, while 80% of Guangdong's budget came from Beijing in 1980, in 1992, only two percent did. Gong, *supra* note 7, at 31.

Another sign that Beijing has been willing to relinquish some degree of control over the economy can be seen in the ever diminishing share of the economy that Beijing has been taking for its central coffers. As William Overholt, managing director of Bankers Trust, Hong Kong, stated in his book, "[i]n a truly socialist economy, such as China was at the beginning of reform, the government sequesters a large fraction of gross national product (GNP) for its purposes. Near the other end of the spectrum, the capitalist, anti-tax U.S. and Hong Kong governments take less than one fifth of GNP. At the time reform was decreed in 1978, Beijing took almost 39%. By 1990, the central government's share of the economy was similar to that of Hong Kong." WILLIAM OVERHOLT, THE RISE OF CHINA 48 (1993).

27. "[T]he state enterprise sector has declined during the reform period from considerably more than half of the total economy to somewhat less than half." OVERHOLT, *supra* note 26, at 50. Macroeconomic reforms have occurred as well. Prices of nearly all products, except for a few basic necessities, have been freed to fluctuate according to supply and demand. One source estimates that only about

achieve a level of economic growth previously unparalleled for a country comprising one-fifth of the world's population.[28] In addition to pure economic growth, China has also managed to achieve an unprecedented increase in foreign trade. This increase has proceeded at a rate which signifies a shift from a position of radical self-reliance and isolation to a position of increased integration into the international economy.[29]

The numbers do not merely show that China experienced economic growth and increased productivity. More importantly, the figures show that economic growth and increased productivity occurred in the emerging nonstate sector.[30] This strate-

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12% of China's industrial output was subject to central planning in 1992. Paul Blustein, *Can 'Half-Reformed' China Last?*, WASH. POST, Aug. 29, 1993, at A27.

28. China's growth rate after Deng Xiaoping's 1979 economic reform plan climbed to an annual rate of 10%. OVERHOLT, *supra* note 26, at 29. Although a brief decline to four percent occurred in 1988 and 1989 as a result of measures designed to arrest inflation, growth has accelerated to seven percent in 1991 and to 12.8% in 1992. *Id.* at 29-30.

The seven percent growth rate, the rate that has characterized the "Asian miracle economies," *id.* at 30, at least until China's experience, has appeared to be a phenomenon largely confined to either relatively small countries, such as Hong Kong (six million), Singapore (two million), Taiwan (20 million) or relatively homogeneous countries, such as South Korea and Japan. *Id.* at 27.

29. By 1992, China's foreign trade rose to $166 billion and its exports increased from $14.8 billion in 1979 to $85 billion in 1992. *Id.* Exports of sophisticated goods increased as well, so that while manufactured goods accounted for only half of China's exports in 1985, they accounted for more than three quarters of all exports in 1991. *Id.* at 30-31.

China's attempts to increase foreign investment through a well-calibrated system of incentives succeeded in attracting more than $20 billion of investment in its first dozen years of reform. *Id.* at 31. In 1992 alone, foreign investors invested $11.2 billion and signed agreements for $57.5 billion in future investments. *Id.* At the end of 1991, foreign-invested enterprises on Chinese soil generated $12.05 billion of exports constituting almost 17% of China's total exports. *Id.* Indeed, foreign enterprises in China, which already account for a major share of China's GNP, are expanding by the phenomenal rate of 50% annually. Even in 1989, the year of Tiananmen, the rate of foreign enterprise investment in China declined only to 43%. *Id.* at 50.

For a description of foreign-invested enterprises in China, see Michael J. Moser, *Foreign Investment in China: The Legal Framework*, *in* FOREIGN TRADE, INVESTMENT AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 106-42 (Michael Moser ed., 1984)

30. The emergence of a private sector outside the traditional state sector has also resulted in the marginalization of the once omnipotent Communist Party. As the *Wall Street Journal* reported, "[t]he economic opportunities since the party unfettered the economy in December 1978 have made money a rival to the party for people's attention." Joseph Kahn & Marcus Brauchli, *China's Communists Face Serious Threat: Creeping Irrelevance*, WALL ST. J., Dec. 19, 1994, at A9. While top college graduates once competed to become party members, they now scorn party

gy of privatization through the creation of a new nonstate sector, rather than the privatization of the existing state sector, is one of the more remarkable hallmarks of privatization in China.[31]

While this vibrant nonstate sector was being constructed, the state sector itself was steadfastly preserved. Unlike the countries of Eastern Europe, which desired to abandon their Communist past and return as swiftly as possible to the folds of free market Europe, China had no such political mandate. Paradoxically, the very institutional legacies that limit the parameters of political change, may also have diverted China from embarking on the route of radical marketization, possibly saving the country from the kind of economic cacophony that has plagued Russia. As a result, the double-edged sword that set limits on the very possibility for total political reinvention has also kept China from underestimating the necessity for maintaining stability. The desire to avoid traumatic transformation remains a foundation of the Chinese model of privatization.

Chinese privatization thus emerged gradually from and was shaped by "market socialism" or "socialism with Chinese characteristics." The state sector, which provides the underpinning of the socialist system, could not be privatized without either undermining the very ideological foundation of Chinese socialism or risking substantial disruption in China's political, social, and economic system.[32] Privatization in Communist

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membership. An entire new world has opened up in the flourishing private economy and the old world offered by the party is dwindling into a sphere of irrelevance.

31. Instead of focusing

> on the destruction of socialist institutions, namely central planning and state enterprises, China has concentrated on construction of market institutions, namely private enterprises, investment systems, stock and bond markets, workable price mechanisms, and most recently modern banks. If one defines the goal as decreasing the share of socialist production in GNP, then one can say that Poland has focused on decreasing the numerator while China has focused on increasing the denominator. The denominator is more malleable, and increasing it expands popular welfare.

William Overholt, *The Rise of China's Economy*, BUS. ECON., Apr. 1994, at 29, 34.

For an examination of Chinese privatization via state sector reform and private equity participation in state enterprises converted into joint stock companies, see discussion *infra* subparts IV.B.2 & B.3.

32. What can or should be done about the decrepit and bankrupt state sector

China necessarily meant privatization by means other than transfer of state assets into private hands. Thus, against the more popular tide sweeping Russia and Eastern Europe, privatization in China must, by ideological necessity, mean privatization through the creation of a nonstate sector separate and distinct from the state.

A completely different scenario can be found in the former Soviet bloc. As the Berlin Wall collapsed, the sense of political urgency and unlimited possibility spilled into the economic sector. All specters from the Communist past were to be eliminated. The future was to be structurally and wholly reinvented, but in the image and likeness of the old Europe with which the Eastern bloc had once shared a common vision and from which it had mistakenly withdrawn. For the former Eastern bloc, immediate divestment of state ownership rights was a political, moral and, by implication, an economic good.

Moreover, this divestment of state ownership rights was to be immediate because "the process of privatization entails enormous risks, and there [was] a real possibility that the process [w]ould still become paralyzed."[33] Thus, in order to forestall political opposition from interest groups adversely affected by privatization such as labor unions, old Party members, and former owners intent on reclaiming their property, privatization had to be implemented as swiftly as possible in order to prevent its opponents from "get[ting] their tentacles around the state enterprises."

Moreover, the appeal of immediate state sector privatization lies not in its unambiguous rupture with the past, but in its steering of the economy in a direction which has great political appeal. Because market economies worked well in the West, because central planning did not work in the East, and because there was no time to experiment with alternative paths, the headlong rush to a Western-style economy has an understandable attraction. Because stripping the state of ownership rights is seen as the quickest path towards such an

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is a question that haunts reformers in China. *See* discussion *infra* parts IV.B.1 & B.2.

For China, in particular, a country of approximately 1,152,428,417 individuals in approximately 300,388,130 households in 22 provinces and five autonomous regions and three special municipalities, see Gong, *supra* note 7, at 30, the risk for social unrest and dislocation cannot be minimized.

33. Sachs, *supra* note 1, at 16.

economy, privatization has been considered a prerequisite to a successful transition.

Thus, while each country in Eastern Europe might have adopted a different privatization strategy,[34] most embraced the privatization of state enterprises as the linchpin of market reform. Privatization has unrealistically been seen as a panacea for unmanageable bureaucracy, inefficiency, and bankruptcy. Because innovation, efficiency, growth, and incentives are believed to be magical properties somehow associated with "privatization," it is believed that the process alone will convert losses into profits, albeit with a certain number of social and political costs. In Poland, for example, "the government position is that privatization . . . should *precede* enterprise restructuring."[35] Similarly, "[c]onsidering it more important to privatize state property quickly than to finalize all the details of a market economy," the Czech Republic announced as early as 1993 that it planned to privatize 2,100 state enterprises worth approximately $17 billion.[36] Even though it is acknowledged

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34. *See* Michele Balfour & Cameron Crise, *A Privatization Test: The Czech Republic, Slovakia and Poland*, 17 FORDHAM INT'L L.J. 84 (1993) (privatization in the Czech Republic primarily by the voucher coupon method—selling voucher coupon booklets to be used by eligible citizens for bidding of shares in state firms and direct sales to foreign investors; privatization in Slovakia by public tenders, public auctions, direct sales and to a lesser degree, the distribution of shares through coupon privatization; privatization in Poland through privatization coupons and investment funds); *see also* Sachs, *supra* note 1, at 18-25 (privatization by initial public offerings, transfer of ownership to insiders, outsider privatization and sales and transfers to financial intermediaries).

35. Sachs, *supra* note 1, at 15 n.1 (emphasis added).

36. Balfour & Crise, *supra* note 34, at 96.

> This naive belief in the emerging market economies, encouraged on occasion by enthusiasts from the West, is that, with the large state-owned enterprises, all that is needed is to change the ownership from the state to private persons. The motivation of the new owners would engender those efficient systems of production so characteristic of the West and so lacking in the East.

Sir Alan Walters, *The Transition to a Market Economy*, *in* THE EMERGENCE OF MARKET ECONOMIES IN EASTERN EUROPE 102-03 (Christopher Clague & Gordon C. Rausser eds., 1992).

Hence, there was a lack of meaningful pre-privatization restructuring of the type occurring in China.

> There was thought to be no point in trying to reform the existing state-owned enterprises while they remained in state ownership . . . . One of the enduring features of all emerging market economies, whatever their state of reform, has been the persistence of *nomenklatura* management. It is doubtful that any political leader in Eastern Europe will seriously attempt the Herculean task of sorting the sheep from the goats among

that other ingredients are needed to implement a workable private market economy, it is also widely believed that the change from state to private ownership itself will result in the creation of a well-functioning capital market.[37]

Western institutions such as the World Bank and the International Monetary Fund have further encouraged state sector privatization and, in some cases, made it a prerequisite for further financial assistance.[38] For example, the prescription for the former Soviet Union stated that "the ultimate goal of ownership reform is to privatize almost all enterprises."[39] Furthermore, the World Bank concluded that "privatization is necessary and highly desirable, even though difficult and time-consuming."[40] The reason, of course, for placing so much faith in privatization is that it has been assumed that "only private owners can establish an enduring basis for self-financing and managerial independence."[41]

Thus, preprivatization restructuring could not be as important as privatization itself. Again, ideology plays a large part in this determination. State firms were seen as vestiges from the past and were associated with inefficiency and unprofitability. Restructuring them was not as politically appealing as turning them over to private owners who could do a much better job of converting struggling enterprises into commercial viabilities. Thus, enterprise reform lies at the low end of the agenda, while sweeping transfer of state property rights

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> the *nomenklatura*. They hope, instead, that privatization will do the sorting for them.

Id. at 103.

37. While various additional measures such as the institution of bankruptcy procedures to facilitate enterprise liquidation, "legal guidelines and procedures of a normal corporation," or "[b]asic concepts of property management" are recommended, these measures are designed to accompany, not precede, state sector privatization. Sachs, *supra* note 1, at 28.

38. *See, e.g.*, John A. Peeler, *Alarm Bell for Third-World Democracies*, CHRISTIAN SCI. MONITOR, Mar. 13, 1992, at 19 (because pro-privatization policies of the IMF are part of the politically dominant prescriptions for ailing economies, governments such as Third World governments have no choice but to adopt such policies).

39. INTERNATIONAL MONETARY FUND ET AL., *supra* note 10, at 26.

40. WORLD DEVELOPMENT REPORT 1991: THE CHALLENGE OF DEVELOPMENT, *supra* note 10, at 144.

41. Kimio Uno, *Privatization and the Creation of a Commercial Banking System*, *in* WHAT IS TO BE DONE? PROPOSALS FOR THE SOVIET TRANSITION TO THE MARKET 150 (Merton Peck & Thomas Richardson eds., 1991).

to private owners remains at the top.

That is not to say, of course, that no attempts have been made to improve state enterprises before they are privatized. Nor has privatization been the only method of reform in Eastern Europe. After all, even the most ardent advocates of privatization admit that while it is "the key element of the transformation process,"[42] "complementary policy initiatives and success in other areas, such as the legal environment, macroeconomic policy, and financial and labor markets are required to achieve the ultimate objectives."[43] However, wholesale, immediate state sector privatization remains the centerpiece of the Eastern European model. Even though it may be but one part of a complex endeavor to construct a market economy, the overall package is still one that requires the immediate introduction of free prices, the removal of subsidies, and the implementation of traditionally recognizable private property rights.

Thus, even a perfunctory comparison of the Eastern European with the Chinese model will reveal stark differences. In all respects, China's method of privatization goes against the dogmatic prescription for privatization ordained by Western reformers. Although embraced by Eastern Europe, immediate privatization of existing state enterprises, traditionally considered to be a prerequisite for a truly reformed economy, has been rejected by China.

42. MANN ET AL., *supra* note 10, at 1.

43. *Id.*

In addition, while state sector privatization remains the dominant method of creating a market economy and demands significant investment in resources and capital from the government, there is also no denying the existence of a private sector in Eastern Europe. When the governments of Poland, Hungary, and Czechoslovakia permitted the formation of private companies in 1989 and 1990, the response was indeed positive. For example, the numbers of registered private enterprises increased in Poland between 1989 and 1991 to 45,000. Leila Webster, *Private Sector Manufacturing in Eastern Europe: Some Cross-Country Comparisons, in* CHANGING POLITICAL ECONOMIES: PRIVATIZATION IN POST-COMMUNIST AND REFORMING COMMUNIST STATES 177 (Vedat Milor ed., 1994).

Still, the private sector accounts for only a small percentage of economic output—one half of one percent of non-agricultural output in Czechoslovakia and eight percent in Poland. Lawrence Summers, *The Next Decade in Central and Eastern Europe, in* THE EMERGENCE OF MARKET ECONOMIES IN EASTERN EUROPE, *supra* note 36, at 29. The Polish private sector has grown from "15,000 in 1989 to more than 61,000 by March 1993" despite the government's lack of attention to fostering its growth. David Gordon, *Privatization in Eastern Europe: The Polish Experience*, 25 LAW & POL'Y INT'L BUS. 517, 552 (1994).

Instead, China has opted for a model founded on the creation of a nonstate sector. This model is occasionally described derisively as only a "*traditional* form of privatization [which] occurs when the state withdraws altogether from certain economic activities and creates an opportunity for private entrepreneurs to act in such fields."[44] Precisely because most commentators believe that the "mere" introduction of private enterprise into the economy is only privatization in its initial, traditional stage,[45] the Chinese model, with its emphasis on a new, enterprising nonstate sector, is all the more uncommon. In effect, it represents a complete rejection of the orthodox view of privatization.[46] As more fully described below, in China, the immediate privatization of state enterprises is viewed neither as a necessary economic corollary to the institution of market-oriented behavior, nor deemed worthy of the political and social costs that would inevitably accompany such a process.

Because of the sense of historical and economic imperative that has swept Eastern Europe, the Chinese approach probably would not have been palatable there. However, while the Chinese model may not be an ideologically feasible or politically appealing alternative, the uncontested economic success it has produced should present some evidence against the more dominant Eastern European paradigm.

44. Tamás Horváth, *State Shrinkage in Hungary in the 1980s*, *in* PRIVATIZATION AND DEREGULATION IN GLOBAL PERSPECTIVE 413 (Dennis J. Gayle & Jonathan N. Goodrich eds., 1990) (emphasis added).

45. *See supra* text accompanying note 12.

46. Under the orthodox view, privatization is desirable not just because it creates the correct market incentives in the newly privatized firms but also because it serves to clarify muddled property relations and rights. As some have observed,

> [t]o a western-trained economist, the centrality and immediacy to any transformation process of establishing well-defined property seems so self evident as to hardly merit discussion. It is little wonder that, leaving aside the sometimes more immediate issues of macroeconomic stabilization, the officially sanctioned position of Western governments and international lending organizations places the highest priority on the aggressive and rapid establishment of well-defined property rights.

MARTIN WEITZMAN & CHENGGANG XU, VAGUELY DEFINED COOPERATIVES AND COOPERATIVE CULTURE: A RECONCILIATION OF A PARADOXICAL PHENOMENON IN TRANSITIONAL ECONOMIES 2 (Harvard Institute of Economic Research Discussion Paper No. 1607, 1992).

C. Social and Economic Considerations: China Compared to Eastern Europe

At the heart of Chinese privatization is a prosperous and thriving nonstate economy tenuously connected to the state sector yet free from its grip.[47] Even though China's ideological quandary might have forced the country's reformers to initially channel the tide of privatization into the creation of a nonstate sector[48] as a supplement to the more dominant state sector,

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47. Because privatization of the state sector is a process separate from the creation of a private sector, both analytically distinct phenomena should be evaluated independently of one another. Thus, because there are costs attached to both the privatization of state sector institutions and the creation of a private sector, a transitional economy may be faced with a tradeoff—the difficult choice of doing what when.

For example, "the creation of a commercial code is probably more important to the new entrepreneurs who are building new commercial relationships and who do not have the backing of the state, than to the state sector firms with their traditional ties." Peter Murrell, *Evolution in Economics and in the Economic Reform of the Centrally Planned Economies*, *in* THE EMERGENCE OF MARKET ECONOMIES IN EASTERN EUROPE, *supra* note 36, at 35, 51 n.32. Thus, a tradeoff occurs when the creation of a private sector framework conducive to entry of new firms receives lower priority in state resources than the creation of state sector privatization schemes.

48. There are generally four categories of firms in the non-state sector: individually owned firms, foreign-invested firms, TVEs, and urban collectives. *See* SHANG-JIN WEI & PENG LIAN, LOVE AND HATE: STATE AND NON-STATE FIRMS IN TRANSITION ECONOMIES (Center for Pacific Basin Monetary and Economic Studies, Economic Research Department of the Federal Reserve Bank of San Francisco, Pacific Basin Working Paper Series No. PB 93-10, 1993). Only the first two are completely privately owned. Individually owned firms, whether rural or urban, consist primarily of enterprises subsumed under the categories of "private economy" and "individual economy." See *infra* note 135 for an account of the status of the private economy and the individual economy in China and the Chinese Constitution. For an account of the development of the foreign-invested enterprise in China, see MARGARET PEARSON, JOINT VENTURES IN THE PEOPLE'S REPUBLIC OF CHINA (1991); see generally Moser, *supra* note 29. Article 18 of the 1982 Constitution provides that "[t]he People's Republic of China permits foreign enterprises, other foreign economic organizations and individual foreigners to invest in China and to enter into various forms of economic co-operation with Chinese enterprises and other economic organizations in accordance with the law of the People's Republic of China." ZHONGHUA RENMIN GONGHEGUO XIANFA [Constitution] [XIANFA (1982)] art. 18.

Because of the protean and obscure state of property rights in China, the focus of this paper is not on how certain enterprises are officially or nominally categorized by the Chinese authorities. Indeed, as Pradumna Rana, senior economist of the Asian Development Bank once remarked, "'enterprises [still] operate in a sort of limbo between public and private ownership, with rights and responsibilities of management and ownership unclear in both practice and law.'" Ramon Isberto, *China Development: From Boom to Bust?*, Inter Press Service, May 11, there are socioeconomic reasons to support this model as well. Socialist ideology may have dictated this particular path of reform. Nevertheless, this method of privatization has allowed China to create a market-oriented sector, while freeing it from the socially disruptive task of dismantling the gargantuan and dinosaurish state sector.[49]

Indeed, advocates of the shock therapy school of reform have sought to cast China's experience in a negative light by highlighting the fact that the Chinese path is more a product of constraint than of deliberative strategy.[50] These advocates contend that China's reformers were forced by political divisions within the Communist Party to operate within the context of "socialism with Chinese characteristics," and that therefore, China's model of reform was "happened upon" through pure serendipity. They argue that it is a model thrust upon China by a deficit of choice and a lack of both vision and consensus. Saddled with such illegitimate origins, China's method of privatization is no model at all because it cannot fairly be called a true strategy of reform.

Whether it is a model or an accident, it cannot be denied that the Chinese experience challenges economic dogma and presents legitimate alternatives for other transitional economies.[51] True, Chinese privatization may have had its origins

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1994, *available in* LEXIS, ASIAPC Library, INPRES File. This Article's focus, therefore, is not on the ambiguity of boundaries that exist between different types of firms but rather on a very unambiguous phenomenon—the rise of a sector which has led to a decrease in the importance of the state sector and an increase in productivity in a sphere outside the control of the state. In addition, it should be noted that the terms "private sector" and "nonstate sector" are used interchangeably in this Article and that privately owned firms, foreign-invested enterprises, TVEs, and urban collectives are all considered to be in the private or nonstate sector (although only the first two are truly privately owned).

49. By contrast, the struggle for ownership claims has taken center stage in Russia. The campaign for privatization was launched even though conflicting claims for ownership by groups other than the state (for example, managers, workers, municipal officials) were being waged. *See* Louis Uchitelle, *East's Problems in Going Private*, N.Y. TIMES, May 19, 1992, at D2.

The model spearheaded by China would defer state sector privatization until a private sector has been created with the capacity to generate enough growth both to overtake the state sector and to absorb some of the social disruptions state sector reform would unleash. *See infra* notes 76-79 and accompanying text.

50. *See, e.g.*, Sachs & Woo, *supra* note 11, at 31-33.

51. Whether or not the Chinese model should be an antidote or an alternative to "shock therapy," its success at the very least indicates that before countries such as Vietnam, Cuba, North Korea, Russia and others from the ex-Soviet Union

in the dictates of China's political imperatives. However, this alone does not mean that it is irrelevant to other transitional economies or that it is somehow stripped of all social and economic legitimacy.

Rather, there are three primary socioeconomic benefits to be derived from the deferral of state sector privatization in favor of first creating a nonstate sector. First, given the inevitable economic tradeoffs involved in the transition process, it may be more beneficial for transitional economies to devote limited resources to favor the creation of a new, nonstate sector over privatization of the state sector. Second, given the social costs and disruption that inevitably accompany state sector privatization, it may make more social sense to establish a new, nonstate sector vibrant enough to absorb some of the dislocation when and if state sector privatization is implemented. Third, given the fact that state sector privatization may not be effective unless a market framework already exists, the sequencing of reform may need to be reversed so that the establishment of a market framework should take precedence over the mass transfer of ownership rights.

There are sound economic reasons for committing economic and creative resources to the creation of a market framework rather than the adaptation or destruction of the state sector. Indeed, given the fact that limited resources are available, some economists have noted that

> too many hopes have been invested in privatization and rather too much intellectual, social, and political capital is being consumed in the process of privatization. The argument is strengthened when the efforts behind privatization are contrasted to the lack of attention being paid to creating and fostering the development of new private sector firms.[52]

Thus, while some economists have acknowledged that true innovation and growth can come only from the emergence of a new private sector rather than the restructuring of established state enterprises, such "emphases are not the major focus of

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become testing grounds for "shock therapy," this all-too-common prescription for ailing transitional economies should be subjected to further scrutiny.

52. Murrell, *supra* note 47, at 45. "In many Eastern European countries, policy toward the private sector can be characterized, at best, as one of benign neglect." *Id.*

the majority of discussions of the transition process."[53]

Because the privatization debate has been defined by the desires and experiences of the former Soviet bloc to reenter the family of Europe, alternative approaches to privatization have been excluded from the possibilities drawn by the more dominant Eastern European model. Thus, although the predicaments of certain developing countries are similar enough to the transitional economies of China and Eastern Europe to warrant comparison,[54] the commonalities in their experiences have not been adequately noted. For instance, despite the obvious differences in institutional structure of the market in the two regions, the desire for increased production and greater productivity have meant that "[i]n each instance, institutions must be adapted or created to generate new earnings streams."[55] In those developing countries where reform has been more or less successful, "growth has taken place primarily through the emergence of new activities, not through the adaptation of older ones."[56]

Because Eastern Europe has focused on the privatization of existing state enterprises,

> the biggest drawback Eastern Europe may have is an understandable but nonetheless misplaced fixation on the old assets . . . .
>
> Important questions are what the old assets are worth and whether they are worth enough to be occupying as much time, attention and scarce resources of politicians, finance ministries and ministries of ownership as they have, in fact, been given.[57]

The administrative complexities of valuation alone have made it difficult to assign a market value to assets which have previously had none.[58] Because accounting systems employed by

53. "[I]t is quite unusual to find authors who emphasize the costliness of the privatization process and the need to slow down this process in order to channel resources to the new private sector." *Id.* at 48 n.18.

54. *See* Anne Krueger, *Institutions for the New Private Sector, in* THE EMERGENCE OF MARKET ECONOMIES IN EASTERN EUROPE, *supra* note 36, at 219, 219-23.

55. *Id.* at 220.

56. *Id.* at 221. Growth in Turkey and Korea, for example, occurred primarily from emerging economic activities, not from privatization or adaptation of old ones. *Id.* at 221-22.

57. *Id.* at 222.

58. For a detailed discussion of valuation problems and suggested solutions,

centrally planned economies are simply not transferable to market economies, they give at best an inadequate and unreliable value of the state enterprises at issue. A wholesale adoption of generally accepted accounting principles takes time to implement. Thus, state sector privatization will have to initially proceed with accounting standards devised on a case-by-case basis.[59] In the absence of a mature market and a developed pricing system, valuation is unreliable, time consuming, and expensive. For example, "the high valuation fees charged by foreign accounting and auditing companies have become a political problem in Poland."[60]

State enterprises saddled with debt must either have that debt forgiven or restructured. Market prospects for such firms have to be reevaluated. These are not easy tasks given the uncertainties in Eastern Europe.[61] These difficulties are compounded by the fact that valuation methods for the very same firm may produce inconsistencies. To sidestep some of these difficulties, formal valuations have occasionally been bypassed and the purchase price subjected to an after-sale adjustment, when market conditions have been clarified.[62]

Aside from valuation costs, there are also high transaction costs given the large amount of time, energy, and resources that must be devoted to devising and administering mass privatization campaigns. The multiplicity of schemes, for example, include public offerings, public auctions, sales to private buyers or institutional investors (such as banks or financial intermediaries), buyouts by insiders (including management), and restitution actions by former owners.

Moreover, in Eastern Europe, the utter lack of domestic capital has created the political and economic dilemma of how

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see Robert J. Toltzman, *Valuation Issues—Problems and Solutions*, *in* BUTTERWORTHS PRIVATISATION IN CENTRAL AND EASTERN EUROPE 61 (Stephen A. Rayner ed., 1992); Gordon, *supra* note 43, at 531-33. These valuation problems, combined with political and social insecurity, caused foreign investors to shy away from purchasing Polish companies. Balfour & Crise, *supra* note 34, at 113.

59. Hans J. Blommenstein et al., *Privatising Large Enterprises: Overview of Issues and Case Studies*, *in* CENTRE FOR CO-OPERATION WITH THE EUROPEAN ECONOMIES IN TRANSITION & ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, METHODS OF PRIVATISING LARGE ENTERPRISES 16 (1993).

60. Jan Szomburg, *Poland: Country Study*, *in* METHODS OF PRIVATISING LARGE ENTERPRISES, *supra* note 59, at 97.

61. Blommestein, *supra* note 59, at 16.

62. *Id.*

to sell assets to domestic buyers who have no capital; hence the quandary between efficiency and equity. To maximize the goals of efficiency, state assets must be transferred to those most capable of increasing their efficiency. To generate much needed capital, state assets must be sold to those with sufficient capital to purchase such assets. The conflict, of course, arises when those with the requisite managerial expertise and capital pool are unlikely to be citizens and much more likely to be foreigners.

Most Eastern European countries have adopted the politically appealing voucher system, which involves the free distribution of vouchers to citizens who can in turn exchange such vouchers for shares in the privatized enterprises. While the dispersion of vouchers creates equitable and widespread private ownership and at the same time permits Eastern Europe to avoid valuation difficulties, such benefits may have come at the expense of efficiency. Domestic owners lack the necessary capital to continue investing in the privatized firms as well as the management know-how to create new markets and enhance efficiency. The wide dispersion of vouchers may have also created a diluted shareholding system without any true ownership interest. Therefore, Eastern Europe has devised a scheme whereby such vouchers can be traded for shares in financial intermediaries, which, like Western holding companies, may either own the entire privatized enterprises, or, like Western mutual funds, may own a certain percentage of shares in the privatized enterprises. However, under either scenario, the costs are certainly not negligible. Such mass privatization schemes can be complex and cumbersome to regulate and administer and may require the involvement of a multiplicity of institutions including voucher agents, stock exchanges, and investment funds.

Thus, limited financial and creative resources may be better utilized if they are devoted to the creation of institutions that foster the rapid emergence of a private sector.[63] A further economic tradeoff between privatizing the state sector and creating a new nonstate sector exists, for example, in the diversion of limited resources from one goal to the other. Thus,

63. Krueger, *supra* note 54, at 222-23. Commercial codes, legal procedures, and a tax collection system are necessary in the framework of incentives to foster the growth of small businesses.

any surplus generated by the state sector during the transitional period can be used either to devise auction schemes, outright sales, or voucher distribution, or it can be used by the state to finance the growth of new companies.

The Chinese experience represents this latter approach. In China, there is undoubtedly a clear and demonstrable correlation between the growth of a dynamic nonstate sector and the success of China's economic reform.[64] More importantly, the proliferation of a nonstate sector in China seems to have been stimulated by the initial presence of state firms. To develop its nonstate sector, China simply removed barriers to entry, thus permitting private initiatives to take root while leaving its state sector firms more or less intact. Instead of being constrained by existing state enterprises, however, these private businesses seemed to have benefited from the presence of the state sector.

In fact, a study of 434 Chinese cities revealed that in the initial phases of reform, state firms appeared to have promoted and stimulated the growth of nonstate firms.[65] Like other centrally planned economies, the purchase of inputs and the sale of outputs in China tend to remain intertwined with the centralized network of the old central planning system, despite efforts to extricate the economy from the dictates of the plan. Thus, once the state takes steps to enable private businesses to form, and once private businesses do in fact manage to enter the economic mainstream, instead of having to sink or swim, they find themselves in the enviable position of not having to worry about input supply and output market. Because state firms are already involved in the "downstream and upstream of the production process,"[66] an established market for purchases and sales exists. Thus, the state firms' demand for new products alone may be crucial for the continued viability of newly emerging private firms.[67]

64. Like China, Taiwan and Korea have both transformed their state-dominated economies not by privatizing state firms but primarily by giving birth to firms outside the state sectors. *See* WEI & LIAN, *supra* note 48, at 3 n.2.

65. *Id.* at 4.

66. *Id.* at 5.

67. The mere announcement of a privatization program for state enterprises tends to result in significant decline in output, because workers and managers whose jobs are threatened no longer are motivated to continue their current level of production. This lack of motivation could retard the growth of new private

By contrast, "if one closes the state firms all at once at the beginning of a reform, the existing interfirm production chains are also severed."[68] In other words, the sudden withdrawal of the state may create a gap in the production and distribution chain that may take years for private businesses to fill. Of course, hypothetically, all entrepreneurs could form new businesses to generate demand for each other's supplies and to provide mutual production and distribution chains.[69] However, this scenario is unlikely to happen, and therefore the "economy can be stuck in a nongrowth equilibrium."[70] Once a private sector has emerged, however, the authors of this study concluded that the dismantling of inefficient state firms should indeed begin.[71]

The peculiar dynamics created by a state sector initially coexisting with an emerging nonstate sector may also give the newly-established private firms the advantage of "free-riding on the social safety net" financed and borne by the old state sector.[72] For example, while a state owned firm pays between 45% and 55% of its profits in income tax, a nonstate sector enterprise, such as a township village enterprise, pays only 35% while foreign-invested firms pay only 15% if they are located in specially designated economic zones.[73] Thus, a Chinese family will often have one person working in the state sector to secure social welfare benefits provided by the state[74]

firms, which would no longer be aided by the interfirm linkage provided by state sector firms. *Id.* at 6-7.

68. *Id.*

69. *Id.* at 8.

70. *Id.*

71. *Id.* at 6. China is currently at the stage where the authors of this study believe it is in fact time to undertake genuine reform of the state sector. *See infra* notes 223-37 and accompanying text.

72. WEI & LIAN, *supra* note 48, at 8.

73. *Id.* at 9 n.5.

74. State enterprises have traditionally provided workers with comprehensive benefit packages such as pensions, subsidized housing, medical care, child care, food, and recreation facilities. Interestingly enough, proponents of "shock therapy" have used this very fact—the generous state sector benefits—to explain why a country like Russia has not been able to encourage workers to leave the comforts of the state sector for the less secure private sector. As Sachs and Woo explained, because Russia's workers are primarily urban and employed by state enterprises which also act as social welfare providers, and because, unlike China, Russia does not have a huge agricultural sector with surplus labor willing to move from the rural economy to the new nonstate or private economy, Russia has had no choice but to take the bitter medicines of "shock therapy" reform. *See* Sachs & Woo,

and another person working in the private sector to generate higher income.[75] As the Chinese experience demonstrates, even after market-supportive measures have been instituted, the state sector may very well play a beneficent role in the emergence of private-oriented businesses.

There is yet an additional reason to defer state sector privatization. The state cannot simply afford to withdraw from the economic foreground, for, as the paradox has been noted even by the more ardent proponents of privatization, "the most important aspect of the transition to a spontaneously functioning market economy cannot be initiated by market forces themselves. Indeed, the only force powerful enough to set the market forces in motion is the very state that is supposed to remove itself from the picture."[76]

The economic benefits of the Chinese model are clear, but the social benefits are equally compelling. Instead of eradicating the state sector from the economy, China has opted to reconfigure its economic universe through a combination of state and nonstate sector economies.[77] The synergy derived

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supra note 11, at 25. *But see* Barry Naughton, *Reforming a Planned Economy: Is China Unique?*, *in* FROM REFORM TO GROWTH: CHINA AND OTHER COUNTRIES IN TRANSITION IN ASIA AND CENTRAL AND EASTERN EUROPE, *supra* note 11, at 49, 67-68.

75. WEI & LIAN, *supra* note 48, at 9 n.6.

76. FRYDMAN & RAPACYNZSKI, *supra* note 14, at 57.

During the early stage of reform, when monitoring mechanisms, banking regulation, securities regulation, and accounting standards are either absent or ineffective, the decision has to be made as to who "is to exert the necessary degree of control over the actions of economic agents in order to preserve budgetary, financial, and monetary stability during the early stages of reform." Murrell, *supra* note 47, at 50. Either the free market or existing state institutions can be used "on a selective and temporary basis to exert control over the state enterprises in the period before privatization and creation of market institutions." *Id.*

77. Is China's model portable to other transitional economies or is it grounded in structures and conditions that are specifically Chinese? Some economists have argued that Chinese privatization took the shape it did primarily because the relatively small size of the state sector allowed reformers to ignore or defer state sector privatization and focus on private sector creation. *See generally, e.g.*, Sachs & Woo, *supra* note 11.

Under this theory, the following initial but unique conditions made China's model workable: a small state sector and a large agricultural sector with a surplus reservoir of agricultural workers. This combination enabled the government to perform the relatively easy task of shifting labor from the rural economy to the newly formed private sector and avoid the more difficult task of populating the new private sector with state sector workers siphoned from the generously subsidized state sector, which the government would have had to do had China not from this interaction allows China to avoid collapse caused by the destruction of the old economy before alternative market forces can be introduced. By virtue of this dual-track approach, transition costs and instability can be kept at a minimum because the preserved state sector is able to provide a kind of social and economic anchor during the tumultuous beginnings of the market. Further, the newly emerging private sector can in turn act as a shock-absorber if and when the state sector is privatized.[78]

Aside from the social and economic considerations described above, creating a nonstate sector before destroying the state sector might be a more effective means than mass privatization at fostering competition, efficiency, and market-supportive institutions. The Chinese model thus focuses on how to create market forces, not how to transfer state assets to private hands. And the implication, of course, is that unless market institutions have been created and secured, privatization of the state sector is ineffective.

In this very fundamental respect, then, the Chinese model is diametrically opposed to the Eastern European model. Eastern European faith in state sector privatization rests on the premise that the change from state to private ownership itself is the necessary trigger to catalytically construct a market economy. Starting from that premise, the following prescription makes perfect sense. "[W]ithout privatisation no meaningful market conditions could begin to exist."[79] Under this

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been "blessed" with such a large pool of unemployed and unskilled peasant workers.

To explain why Russia could not have adopted China's model, the following Russian conditions were noted: heavy state subsidies of both state-owned farms in Russia and state-owned industries. Thus, workers from neither sector would have been willing to move from their heavily subsidized enterprises into the new, nonsecure, nonsubsidized, nonstate sector—unless state sector subsidies were either drastically reduced or eliminated. Russia, therefore, did not have access to a ready reservoir of surplus workers to shift into a newly legalized private economy. Moreover, because the Russian state sector was so large, Russian privatization had to start with state sector privatization.

78. However, China has encountered pitfalls and has had to backtrack. For example, economic retrenchment after Tiananmen in 1989 was reversed in 1991 after a severe depression in economic growth. In a report designed to demonstrate renewed commitment to market reforms, General Secretary Jiang Zemin "strongly reaffirmed the importance of private and collective enterprises." Jiang "emphasized the urban . . . sector as an area of future growth that could absorb workers displaced by reforms in the State sector." Miller, *supra* note 22, at 28.

79. Salvatore Zecchini, *Critical Issues in Privatisation*, *in* METHODS OF

theory, the transformation in ownership itself provides the necessary incentives required to induce recently privatized organizations to respond in new ways.

> The transfer of State ownership is essential to create competition among enterprises in the market place, to promote entrepreneurship and risk taking in economic initiatives, to spur innovation in production and management and to favour the development of a new managerial class that is fully committed to achieving cost efficiency in combining different factors of production.[80]

Although this strategy needs to be supplemented with other strategies such as fostering "the emergence of market participants and entrepreneurs that . . . are neither fully nor mainly under the direct control of the State-owner, [t]he transfer of public-owned firms into private hands is the main avenue to obtain this result in a short period."[81]

Thus, according to the East European model of privatization, state sector privatization sets a market economy in motion and makes it function. The question, of course, is how a market can possibly function if it has not yet been established. Nonetheless, proponents of state sector privatization are convinced that the removal of the state from its management and ownership roles in the economy will put the workings of a well-functioning market into action.

It is the typical chicken and egg problem. Can a simple transfer of ownership from the state to the private sector create the institutional environment necessary for a successful transition?[82] Or is a market-conducive environment consisting of private businesses, reformed state enterprises and a legal infrastructure equipped with banking laws, commercial and civil codes, stock market regulation, modern accounting and

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PRIVATISING LARGE ENTERPRISES, *supra* note 59, at 72.

80. *Id.*

81. *Id.*

82. Of course, even its most ardent advocates do not believe that privatization alone will cure all ills. However, privatization is still viewed as the centerpiece of the reform process. *See, e.g.*, MANN ET AL., *supra* note 10, at 1. "Privatization of large-scale, state-owned enterprises depends on and is part of a complex effort to achieve the private market economy." *Id.* at 4. In this regard, it is believed that the transfer of "ownership, control, and monitoring of firms will affect their conduct, and therefore the economic outcome of reforms." *Id.* at 3.

auditing system, and other regulatory agencies a prerequisite to state sector privatization?

Ideologically as well as economically, China has been skeptical that privatizing the state sector could impart any meaningful benefits when implemented in the absence of an established market framework. Privatization will not spawn the benefits of competition or efficiency unless market forces have taken root. The Chinese model assumes that without the right market conditions, the newly privatized entity has no reason to act competitively if the new environment in which it finds itself is devoid of other competitive firms. Additionally, the privatized firm has no incentive to respond to consumer demands if the scarcity of consumer goods means that any and all goods produced by the firm will be consumed.[83] Shareholder control over management may not even be feasible if the ownership structure is too diffuse, either because domestic shareholders have insufficient capital to purchase large blocks of shares or because foreign investors are unwilling or unable to own a controlling share.

The central question for transitional economies is: what should be put in place first, private enterprises or competitive capital markets? For China, it is competitive capital markets.

III. THE CREATION OF THE CHINESE NON-STATE SECTOR

China was successful in establishing a sector of nonstate firms responsible for its record growth rate by adopting the right combination of initial conditions: a comprehensive legal infrastructure, rural decollectivization in favor of smaller-based household farming resulting in significant increases in productivity, income, and surplus capital. The increase in household savings combined with the shift towards light consumer industries have led to the establishment and proliferation of new economic organizations called the township village enterprises (TVE) further responsible for China's strong economic condition.

This section examines China's step-by-step transformation

83. Poland faced a different problem. Trade liberalization at the very early stages of reform led to a surge of imports into Poland which made it difficult if not impossible for domestic goods to compete. *See* Vedat Milor, *Changing Political Economies: An Introduction*, *in* CHANGING POLITICAL ECONOMIES: PRIVATIZATION IN POST-COMMUNIST AND REFORMING COMMUNIST STATES, *supra* note 43, at 14.

process and explores how each one contributed to future gains. It also examines the emergence of the nonstate sector and focuses on the TVE, one of the most productive economic entities in this newly emerging sector. Finally, it studies the nontraditional corporate organization of TVEs and explores the implications TVE productivity pose for conventional understandings of economic growth and property arrangements, especially in the context of transitional economies.

A. Inducing Growth through Decollectivization, Household Farming and Nonstate Entities

Since 1978 when China first instituted its open door policy, it has implemented the legal infrastructure of a market economy. Examples include commercial and contract law, antitrust and labor law, environmental regulations, legislation regarding foreign-invested enterprises such as joint ventures and wholly foreign-owned companies, and regulations regarding the acquisition and transfer of foreign exchange by nonstate actors.[84] Aside from establishing the requisite legal infrastructure, it has also adopted courses of action which together create the environment necessary to foster the emergence of a new, nonstate economic sector.

How did China create this nonstate sector? As one economist has remarked, "factors of production need[ed] to be released to the new private sector."[85] For example, new entrepreneurs must have capital, labor, and land at their disposal. By first focusing on rural growth and reform[86] and "generating huge increases in productivity, income, and output, with negligible state investment,"[87] China laid the groundwork for

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84. For an overview of the legislative framework, see David Wall & Kiichiro Fukasaku, *China's Open Economy Reforms 1978-1992*, *in* FROM REFORM TO GROWTH: CHINA AND OTHER COUNTRIES IN TRANSITION IN ASIA AND CENTRAL AND EASTERN EUROPE, *supra* note 11, at 141, 152-55.

85. Christopher Clague, *Introduction: The Journey to a Market Economy*, *in* THE EMERGENCE OF MARKET ECONOMIES IN EASTERN EUROPE, *supra* note 36, at 1, 11.

> Land and building space should be made available; labor needs to move out of the public sector, and loans should be provided. Since it is unlikely that private banks would provide sufficient capital for the new private sector if it is expanding at an appropriate speed, state banks will probably need to channel capital to new private enterprises.

86. By doubling the incomes of China's farmers, rural reforms had the immediate result of benefiting 800 million people. OVERHOLT, *supra* note 26, at 37.

87. Overholt, *supra* note 31, at 30. Agrarian land reform was begun in 1978

an institutional structure which, in turn, generated sufficient surplus capital to be reinvested in even more profitable enterprises.

In one of the more significant moves, China dissolved farming communes in favor of household-based agriculture. Commune-based agricultural lands were distributed en masse to individual households which were granted a wide degree of autonomy in production and marketing decisions so long as certain production quotas were met.[88] Because nonagricultural assets formerly owned by the communes were sold at very inexpensive prices, newly emerging businesses were also provided with an inexpensive source of assets with which to start up production.[89]

The state fostered initiatives and incentives by the institution of a "contract responsibility system,"[90] whereby farmers organized by household units[91] are allowed to contract with

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and resulted in China becoming "self-sufficient in food within two years." Diane Francis, *Election the Only Solution for Russia: Interview with Mikhail Gorbachev*, FIN. POST, Mar. 27, 1993 (weekly ed.), §5, at S3, *available in* LEXIS, News Library, ASIAPII File.

As a point of contrast, as of 1993, only three percent of Russian farms had been privatized. *Id.*

88. Keun Lee, *Making Another East Asian Success in China*, *in* FROM REFORM TO GROWTH: CHINA AND OTHER COUNTRIES IN TRANSITION IN ASIA AND CENTRAL AND EASTERN EUROPE, *supra* note 11, at 183, 190.

89. *Id.*

90. Robert Wessel, *Reestablishing Private Business in Previously Socialist Economies*, BUS. ECON., Jan. 1992, at 30, 32; *see also A Survey of Perestroika*, ECONOMIST, Apr. 28, 1990, at 59, 21 (describing the responsibility contract as a system in which assets of the state are divided into household or "family plots" designed to grant farmers a "leasehold" on the land). For a general definition, see Article 27 of the General Principles of Civil Law, adopted by the Fourth Session of the Sixth National People's Congress on April 12, 1986, effective as of January 1, 1987 ("[T]he members of rural collective economic organizations who engage in commodity businesses within the scopes permitted by law and in accordance with the provisions of responsibility contracts are rural management undertaking households").

A household enterprise is the smallest licensed unit for running a business in China.

The responsibility contract system is not limited to rural areas but is popularly utilized in urban enterprises as well. The underlying principle remains the same: managers and workers of state enterprises enter into contractual relationships with the state whereby performance goals are set. Anything above the stipulated goal can be retained by the enterprise as distribution to the employees.

91. Andrew X. Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 UCLA PAC. BASIN L.J. 62, 74 (1993).

the state to sell a set quantity of produce at an officially set price. Any surplus generated by the household units can be freely sold on the market at the market price.[92] Within ten years after rural reform was initiated, gross farm output increased by a startling 138%.[93]

The spectacular increase in output so significantly boosted the farmers' cash reserves that most were able to finance new projects themselves without having to resort to state loans. "In effect, very hard budget constraints were imposed on farmers (i.e., little credit was made available by the state banking system) as they entered the market economy. Further, the newly independent farmers viewed themselves as being undercapitalized for financing on-farm investments, and they began building up their cash reserves."[94]

In fact, it is uncontested that China's household saving rate is "unusually high even by East Asian standards."[95] Household savings in China is approximately 23% of disposable income as compared to 21% in Japan, 18% in Taiwan, 16% in Belgium, 13% in West Germany, and eight percent in the United States.[96] A significant proportion of these savings is deposited into the state banking and rural credit cooperative system to be extended either as loans to nonstate firms or subsidies to state firms.[97]

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92. Wessel, *supra* note 90, at 33-34.

93. *Id.* at 34.

"This principle has been applied, in a more limited fashion, even in large state enterprises. Various redrawn profit contracting schemes, and the eventual replacement of profit remission by tax payments, has led to the increased retention of profit by firms rather than government." Andrew G. Walder, *Corporate Organization and Local Government Property Rights in China, in* CHANGING POLITICAL ECONOMIES: PRIVATIZATION IN POST-COMMUNIST AND REFORMING COMMUNIST STATES, *supra* note 43, at 53, 58.

China's growth rate expanded at an annual average of 8.3% in real net material product from 1978 to 1984, the first six years of reform. In contrast, the Soviet economy recorded a bare 2.7% growth rate from 1986 to 1989, the first five years of its reform. Lee, *supra* note 88, at 185.

94. Pradumna B. Rana & Wilhelmina Paz, *Economies in Transition: The Asian Experience, in* FROM REFORM TO GROWTH: CHINA AND OTHER COUNTRIES IN TRANSITION IN ASIA AND CENTRAL AND EASTERN EUROPE, *supra* note 11, at 119, 127, 130.

95. Sachs & Woo, *supra* note 11, at 28.

96. *Id.* Before reforms were instituted in 1978, however, the average household saving rate in China was only two percent of household income. Naughton, *supra* note 74, at 58.

97. Sachs & Woo, *supra* note 11, at 30 ("Loans are continuing to be injected

The combination of each of the five intricately intertwined factors described above (the dissolution of communes, the establishment of household-based family farming, the distribution of communal assets to family units, the "contract responsibility system," and the increased household saving rate) created the foundation for the emergence and proliferation of nonstate enterprises in rural and urban areas of China. Thus, while the dominance of state owned enterprises decreased, the number of nonstate enterprises, most notably the TVEs engaged in both rural and industrial-based production increased.

In fact, because "initial success[es] with the agricultural reform brought in more than 800 million peasant families as a strong support group for the reform,"[98] China took advantage of this growth momentum and, in 1984, declared that similar reforms would be extended to the urban areas. Indeed, it was the "accumulation of wealth by rural families in China [which] led to the emergence of nonfarm industrial production and corresponding markets in rural and suburban towns and townships."[99] Because the Chinese economy, like other centrally planned economies, had historically devoted a disproportionately large portion of total resources to the state coffers and military industrial complexes while neglecting the production of consumer goods, it took but a modest amount of resources to provide the needed corrective. Thus, when the central government relaxed its monopolistic grip over industry as early as 1979, many of the start-up firms rushing to fill the void left by deregulation were rural industries organized along market-based ownership lines. Ownership types included: collective, private, or foreign ownership, and even some officially listed as state owned because they had been sponsored by local governments.[100]

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to enterprises which are obviously at the edge of bankruptcy. Some loans have been used to pay wages, which have a pretty name: 'loans to keep social stability.'").

98. Lee, *supra* note 88, at 185.

99. *Id.* at 190.

The phenomenal surge in surplus income derived from the dissolution of communes and the establishment of household farming has provided one source of capital used to create start-up businesses. Other sources include capital provided by the Chinese diaspora, especially those from Hong Kong and Taiwan, whose swift response as a source of foreign investment has resulted in the rapid development of coastal provinces such as Guangdong and Fujian. Wall & Fukasaku, *supra* note 84, at 156-57.

100. Naughton, *supra* note 74, at 58.

Given such heavy distortions, even a modest shift in resource allocation from government to consumer goods manufacturing could effectively jump-start the nonstate economy, since early entrants into this emerging and unexplored terrain were able to earn rapid and hefty profits.[101] Thus, the very distortions that had plagued so many planned economies acted as inducements to entrepreneurial and household businesses eager to fill unexploited niches.[102] In China, the rise of a rural economy in conjunction with the shift from heavy industrial investment to light consumer goods production has created a strong nonstate sector with a maximum of economic productivity and a minimum of transition costs.[103]

A further breakdown will reveal even more distinctions among economic entities within the nonstate sector: "foreign ventures, individual peasant farms, individual businesses, private enterprises, small-scale rural and urban co-operatives, and medium-sized rural and urban collective enterprises." Lee, *supra* note 88, at 202.

101. Naughton, *supra* note 74, at 50.

102. China, of course, is not alone in this regard. For example, the Polish private sector grew from "15,000 in 1989 to more than 61,000 by March 1993" even though the government made little attempt to foster its growth. Gordon, *supra* note 43, at 552.

103. Is the Chinese model of maximum nonstate sector growth and minimum state sector disruption applicable to other transitional economies? Certain initial conditions in China's economic structure might have facilitated the implementation of the two-track model: a relatively small state sector, a relatively small central plan, and a relatively large agricultural sector with a surplus pool of peasant workers combined to create optimal conditions for structural change. The state could afford to ignore the state sector and simply draw on surplus rural workers to create a new private sector. Sachs & Woo, *supra* note 11, at 23. Laos, Myanmar and Vietnam appear to be following the Chinese approach.

It has also been suggested that China has been additionally blessed by the "advantage of backwardness," that is, that its lower level of income and skills have helped its quest to enter world markets. By contrast, in order to penetrate the international economic system, more economically advanced countries with a close to full employment economy, such as the Eastern European countries, would have to compete in the more competitive and technologically advanced sectors, making the task of restructuring more difficult. How significant are these differences? Would different structural conditions in Russia, for example, mean that the Chinese model is utterly inapplicable to the Russian experience? As one economist has noted, while China had to transfer unskilled rural workers from the agricultural sector to the new manufacturing based private sector, Russia would have had to transfer state sector skilled urban workers to alternative nonstate sector urban jobs, if it had pursued the Chinese model of private sector creation. *See* Naughton, *supra* note 74, at 67-68. According to Naughton, a comparison of the Chinese and the Russian and Eastern European experiences reveals that the latter would have been faced with a less difficult task than China faced had they pursued the Chinese model.

Among the newly emerging firms within this robust nonstate sector, the TVEs have exhibited remarkable growth and output rates. With the growth of TVEs, production of consumer goods for both the export and domestic market developed,[104] and indeed prospered at an unprecedented rate.[105] Between 1981 and 1990, TVE output grew at an average rate of 29% per year while exports grew at an astounding average rate of 66% per year.[106] Exports by rural industrial enterprises include light manufactured goods, such as textiles (which account for one-fifth, or $6.5 billion of total exports in 1988), chemicals, and even machinery.[107] The TVE sector is now the second largest in China's national economy, producing approximately 33% of all coal, 40% of all canned foods and 50% of electric fans in China.[108] Thus, TVEs have contributed to economic growth in China as well as to the increasing market orientation of the nonstate sector.

B. Collective Enterprises: Township and Village Enterprises

As discussed above, TVEs came into being through a combination of factors: the success of agricultural reforms, the

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> [The] ECEs [Eastern and Central European economies] do not need to continuously generate millions of new jobs; they simply need to create enough new jobs to absorb the workers shed by inefficient producers. In that sense, a moderate growth of new firms should be able to gradually draw workers away from inefficient state firms, and produce a transition without massive amounts of socially destabilising unemployment. The ECEs have the same unexploited niches that China has, but fewer reserves of grossly underutilised labour in the countryside. Thus, a strategy of opening niches to new entrants should aid the restructuring process *more* rapidly than in China.

Id. at 68.

Thus, despite initial differences in structural conditions (China's labor surplus, large rural sector, unskilled peasants and lesser developed economy versus Russia's relatively full employment, small rural sector, large urban industry, skilled workers and more developed economy), a strategy of private sector development, for reasons discussed in this Article, could have been a viable alternative to immediate state sector privatization and its concomitant social and economic dislocation.

104. Cairncross & Lin, *supra* note 26, at 13.

105. For an account of the home-grown private sector and the growth of small TVEs, see *Hong Kong's Economy Safe in China's Hands*, S. CHINA MORNING POST, Jan. 12, 1993, at 14, *available in* LEXIS, News Library, SCHINA File.

106. WEITZMAN & XU, *supra* note 46, at 9.

107. Lee, *supra* note 88, at 190.

108. WEITZMAN & XU, *supra* note 46, at 9.

availability of surplus rural labor, savings from increased agricultural income, and increased consumer goods consumption due to the rise in income.[109] Although TVEs are not privately owned enterprises in the traditional sense,[110] they do operate outside the orbit of the state sector and are very different from state sector firms. TVEs are "collectively owned"[111] but are not subsidized by the state and have hard budget constraints. They operate in a market environment by buying and selling on the market completely outside of the state plan, and they exercise much greater autonomy than state firms over their production decisions.[112]

Despite their market orientation, TVEs are not purely private firms and are behaviorally as well as organizationally distinct from both state and private sector enterprises. TVEs are collectives often intricately intertwined with local governments. In this respect, TVEs exhibit behavior which reflect their hybrid and nontraditional origins. First, even though they are socially-based, they "must maintain financial responsibility due to the limited financial means of local governments."[113]

> While township and village officials control TVE property rights, their incentives are not identical to those of private owners. Township and village officials must take into account the interests of the local community to some extent, if they are to be effective in achieving a spectrum of economic and social indicators.[114]

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109. F. Gerard Adams, *Economic Transition in China: What Makes China Different*, *in* FROM REFORM TO GROWTH: CHINA AND OTHER COUNTRIES IN TRANSITION IN ASIA AND CENTRAL AND EASTERN EUROPE, *supra* note 11, at 215, 224.

110. TVEs are collectives and their members do not have a right of indivisible ownership nor the right of exclusivity over the collective.

111. All members of the community are nominal owners and the community government is the de facto owner. WEITZMAN & XU, *supra* note 46, at 11.

112. WEI & LIAN, *supra* note 48, at 13.

In contrast, collectives in the rural areas of the former Soviet Union were as tightly controlled as state farms with no apparent practical differences. Lee, *supra* note 88, at 203.

113. Adams, *supra* note 109, at 224.

114. Barry Naughton, *Chinese Institutional Innovation and Privatization from Below*, 84 AM. ECON. REV. 266, 268 (1994). Regard for community and social considerations, however, do not mean that TVEs are immune from either bankruptcy or budget constraints or that TVEs are iron bowls and guarantee workers permanent employment.

TVEs are neither private nor state enterprises and cannot easily fit into the traditional and binary classification of state planning or free market.

TVEs, in fact, appear to be decentralized local states acting in an entrepreneurial capacity. When the central government eased barriers to entry into the light manufacturing sector, various economic actors, including local governments, stepped in to fill the economic void.[115] These local governments vary in size and orientation but exhibit a common knack for detecting new market opportunities and mobilizing resources to promote selected industries within their jurisdictional zones. Some are large enough to encompass the entire population of certain European countries,[116] most are subjected to hard budget constraints and possess "limited access to concessionary credits."[117] Thus, many "act more like diversified corporations, competing with other locales, than like sovereign entities."[118] Yet, despite their market orientation, TVEs' collective ownership base also drives them "to take into account community members' preferences in their decision making . . . . [D]ecisions on the establishment of new TVEs [are] often discussed and made collectively at village meetings."[119]

The fact that such vaguely defined cooperatives have been a driving force behind the country's economic growth has been described as a paradox: an institution with a "vaguely defined ownership and reward structure,"[120] which has outperformed the Eastern European model with its well defined bundles of private property arrangements.

It has been summarily assumed that a full gambit of unambiguous private property rights are essential for a market economy.[121] Under this view, there must be a clear and exclusive owner with the right to residual income which accrues in the property, as well as the right to transform, lease or sell it. Such private property rights are thought to be required be-

115. Naughton, *supra* note 74, at 53.
116. *Id.* at 65.
117. *Id.*
118. *Id.*
119. WEITZMAN & XU, *supra* note 46, at 16-17.
120. *Id.* at 3.
121. *See, e.g.*, *id.* at 5-6.

cause they provide owners with incentives to act as true owners, to increase productivity and efficiency within the necessary confines of hard budget constraints.[122]

TVEs simply do not fit within the established rules which a traditional property rights regime is supposed to entail. Because TVEs are collectives, the local community government, not a private owner, exercises ownership rights. Yet, such ownership rights are remarkable for what they omit rather than what they include. They do not include the right to sell or bequeath the TVE or its assets.[123] Moreover, collective members, who are nominal owners, do not decide when or how much benefits should be distributed, nor how to use such benefits once they are distributed.[124] For example, approximately 60% of the after-tax profits of TVEs must be reinvested in a reserve fund, a welfare fund, and a bonus fund and cannot be distributed. In addition, even though collective members are "owners," nominal ownership rights do not bestow on them the automatic right to work in a TVE.[125] Similarly, even though the local state is the "representative of all the 'owners,'"[126] its ownership rights do not give it the right to fire TVE workers unless certain formal requirements are met.

Yet, despite the lack of private ownership rights and the lack of full transfer, sale, or even use rights, TVEs have an uncontested record of economic growth. In an effort to make sense of this seemingly perplexing phenomenon, some economists have sought to impose a bright line conception of property ownership on the TVEs by characterizing them as "privately-owned firms in disguise."[127] These private firms are said to register as collective enterprises in order to receive benefits accorded to collectives. However, regardless of how these firms are formally registered, they are undeniably in a separate category from state and private enterprises as they

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122. *Id.* at 6.

123. *Id.* at 12-13. The individual "owners" lose their ownership rights if they leave the community.

124. *Id.* at 11.

125. *Id.* at 13.

126. *Id.*

127. WEI & LIAN, *supra* note 48, at 14 ("'[P]rivate enterprises often registered as collectively owned [i.e., TVEs], with full concurrence of local officials, allowing the enterprises to gain access to bank credit and more favorable tax treatment.'") (quoting source provided by the Asian Development Bank, 1993).

exhibit a combination of market and collective-oriented behaviors.

Thus, the fact that China's transition from central ownership to market-oriented behavior has been driven by a collective base with socially-founded property rights which are not clearly defined should bring several privatization assumptions into question. According to conventional Western prescriptions, all entities with seemingly unclear property rights or multiple owners with overlapping interests are considered economically hazardous. Hence, the common Western indictment against Eastern European collectives or workers' cooperatives may not be universally accurate.[128] With such single-minded focus on clear private property rights, it is no wonder that privatization of state assets has been mandated.

First, the success of the TVEs reveals that wholesale reassignment of state property to private owners in order to clarify property rights may be neither a cure-all nor a prerequisite for all economies. Additionally, even in the West, it would be hard to find so much lopsided faith invested in such reassignment from public to private ownership alone. After all, even if greater productivity and efficiency is the economic raison d'etre of private ownership, it is not merely tied to ownership, but also to the perennial principal/agent problem of management and regulation. Private property without market forces may simply create private owners who perpetuate the patterns of inefficient and monopolistic behavior of their state predecessors.

Second, it is ironic that unrestricted and unambiguous ownership rights are prescribed as imperatives for transitional economies when such rights do not always exist in Western economies themselves. Despite the indictment against "jumbled and unclear" property rights and the deification of "unambiguous individual rights needed for a successful market economy,"[129] even Western property regimes do not guarantee private owners the unfettered right to use, destroy, develop, transform, sell, or lease the property in question.

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128. For a discussion of the necessity of worker ownership and control of former SOEs in Poland and the attendant conflicts which accompany it, see Robert Wisner, *A Socialist Shortcut to Capitalism? The Role of Worker Ownership in Eastern Europe's Mass Privatizations*, 19 N.C. J. INT'L L. & COM. REG. 123, 138-46 (1993).

129. Christopher Clague, *supra* note 85, at ix.

Nonetheless, the organizational structure of the TVEs reveals a set of property arrangements which appear to be much more perplexing than the typical Western property arrangement. For example, the social base (land and productive assets) which forms the foundation of the TVE, does not belong to any one individual, but to the collective and cannot be sold. If a TVE has been contracted to outside management, "all the assets (including the incremental part contributed by the contractor) are still owned by all the labor mass collectively."[130]

Third, the institution of private ownership rights, whether clearly or poorly defined, is not always a necessary requirement to a well-functioning market. TVEs are collective enterprises under the ownership and nominal control of governments at the local township, provincial, and village level. Since reform began in 1978, deregulation by the central government has presented the local state with new opportunities to respond in classically entrepreneurial ways. Thus, like entrepreneurs, local governments have invested resources in TVEs poised to take advantage of new market niches. Local governments have also taken steps to facilitate the entry of new enterprises by: (1) allocating credit; (2) providing incentives; and (3) harnessing the pattern and direction of economic growth, while at the same time ensuring a minimum of state interference in the management of such enterprises.[131] Therefore, the local state retains an active role, with village and township officials "reviewing all important plans and decisions regarding expansion, investment, and product lines and playing very active roles in marketing. In many respects, local officials in rural areas have become entrepreneurs analogous to company executives."[132]

In this regard, the TVE experience has an additional implication; a well-functioning market, efficient allocation of resources, and economic productivity may very well coexist with conditions inconsistent with the very logic of privatiza-

130. WEITZMAN & XU, *supra* note 46, at 11.

131. "[M]anagement is almost entirely independent of government." Cairncross & Lin, *supra* note 26, at 13. Thus, despite the fact that TVEs are "half-private, half-local government in ownership . . . their most important characteristic has little to do with ownership. They are established by entrepreneurial initiative, not by plan, and they have no assured support if they do not meet the test of the marketplace." OVERHOLT, *supra* note 26, at 67.

132. Walder, *supra* note 93, at 62.

tion—the absence of private owners but the presence of very active local states which show no signs of withdrawing. Additionally, such local states are embodiments of organizational entities with wholly contradictory tendencies and mixed ownership structures which are neither behaviorally nor structurally capitalist in the strictest sense of the word. Thus, effective, market-oriented reform is distinguishable from privatization as currently implemented by the former Soviet bloc.

Fourth, wholesale state sector privatization may not be the only way to remedy the problem of soft budget constraints.[133] By downwardly reassigning use rights and income flows, from government administration to collectives and then to households, China, through the contract responsibility system, was able to alter the incentive structure without widespread and rapid state sector privatization, decreasing the need for the state to intervene with subsidies to keep an enterprise afloat. In addition, even though collectively held assets are retained by the collective, households are given the right to make management and marketing decisions regarding the assets in exchange for payments to the owners. As one commentator has described the shift,

> [i]n all of these downward transfers of use rights, the relationship between the principals (owners) and agents (their subordinates) has been altered from one of hierarchical authority, in which the principal specifies in detail the duties and methods of work of the agent, to one of contract, in which the agent gains increased autonomy in carrying out the assigned task in return for a contractually specified payment to the owners.[134]

Economic growth in China has been generated primarily by the newly emerging nonstate sector and its economic entities. Despite their nominally complementary status,[135] enter-

133. Originally coined by the Hungarian economist Janos Kornai, an enterprise experiences soft budget constraints when no connection exists between its earnings and its expenditures. Thus, even if expenditures chronically exceed earnings and cause deficits, such deficits are resolved not by internal adjustments but by outside intervention. In centrally planned economies, the state usually steps in and provides the needed subsidies, either with capital from the central bank or from other money-making state enterprises, creating the additional problem of a never-ending chain of interfirm debt. Milor, *supra* note 83, at 20 n.17.

134. Walder, *supra* note 93, at 57-58.

135. For example, the Constitution was revised in 1988 to reaffirm the state's

prises outside the state sector have proliferated to such an extent that they have overtaken firms inside the state sector. According to the Asian Development Bank's 1994 Asian Development Report, state firms, which still produce half of China's total industrial output, grew by a mere 6.4%. In contrast, the outputs of TVEs grew by over 40%, and private enterprises and foreign joint-venture enterprises grew by more than 45%.[136]

While this separate sector of new firms has provided the engine for growth and contributed to the emergence of a more market-oriented culture and environment,[137] the state sector has not necessarily benefitted from the surge of nonstate growth. The state sector has remained essentially unaltered, not just as the canonical foundation of "socialism with Chinese characteristics," but as a statistical albatross on the Chinese state. Indeed, after years of reform, the state sector still consists of over 100,000 state enterprises which employ 75% of China's urban labor force of approximately 108 million workers. Additionally, in September 1994, 44.5% of state owned enterprises were losing money, with total losses climbing to

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commitment to a system of public ownership supplemented by an ancillary sector consisting of individual and private economies. "The state permits the private sector of the economy to exist and develop within the limits prescribed by law. The private sector of the economy is a complement to the socialist public economy." ZHONGHUA RENMIN GONGHEGUO XIANFA [Constitution] [XIANFA (1982)] art. 11.

Under China's system of classification, there are two categories of private businesses. First, there are private individual businesses, which are driven by single-household labor and hire less than eight employees. Second, there are private businesses which hire more than eight employees. This group is also called "private capitalistic businesses" and is considered exploitative in nature. *See* Lee, *supra* note 88, at 191.

136. Isberto, *supra* note 48.

A sample of 434 Chinese cities showed significant differences between the performances of state and nonstate firms. Nonstate firms grew at a faster rate than state firms. Moreover, the shares in output for state firms declined from 78.1% in 1988 to 73.3% in 1990. Meanwhile, the shares in output for nonstate firms increased over the same period, with TVEs gaining an increase of five percentage points. *See* WEI & LIAN, *supra* note 48, at 15.

137. China's strategy of creating an increasingly market-oriented environment also included the establishment of special economic zones (SEZs), economic laboratories, in other words, for the experimentation with trade and investment between Chinese and foreign investors. SEZs were more than export processing zones and were in fact intended to be "windows and bridges," windows through which the outside world could view the Chinese economy, and vice versa, and bridges over which Chinese and foreign enterprises could cross. Wall & Fukasaku, *supra* note 84, at 157.

over 29 billion yuan.[138]

IV. Reforming the State Sector

This part examines efforts taken towards the transformation of the state sector. The first section explores various measures adopted by the government to expose state sector enterprises to market disciplines and to reorient state sector behavior in the absence of state sector privatization. The second section studies the current phase of Chinese state sector privatization. It examines the recent securitization of Chinese state enterprises and assesses the ideological and regulatory framework adopted by the government to control and limit state sector privatization.

A. *Enterprise Reform without State Sector Privatization*

"It takes more than one cold day
for a river to freeze three feet deep."[139]

In general, it has been said that "the important distinction is not public versus private—it is monopoly versus competi-

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138. Xiao Yu, *Backing for State Firms*, S. CHINA MORNING POST, Nov. 7, 1994, *available in* LEXIS, News Library, SCHINA File.

In 1992, a full one-third of China's state enterprises were insolvent, another one-third suspected of heavy losses, and only one-third could be considered profitable. Gong, *supra* note 7, at 34. Also in 1992, $7.82 billion of China's 1992 state expenditures were used as subsidies to cover losses, an amount which did not include "soft loans" made with little expectations of repayment by state banks. *Id.*

For an understanding of the sheer size and magnitude of China's economy and the complexity of reforming such a vast number of enterprises, see David Bachman, *China and Privatization*, *in* THE POLITICAL ECONOMY OF PUBLIC SECTOR REFORM AND PRIVATIZATION 275 (Ezra Suleiman & John Waterbury eds., 1990). As of 1985, there were approximately 463,000 urban industrial enterprises, 94,000 state-owned factories, 368,000 collective enterprises, 1,570,000 rural collective industrial enterprises, and more than 10,000,000 private rural enterprises. Also there were 25,000,000 commercial enterprises, of which 4,000,000 were state enterprises, 9,000,000 were collective enterprises and 12,000,000 were individual enterprises. All have undergone some type of reform. In contrast, Hungarian economic reform involved only about 700 enterprises. *Id.* at 278.

139. *"Exclusive Extracts" from Wu Bangguo Speech at Economic Meeting*, British Broadcasting Corp. Summary of World Broadcasts, Jan. 30, 1995, *available in* LEXIS, News Library, TBBCSW File [hereinafter *Bangguo Speech*]. "The reform of state-owned enterprises is a long-term task. The goal in terms of timing raised by the central economic work conference is to properly solve the problems of state-owned enterprises by the end of this century. The reason is quite obvious: 'It takes more than one cold day for a river to freeze three feet deep.'" *Id.*

tion."[140] Under this theory, a simple transfer of ownership from public to private interests will not increase efficiency. Managerial responsibility and accountability to the public interest must be introduced through a complementary system of competition from other providers, and compensation and incentives based on performance measurements.[141] Essentially, at the core of Chinese reform is the eventual separation of state and private enterprise. That is, a separation of the government's economic management function from its role as the custodian of state assets.[142]

It has been precisely within the parameters of this theoretical umbrella that China first attempted to revamp its state sector. In 1991, the Party's reformist ideology re-emerged after Tiananmen and reasserted Deng Xiaoping's economic agenda, which places fundamental reforms of medium and large state enterprises at the forefront.[143] The changes approved by the Communist Party's 14th Congress included bold measures for managerial reform in accordance with the "law of the fittest," management with neither state interference nor state assistance,[144] designed to force the state sector to "emulate the more dynamic collective and private sectors through competition at home and in the international economy."[145]

Most recently, the Chinese government has identified state owned enterprise reform as the major task of economic restruc-

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140. John B. Goodman & Gary W. Loveman, *Does Privatization Serve the Public Interest?*, HARV. BUS. REV., Nov.-Dec. 1991, 26, 28. In what the authors term an attempt to move the privatization debate from "the ideological ground of private versus public to the more pragmatic ground of managerial behavior and accountability," the focus becomes simply "good management—regardless of ownership." *Id.* at 28.

141. *Id.*

142. Yu, *supra* note 138.

143. Miller, *supra* note 22, at 24. The emergence of a nonstate sector means that "more than two-thirds of current economic activity takes place outside the State system." *Id.* at 28-29. However, "the remaining third," the inefficient state enterprises, still has to be reformed. This is a difficult task considering the size of some of the enterprises. For example, some steel or coal companies have more than 100,000 employees. OVERHOLT, *supra* note 26, at 62.

144. Miller, *supra* note 22, at 29.

145. *Id.* at 31. Other modes of reform include mergers. In the 1980s, almost 7000 enterprises were merged and approximately 4000 enterprises came out of the red, reducing the level of losses by 522 million yuan. *Speeding Up Reform with Regard to Property Rights*, Xinhua General Overseas News Service, Mar. 14, 1994, *available in* LEXIS, News Library, XINHUA File.

turing in 1995. China's President, Jian Zemin identified the "three keys" required to successfully open up China's economy, each of which is dependent on and intimately connected to the success of state sector reform. Thus,

> the key to building socialism with Chinese characteristics lies in successfully running large and medium state owned enterprises; the key to accelerating the establishment of a socialist market economic system lies in making substantive progress in the reform of large and medium state owned enterprises; and the key to gaining a favourable position for fierce international economic competition in the 21st century lies in comprehensively enhancing the competitiveness of large and medium state owned enterprises.[146]

The gradual shift towards market-oriented reform in other spheres of the economy has had a percolating effect on the behavior and performance of the state sector. No longer are state enterprises automatically immune from the effects of market forces. State enterprises must now cope with market competition rather than simply navigating the bureaucratic channels for their survival. No longer can they concentrate solely on satisfying the central plan's targets at the expense of the needs of their customers. TVEs and other nonstate enterprises "have seeped into all the nooks and crannies of businesses formerly under the monopoly control of state enterprises, like salt water infiltrating cement and gradually breaking it up."[147]

Thus, the environment in which state enterprises dwell is no longer completely centralized and monolithic. Competition from the outside has forced state enterprises to be competitive from within as well. Hence, a steady, though insufficient, increase in state sector productivity and competitiveness has occurred.[148]

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146. *Bangguo Speech, supra* note 139.

147. OVERHOLT, *supra* note 26, at 67.

148. Even China's largest tractor manufacturer, for example, had to experiment with new ways to increase its market share. It has tried "'to improve the quality of its products as well as its marketing and publicity techniques in a bid to offset . . . sluggish domestic sales . . . . The Luoyang tractor complex had been forced to sacrifice more than half of its profits in trying discounts, lotteries and free delivery of goods to boost sales.'" 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 39

Aside from exposing state enterprises to increased competition from the nonstate sector, the government also added a second ingredient for reform: private initiatives and managerial compensation based on performance instituted under a system essentially similar to the agricultural responsibility contract system.[149] Responsibility contracts have been utilized by parties at all levels of the production and distribution chain: "between the state and enterprises . . . between central and local authorities, between localities, between local authorities at various levels and between an enterprise and its staff and workers."[150]

Under the managerial responsibility system, managers are given greater autonomy and responsibility over the "microeconomic" details of the enterprise. Thus, consistent with reforms begun during the late 1970s and early 1980s designed to increase enterprise autonomy, managers are granted greater power to decide such things as what to produce, where to buy supplies, how to market the products, and how large the work force should be.[151] Reforms initiated include profit sharing plans, bonus plans tied to managerial or enterprise performance, and the legalization of price flexibility based on supply and demand.

Enterprise and state can also enter into contracts stipulating the amount of tax and profit the enterprise is required to turn over to the state.[152] Once the performance goals of the enterprise have been met, the enterprise is allowed to retain excess profits which may be used however its management

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(Vedat Milor ed., 1994) (quoting Anming Gao, *Giant Tractor Maker Plagued by Slow Sales*, CHINA DAILY, May 28, 1991, at 4).

149. The major laws on reform of state enterprise management include, among others, the following: Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People, Apr. 13, 1988, *China Laws for Foreign Business*, 2 Business Regulation (CCH) ¶ 13-534 (1989); and, Provisional Regulations for State-Owned Industrial Enterprises, Apr. 1, 1983, *China Laws for Foreign Business*, 2 Business Regulation (CCH) ¶ 13-500 (1989).

150. *Observe Economic Laws, Speed Up Four Modernizations*, Xinhua General Overseas News Service, Oct. 16, 1978, *available in* LEXIS, News Library, XINHUA File.

151. Bachman, *supra* note 138, at 279.

152. *Id.* The system based on managerial incentives has also been called "management targets responsibility," in which enterprise managers and the state would enter into a contract enumerating certain targets to be met by managers within a specified period of time. Qian, *supra* note 91, at 73.

deems desirable. In addition, workers within the enterprise are granted an incentive bonus if they exceed the performance commitments contracted with management.[153] Both enterprises and workers are granted a portion of the enterprises' income rights in the form of profit retention for enterprises and bonuses for workers.

Therefore, even within the parameters of state ownership, China instituted property rights reform by assigning use rights downward from the central plan towards more enterprise autonomy. The downward transfer of use rights (the right to use the enterprise and its assets) was also accompanied by the parallel transfer of the right to retain profits.[154] By adopting profit contracting arrangements and by shifting from requiring enterprises to remit profits to simply requiring them to pay taxes, state enterprises have been allowed to retain a larger proportion of their profits to be disposed of at the discretion of the enterprise managers.[155]

Transfers of property rights have in turn led to other forms of unofficial assignments. An example of these assignments is the system of informal subcontracting and leasing arrangements which have, in effect, created a "'secondary market' in use and income rights over productive assets."[156] Such secondary markets have allowed state enterprises to lease the right to use land, offices, buildings, and vehicles to entrepreneurs, thereby maximizing their budgets through such informal arrangements.[157]

In addition to separating ownership and management to

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153. Bersani, *supra* note 6, at 306; *see also* Hilary Joseph, *Labor Reform in the Workers' State: The Chinese Experience*, 2 J. CHINESE L. 201, 206 (1988).

Other arrangements designed to boost production through a system of private initiatives include arrangements allowing managers to bid for the right to manage certain enterprises. Potential managers enter a bidding process and the successful bidder contracts with the state to generate a set amount of profit over a fixed period of time. The manager awarded the "lease management rights" is allowed to retain all profits minus the amount previously committed. Bachman, *supra* note 138, at 279-80. For example, in the seaport town of Qingdao, reformists have disposed of near-bankrupt businesses by allowing local entrepreneurs to take over everything under the "state ownership, private management" arrangement. Pete Engardio, *Capitalism Seeps Into an Old Port*, BUS. WEEK (Int'l Ed.), June 13, 1994, at 4.

154. *See* Walder, *supra* note 93, at 58.

155. *Id.*

156. *Id.* at 59.

157. *Id.*

increase enterprise efficiency and productivity,[158] China also spearheaded an additional series of reforms designed to create a dual track pricing system consisting of dual prices within the state sector itself. Thus, there are two prices for each commodity, one price set by the state in accordance with its plan, and the other set by the market in accordance with the law of supply and demand. While state owned enterprises must still meet their compulsory quota within the plan and must still sell their products to the state at a typically lower, state-assigned price, any surplus generated above the state's quota becomes market products to be sold at market price. As more commodities are released from the auspices of the plan, more enterprises are seeking new ways to take advantage of these more profitable opportunities, thus eroding the centrality of the plan. Contrast this strategy of gradual price reform with the conventional Western prescription for "Big Bang" price adjustment which requires an immediate shift from controlled prices to market prices.

This two-tier pricing system for state sector goods accomplished two purposes. First, it introduced state sector enterprises to the basic concept of the market and, when combined with the system of managerial incentives described above, it encouraged them to adopt certain conceptual as well as concrete changes in behavior. For instance, it encourages these firms to operate at market prices and to think in terms of greater productivity and efficiency. Second, it allowed state sector enterprises to interact and transact with nonstate sector enterprises, and these transactions "developed into a remarkable variety of forms."[159] State sector and nonstate sector trade, whether in the form of various cooperative arrangements or joint ventures, increased, as profit-minded state sector enterprises sought to economize by subcontracting with more efficient nonstate rural businesses.[160]

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158. In a command economy such as China's, the state owns and manages the enterprise. By contrast, an American corporation generally divorces management from ownership so that the owners (shareholders) are not the same as the managers who run the enterprise on a daily basis. China has sought to build a "Chinese wall" between ownership and management without losing ownership control.

159. Naughton, *supra* note 74, at 53.

160. *Id.* However, private sector firms should not be allowed to make excess profits by purchasing goods at below market price from state firms and selling them to the public at market price. The misuse of the dual price system by inter-

By increasing the competitive pressures exerted on state enterprises and by implementing other measures designed to improve enterprise performance, the move towards enterprise reform has led to some positive results. For example, basic data on state and collective industry compiled from 1978 to 1988 revealed that the gross output value of state owned enterprises increased from 342.1 billion yuan in 1978 to 1.35 trillion yuan in 1988.[161] Other data also revealed sustained improvements in at least several measures of productivity. For instance, the total factor of productivity in state owned industry during the 1980s increased at an annual average of 2.4%, not as rapidly as the TVE sector, which improved at a rate of 4.6%, but an increase nonetheless.[162]

While the reforms described above have clearly created palpable changes in the environment in which state enterprises operate and hence changes in the behavior of state enterprises, they appear to be inadequate mechanisms in and of themselves unless adopted in conjunction with some state sector privatization. Although it appears that state enterprises have experienced increased productivity, the generous profit retention schemes expended towards worker bonuses, worker housing construction projects, and other enterprise funds have resulted in a decrease in enterprise profits remitted to the state.[163] The resulting increase in the accumulation of consumption funds, which exerted inflationary pressure on the economy,[164] the concomitant reduction of state revenues, and the increase in state subsidies to inefficient enterprises have forced the state to find ways to raise money and at the same time curb inflation. The continued inability of the state sector to support itself—20% of China's annual revenues had to be pumped into the more than 60% of the state owned enterprises that continued to lose money[165]—meant that the government

mediaries and the popular resentment generated may have contributed to the Tiananmen Square demonstrations. Clague, *supra* note 85, at 8 n.2.

161. Rawski, *supra* note 148, at 30. *But see* Lee, *supra* note 88, at 194 (increases in profit retention schemes and managerial autonomy have not resulted in significant increases in economic efficiency and productivity).

162. Walder, *supra* note 93, at 60.

163. Lee, *supra* note 88, at 194.

164. *Id.*

165. Schell & Lappin, *supra* note 7, at 728. Some economists, however, have come to a different conclusion. While acknowledging 1989 data showing state sector losses, they nonetheless point to the fact that such mounting losses came pri-

truly had no choice but to move the experiment from a simple contract system with limited marketization to a more ideologically complex shareholding system. That is, to a system of decentralized ownership and multiple shareholders.

However, in keeping with past practices, extensive preparatory work had to be done along ideologically meticulous lines so that radical experimentation could be safely channelled into harmony and conformity with socialist theory. Thus, divesting the state of its ownership interest in state owned enterprises could not be called privatization in China. As Liu Hongru, Vice Minister of the State Commission for Restructuring the Economic System, declared, "What we resolutely oppose is privatization. But we do not because of that oppose a stockholding system."[166]

B. Privatizing the State Sector

> "Are such things as securities and stock markets good or bad? . . . Can they only exist under capitalism? Cannot they also be adapted to socialism?"[167]

While there is a mandate for mass and rapid privatization of state sector enterprises in Eastern Europe, no such mandate exists in China. Thus, the securitization of state enterprises and the establishment of a securities market presented China with one of its most controversial ideological issues to date: the conversion of state enterprises into a joint stock or shareholding system and the subsequent ownership of equity in such enterprises by private participants. After years of trying to revive the state sector through a series of half-hearted measures, China has finally begun to allow outside equity interest in state enterprises. However, as will be demonstrated

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marily from two sectors—coal mining and petroleum extraction—due primarily to artificially low prices administered by the state. *See* Rawski, *supra* note 148, at 38. Additionally, other losses occurred in defense industries and were caused by declining demand resulting from the easing of tension between China and its neighbors. Thus, about two-thirds of 1989 losses could be traced back to causes which were unrelated to state sector inefficiency. *Id.* at 38-39.

166. Qian, *supra* note 91, at 83.

167. Speech made by Deng Xiaoping on his visit to one of China's most economically thriving zones, Shenzhen Economic Zone in Guangdong Province, *quoted in* Schell & Lappin, *supra* note 7, at 729.

below, the ideological framework currently in place, designed to accommodate both market and socialism, reflects not just the quandaries of its two genetically mixed origins but also the hiccups of political deadlock and compromise.

The following sections examine Chinese state sector privatization. In particular, focus will be placed on the motivations underlying the government's decision to securitize its state enterprises and on its marked preference for securitizing such enterprises through debt rather than equity. The recent creation of the securities exchanges and the ideological undercurrents which have shaped and defined the Chinese securities market will then be discussed. Particular emphasis will be paid to the government's preference for issuing debt instead of equity, the government's desire to engage in only limited state sector privatization, and the government's insistence on retaining its paramount interests as majority shareholder.

1. Motivations and Historical Developments

There are two overriding motivations underlying China's move towards a securities system: the inability of traditional sources of financing to meet the capital requirements of insolvent state enterprises[168] and the desire of the state to tap into a pool of private capital outside direct state control. In this latter respect, the Chinese model of privatization has produced a distinctively Chinese reality—state sector privatization motivated by the surplus, not the dearth of domestic capital. This fact makes the free distribution schemes adopted in Eastern Europe economically unnecessary.

The Chinese government has shown remarkable dexterity in its capital fundraising endeavor. It has converted state businesses into shareholder enterprises and allowed shares of select enterprises to be traded on the stock exchange. In this way, the government was able to raise funds without direct foreign credits or direct foreign investment in either joint ventures or wholly foreign-owned enterprises.[169] By establishing

168. There are four main sources of financing for state enterprises: (1) fiscal appropriations; (2) funds generated by the enterprises themselves, including profits and depreciation expenses; (3) bank loans; and (4) debt and equity issuances. Qian, *supra* note 91, at 66 n.11.

169. *See* Jia Zhao & Li Qian, *Trading Stocks in China: Development, Regulation, Issues and Prospects*, E. ASIAN EXECUTIVE REP., June 15, 1992, at 7, 8. "Be-

a securities market, the government was able to create a unique opportunity to raise capital and, at the same time, draw into its sphere of control a wealth of private resources previously hidden outside the state's reach, namely a surplus of savings under almost one billion Chinese mattresses.

The prosperity and proliferation of the nonstate sector has meant that China's citizens have been able to save large amounts of money.[170] With one of the highest saving rates in the world (30%),[171] private surplus capital amounted to an under-utilized pool of approximately 1.3 trillion yuan ($260 billion).[172] This pool of private capital was either hidden under mattresses or tied up in low-yield bonds or low-interest savings accounts.[173] The amount of private savings is even

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cause of the government's policy of encouraging foreign investors, enterprises that could not themselves get loans from banks for the purpose of expanding production capacity were given an opportunity to obtain financing if they entered into joint ventures with foreign investors. With the general shortage of financing, however, Chinese companies found that entering into a joint venture did not necessarily guarantee bank loans." *Id.*

170. The problem confronting Eastern Europe and Russia is almost the reverse. While an enormous pool of private capital in China has been created both to the dismay and joy of the government, the opposite has occurred in the former Eastern bloc. Because of a scarcity of domestic capital, privatization in Eastern Europe has indeed taken a markedly different route. For example, an outright purchase of shares by Polish citizens of privatized enterprises had to be ruled out because even "under the very optimistic assumption that people are prepared to spend 20-30% of all their savings to buy shares in the privatized enterprises, the amount of money available for the purchase of the state companies would equal between 2.4% and 3.6% of their book value." FRYDMAN & RAPACZYNSKI, *supra* note 14, at 22. A distribution program of free vouchers, therefore, would "eliminate the problem of capital" as well as "legitimacy problems associated with selective give-aways." *Id.* at 27.

171. Schell & Lappin, *supra* note 7, at 730. Other sources have estimated an even higher savings rate of 39%. *See, e.g., Money and Banking: 11.4 Securities and Bond Markets*, CHINA HAND, Oct. 1, 1993, *available in* LEXIS, ASIAPC Library, CHINAH File. Despite its high savings rate, "[s]aving remains an unattractive prospect because the bank interest rates are typically low (often lower than the rate of inflation)." *Id.*; *see also China*, EUROMONEY: HANDBOOK OF WORLD ECONOMIES AND INVESTMENT OPPORTUNITIES, Sept. 1992, at 121, 124 (Supp.). Analysts estimate that as much as $200 billion sits idle in the domestic banking system, while up to $100 billion is concealed outside the system by individuals distrustful of banks. Household savings in China provides approximately 70% of funds used to finance new investment. Guardiano, *supra* note 1.

172. Others have estimated that the private savings in China have amounted to $310 billion. *Business Briefing: China*, FAR E. ECON. REV., Apr. 1, 1993, at 83, *available in* Westlaw, Far Eastern Economic Review Database.

173. Schell & Lappin, *supra* note 7, at 730.

The financial system remains primitive but is slowly improving. Despite a more astonishing when compared to the value of state held assets, which totalled approximately $240 billion.[174]

With $41 billion worth of foreign debt[175] and its state enterprises chronically running at a deficit, China's securities exchange system was undoubtedly motivated by the desire to utilize private capital to finance public debt.[176] The availability of domestic private capital allowed China to avoid Eastern Europe's problem of finding domestic buyers for state assets. By contrast, Russia and certain Eastern European countries such as Poland have had to resort to the free distribution of vouchers,[177] thus foregoing the possibility of raising funds for insolvent enterprises through the privatization process itself. China, on the other hand, had no difficulty locating domestic capital. In fact, the very existence of such a vast source of private capital beyond the state's control may have been one of the primary motivations behind China's decision to institute state sector privatization.

The development of a shareholding system and a stock exchange was also motivated by the concern that a surplus accumulation of savings would overheat the economy. In short, too much money could create high inflation if used to chase too few consumer goods.[178] In this respect, China's attempt to di-

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large disposable pool of savings, investment opportunities remain limited. These opportunities are, however, rapidly expanding. At the end of 1993, the combined value of all securities outstanding in China had a value of 750 billion yuan, of which 544 billion are debt securities. (The exchange rate, as of March 1, 1994, is $1 equals 8.7 yuan.). Yu Zhang, *China's Emerging Securities Markets*, 29 COLUM. J. WORLD BUS. 113 (1994).

174. *Business Briefing: China*, *supra* note 172, at 83.

175. Juliet Sychrava, *China: Marches to a Changing Tune*, EUROMONEY, Aug. 13, 1990, at 47, 48. Another estimate puts the foreign debt at the highest available figure of $67 billion at the end of 1991. *See* OVERHOLT, *supra* note 26, at 56.

176. As Jing Shuping, one of the first proponents of a shareholding system and a permanent director of the China International Trust and Investment Corporation has unabashedly explained, a shareholding system can do the following: "'First, it can turn some of the consumption fund into production fund and promote the development of production . . . . Second, it is a new way to absorb foreign capital . . . . Third, it helps enterprises to restrain themselves and makes them improve efficiency and develop healthily.'" Qian, *supra* note 91, at 83.

A share system also allows the government another way of raising money besides "forcing state factories to buy government treasury notes through compulsory wage deductions." Peter Goodspeed, *'Capitalist Oppression' Is Back as Shanghai Market Re-Opens*, TORONTO STAR, Dec. 16, 1990, at F1, *available in* LEXIS, ASIAPC Library, TSTAR File.

177. Gordon, *supra* note 43, at 522-23.

178. Paul Schroeder, *Rebuilding China's Securities Markets*, CHINA BUS. REV.,

vert surplus capital away from either idle savings or overheated inflationary spending has been quite successful.[179] It has not only presented the government with a strategy for averting inflation, but has also given the government an opportunity for using domestic resources, rather than relying exclusively on foreign capital, to generate economic growth.

Like its other market-oriented measures, China's conversion of inert domestic savings into investment capital had to be accomplished within the specific parameters of market socialism. Just as the private sector could only supplement the more dominant public economy, so too must private capital be contained. Thus, as more fully discussed below, any equity the state extracts from Chinese personal savings could only be channelled, at the early stages of the securitization experiment, into debt instruments which do not implicate socialist ownership of the means of production; and currently, into limited minority interests in state enterprises.[180]

As the Deputy Director of the State Commission for Restructuring the Economy, Liu Hongru, boldly announced, "We

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May-June 1991, at 20, 21 ("A capital market could also assist further experiments in price reform by easing inflationary pressures, as money would be steered toward investment rather than consumer spending."). A shareholding system has been assigned a multitude of functions. Shares can be used to raise capital for financing purposes by coaxing private savings into an arena susceptible to the control of the state. They can also be used to solve China's "two contradictory economic imperatives. One is slowing an overheated economy. The other is seizing perceived historical opportunities for accelerated development." Gong, *supra* note 7, at 36.

179. As the head of a consulting company remarked: "'The most important sign of China's economic development in the 1990's is that savings have started to come out into the market.'" Sheila Tefft, *Shanghai: Boom Town of the East*, CHRISTIAN SCI. MONITOR, Dec. 31, 1993, at 6.

180. Everywhere in China it seems, scholars and practitioners strain to reiterate the idea of private equity shareholding within the context of public ownership. One scholar made the distinction that "changes in the forms of realization of public ownership" will not undermine "the essence of public ownership," Qian, *supra* note 91, at 81 n.74, since a shareholding system is only a product of the socialization of the means of production and not an inherent product of capitalism:

> 'The shareholding system has emerged under the capitalist system but it is not the exclusive right of capitalism. Rather, it is the product of the socialization and commercialization of production. It may exist under the capitalist system but it can also exist under the socialist system and serve socialism.'

Qian, *supra* note 91, at 82 (quoting Xiao Zuoji, *Shixin Shehui Zhuyi Gongyouzhi De Xinshi* [*On the Forms of Realizing Socialist Ownership*], 2 JINGJI YANJIU 38 (1992)).

are a socialist country, and we must hold fast to public ownership of assets, and to the principle of combining a market economy and a planned economy. Under these conditions we will create securities markets."[181]

2. The Initial Securitization of State Sector Firms: Equity Subdued

The securitization of Chinese state enterprises occurred in two phases. The first phase was marked by a sharp preference for the issuance of debt over equity. The second phase was marked by the mandate for majority state interests in the privatized enterprises.

Initially, China's experiments with securities were strictly limited to the issuance of internal bonds in the form of workers' bonus shares. Unlike the first phase of reform, where sound economic reasons existed for the strategy of retaining the state sector while creating a new nonstate sector, the path of state sector securitization currently pursued by the government is much less the product of rational economic policy than political impasse.

In an ideologically inoffensive move designed to make socialist "worker ownership" compatible with individual incentives and profits, enterprises were allowed to issue incentive shares to their own employees.[182] It was hoped that by tying employee compensation to economic performance through employee equity participation in the enterprise, employees would have greater incentives to make the enterprise more profitable. In the early 1980s, however, as enterprises became insolvent, incentive shares originally intended to boost worker morale transmogrified into compulsory bonds forced onto employees by money-losing enterprises as a substitute for monetary compensation.[183] Sometimes as much as 10% of an

181. Sychrava, *supra* note 175, at 48.

182. As one worker in the state-run People's Bank of China said, "We feel a stock market will not affect socialism. Most of our shareholders will be workers. There is no contradiction." Goodspeed, *supra* note 176, at F1.

183. *See* Zhao & Qian, *supra* note 169, at 8. Once it was discovered that nonnegotiable debentures were routinely forced by financially shaky enterprises upon staff members and workers, the State Council, on March 5, 1989, issued a directive requiring that "internal debenture subscriptions be on a voluntary basis and only for short-term working capital needs." *Id.*

When faced with the prospect of capital shortages, Beijing, however, has not employee's salary had to be taken in bonds.[184]

Despite its inauspicious beginnings, the introduction of bonds into the economy presented the government with a much-needed opportunity. Bonds represented a noncontroversial financing tool, providing the Chinese government with an ideologically compatible vehicle for raising needed capital. Debt instruments wholly void of equity interests allowed the government to raise money without implicating socialist ownership of the means of production and without undermining government control of state enterprises.[185] In its initial stages, China's regulatory regime has exhibited a pronounced preference for the use of debt over equity as a financing tool.[186] Indeed,

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hesitated to engage in compulsory sales. When it was discovered in May of 1993 that only 15% of 30 billion renminbi worth of treasury bonds issued by the government had been subscribed, Beijing warned the provinces and cities that unless they buy their quota of the entire issuance, they would be barred from listing their stocks on the Shanghai and Shenzhen exchanges. Beijing also warned that workers would be forced to buy all government bonds that had failed to sell. By August, more than 37 billion renminbi worth of treasury bonds were sold. *Money and Banking: 11.4—Investing in B-Shares*, CHINA HAND, Oct. 1, 1993, *available in* LEXIS, WORLD Library, CHINAH File.

184. Sychrava, *supra* note 175, at 50. Nevertheless, the fixed returns on these internal debt instruments, which are nonnegotiable and carry no promises of ownership, did not help create employee incentives. Even when instruments deemed shares were distributed to employees, they resembled bonds more than stocks. They were "redeemable at specified maturity dates, could be called by the enterprise, and did not provide the holder with any voting rights." Bersani, *supra* note 6, at 307 n.12.

185. *See* OVERHOLT, *supra* note 26, at 151-56 for an account of the development of the bond market in China. Fiscal tightening by the government in the mid-1980s forced enterprises to issue bonds as a way of subsidizing their own capital shortages. Although bonds carry no ownership rights and thus do not endanger socialist notions of ownership, Beijing's issuance of treasury bills in 1981 to finance its modernization drive did constitute a "break with Maoist economic theory, which categorically rejected any form of national debt." Schell & Lappin, *supra* note 7, at 728.

Other types of financing followed and by the end of the 1980s, "the forms of state-issued bonds had proliferated: they included government bonds, treasury bonds, special project bonds, and value-guaranteed bonds with interest rates indexed to inflation." OVERHOLT, *supra* note 26, at 152. The public's need to trade in bonds led to the emergence in 1988 of secondary market trading. Experimenting markets initially appeared in seven big cities and later, in 54 cities. *Id.* By December 1990, a nation-wide, computerized bond-trading network, the Securities Trading Automated Quotations Systems (STAQS) (with the capacity to expand to include stocks) was opened. *Id.* at 155. The presence of a bond market also helped curb inflation by absorbing excess money that could have flooded the consumer market. *Id.* at 156.

186. For an account of China's discriminatory treatment against stocks, see

from 1981 to 1988, bonds alone were the driving force behind the securities industry.[187]

Soon after bonds were introduced and successfully used in China as a fundraising tool by the government, in 1984 the World Bank proposed a shareholding system in which it recommended that "the enterprises' assets . . . be divided into shares and owned by several government departments."[188] Although the "original single ownership system"[189] would eventually be dispersed into a "multi ownership system,"[190] under this proposal, equity interests in a state enterprise would still be held by other state-controlled enterprises with enough excess capital for investment. Enterprises would be converted into shareholding companies, with their shares held by other state enterprises.

Even though China's securities legislation has evolved far beyond the prescriptions by the World Bank, and despite Chinese regulations which permit private equity ownership, majority state ownership has continued to dominate China's secu-

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Pitman Potter, *Shanghai Securities Regulations*, E. ASIAN EXECUTIVE REP., Aug. 15, 1991, at 7, 7. According to Professor Potter, Shanghai's regime is designed to restrict private enterprises' access to capital. "In light of the provisions of central government bond regulations restricting the capacity of private enterprises to issue bonds, these entities must rely heavily on stock issues to raise capital. The more stringent controls on stock issues indicate an effort to restrict the ability of private enterprises to compete against bond-funded state projects for investor capital." *Id.* at 8 (citation omitted). Requirements for stock issuances are designed to be more onerous than those for state bond issuers because bond issuers are generally limited to government entities and state banks while stock issuers are generally enterprises of all kinds, including private enterprises.

187. Qian, *supra* note 91, at 66 n.15.

In December 1991, it was reported that of the 200 billion yuan in securities issued to date, over 80% were in the form of bonds. *Automated Quotation System Helps Securities Trading in China*, Xinhua Gen. Overseas News Service, Dec. 5, 1991, *available in* LEXIS, News Library, XINHUA File. As part of the campaign to elevate bonds above stocks and to curb the growth of stocks, the state council, on March 28, 1987, promulgated a notice which declared that: (1) stocks may be issued only by a small number of approved collective enterprises; (2) state enterprises may not issue stock. Conversely, state enterprises may issue bonds and other debt securities. Zhao & Qian, *supra* note 169, at 8. Clearly, these measures were motivated by no reason other than the desire by the state to remain the sole owner of state enterprises.

The first stock issued by a state enterprise occurred in 1986 when the state-owned Shenyang Jinbei (Gold Cup) Auto Industrial Shareholding Corporation reorganized as a shareholding company. *Id.*

188. Qian, *supra* note 91, at 75.

189. *Id.*

190. *Id.*

rities market.[191] While the urgent need to raise additional capital forced China to experiment with a shareholding system "that would transfer portions of state owned enterprises to individuals or organizations below the central level,"[192] the experimentation has been extremely constricted and distorted because it had to be conducted within a regulatory framework that reformers could defend as complementary to socialist ideology.

3. China's Securities Exchanges: The Emerging Regulatory Framework[193]

Although the creation of a shareholding system and securities market reflects an ideological willingness to experiment with ownership reform, the experiment has been hampered by the Party's insistence that majority state ownership remain the irreducible core of all reforms. In an effort to keep intact what it considers to be the residual values of social ownership of the means of production, the Chinese government has refused to relinquish majority state ownership. A shareholding system with the state as majority shareholder allows the state to divorce itself from the management operations of the enterprise (a step in the same direction as prior attempts towards enterprise reform discussed above)[194] without risking the loss of control.

This section investigates the development of the Chinese stock market and China's manipulation of its shareholding system to privatize as a means of state-directed development. Although Chinese enterprises had been issuing shares to em-

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191. Of all the shares issued on the Shanghai Stock Exchange, approximately 70% were in the hands of state or state-controlled enterprises. Ann S. Tyson, *China Restricts Shanghai Stock Exchange*, CHRISTIAN SCI. MONITOR, July 3, 1991, at 7.

192. Schroeder, *supra* note 178, at 21.

193. It is not the purpose of this article to study China's securities or company legislation. For an excellent examination of the former, see Qian, *supra* note 91, at 85-97. For an excellent examination of the latter, see Bersani, *supra* note 6, at 307-28.

194. The separation of the state as owner of a state enterprise from its role as manager of the enterprise has been approved at the recent National People's Congress, which adopted a constitutional amendment designating state enterprises as "state owned" rather than "state run." *See* Bersani, *supra* note 6, at 304-05 n.6; *see also* Preston Torbert, *China's Evolving Company Legislation: A Status Report*, 14 NW. J. INT'L L. & BUS. 1, 2-3 (1993).

ployees and outside entities,[195] the idea that shares of state owned enterprises[196] will be publicly traded by private owners on a stock exchange was not officially considered until Beijing had given official sanction to the securities exchanges in Shanghai in 1990 and Shenzhen in 1991.[197]

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195. Companies may be allowed by the government to issue shares without being allowed to list those shares on the stock exchanges. Schell & Lappin, *supra* note 7, at 727-28.

Until 1992, the transformation of Chinese state-owned enterprises into shareholding enterprises was done on an ad hoc basis. On July 1, 1994, China's new company law became effective and is considered a breakthrough in the country's economic reforms. The new national law will play an extremely important role in the transformation of China's state enterprises from state-owned entities into modern, shareholding corporate entities. It also presents new opportunities and challenges for foreign investors. *See* Preston Torbert, *China's New Company Law: Foreign Investment Issues*, E. ASIAN EXECUTIVE REP., Aug. 13, 1994, at 7.

China has had a number of separate forms of corporate enterprises: state-owned enterprises, nonstate owned enterprises such as TVEs, private enterprises and foreign-invested enterprises, each with its own legal regime. The regulations on companies are but a first step towards a unified set of legislation on companies. The new company law will have primarily a gap-filling function, as far as foreign investment is concerned, since it appears that it will only have an effect on issues not covered by prior legislation. *Id.*

196. Not all shares of state-owned enterprises can be publicly traded. *See infra* note 207 and accompanying text.

197. As is often the case with China, the center of regional initiatives has leapt far ahead of the ability of the central authorities to legislate or regulate. Even before Shanghai opened China's first national computerized stock exchange, over-the-counter markets for equity and bond trading had occurred in Shanghai and Shenyang as early as 1986. *See Securities Exchange Opens in Shanghai*, ASIAN WALL ST. J., Dec. 20, 1990, at 13. And the first public offering of shares occurred as early as 1984, with the offering of shares in Shanghai Feile Audio.

Following Shanghai's lead, informal over-the-counter trading of enterprise bonds and treasury bills began to proliferate without official authorization or supervision as peddlers began hawking stocks and bonds to investors on street corners. *See* Henry R. Zheng, *Business Organization and Securities Laws of the People's Republic of China*, 43 BUS. LAW. 551, 604-19 (1988). In an attempt to give some order to the frenzy of trading, Beijing, in 1986, authorized Shenyang to open a "stock market," which in reality was nothing more than a cashier's window in a bank office and a blackboard listing the prices of a few fixed-interest government bonds. Schell & Lappin, *supra* note 7, at 728.

Shenzhen too experienced the frenzy of securities trading. Located across the border from aggressively entrepreneurial Hong Kong, Shenzhen became a trading center for smaller, export-oriented enterprises while Shanghai became the trading center for securities in larger state enterprises. In 1987, the first public issue of equity securities took place in Shenzhen. *See* Andrew Quinn, *China's Southern Stock Market Butts Heads with Beijing*, Reuter World Service, July 15, 1991, *available in* LEXIS, WORLD Library, TXPRIM File. By 1992, when the upstart regional economic zone decided to open its own stock exchange with or without Beijing's official approval, there was little Beijing could do except meekly work out a compromise in which Shenzhen agreed to defer its opening until after

In an effort to exert some semblance of control over the development and governance of the exchanges, both Shanghai and Shenzhen have adopted a confusing maze of regulations to cover a range of activities including regulations on share issuance, broker-dealers, and stock exchange operations.[198] As

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Shanghai's. Schell & Lapin, *supra* note 7, at 727.

Demand for the limited number of listed securities became so great in both exchanges that officials in Shanghai and Shenzhen had to adopt a system of numbered tickets. The system allowed the ticket purchasers to enter a lottery in which the winners alone were entitled to register with a broker for the purchase of listed shares. *See* Schell & Lappin, *supra* note 7, at 732. In August of 1992 a riot broke out at the Shenzhen stock market when a million hopeful investors stood in line to buy five million lottery tickets only to discover that there would not be enough tickets to go around. Andrew Browne, *China Stocks Surge as Rescue Package Unveiled*, REUTER ASIA-PAC. BUS. REP., Mar. 14, 1994, *available in* LEXIS, ASIAPC Library, REUAPB File.

Despite astronomical demands, the authorities have moved cautiously. When Shenzhen first opened its exchange in 1991, only five companies with a book value of 200 million renminbi were listed (although approximately 200 enterprises had been transformed into shareholding companies ready for listing and although almost 520 million yuan worth of stocks had been issued). OVERHOLT, *supra* note 26, at 168; *China Curbs Shenzhen Bourse*, CHRISTIAN SCI. MONITOR, Feb. 13, 1991, at 7; *Shenzhen Securities Exchange Opens*, Xinhua Gen. Overseas News Service, July 3, 1991, *available in* LEXIS, News Library, XINHUA File. By 1992, only 17 companies had succeeded in listing on Shenzhen. Similarly, Shanghai opened with seven listed shares in 1991 and by the end of 1992, increased to twenty-six. OVERHOLT, *supra* note 26, at 169. These were but a tiny portion of the more than 3000 issues that Chinese enterprises were already selling internally to their employees and over-the-counter to other investors. Schell & Lappin, *supra* note 7, at 727.

198. *See* Shanghai Securities Transaction Regulations, Dec. 12, 1990, *translated and microformed on* Foreign Broadcast Information Service, Daily Report, China, No. FBIS-CHI-90-245, at 46 (Dec. 20, 1990); *see also* Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares, June 15, 1991, *translated and reproduced in* E. ASIAN EXECUTIVE REP., Sept. 15, 1992, at 21, *available in* LEXIS, ASIAPC Library, EASIAN File (hereinafter Shenzhen Regulations). For a discussion of the Shenzhen regulations, see Pitman Potter, *The Legal Framework for Securities Market in China: The Challenge of Monitoring State Control and Inducing Investor Confidence*, 7 CHINA L. REP. 61, 74-76 (1992).

There is, in addition, an ancillary set of regulations consisting of notices and interim measures. For regulations relating to Shanghai activities, see Detailed Implementing Rules for the Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares, Nov. 25, 1991, *reproduced and translated in* CHINA HAND, Oct. 1, 1992, *available in* LEXIS, WORLD Library, CHINAH File; Measures of Shanghai Municipality for Administration of Special Remnibi-Denominated Shares, Nov. 22, 1991, *reproduced and translated in* CHINA HAND, Oct. 1, 1992, *available in* LEXIS, WORLD Library, CHINAH File (covering B shares).
For regulations relating to Shenzhen activities, see Rules for the Implementation of the Interim Procedures for the Administration of Special Stocks in RMB (B-type

yet, there is no national securities legislation.[199] However, the Interim Regulations on the Issue and Trading of Shares were passed on April 22, 1993 to alleviate some of the confusion and fill in some of the gaps unaddressed by the Shanghai or Shenzhen regulations.[200] The following analysis does not serve to elucidate all of the regulations enumerated above, but rather only those rules and regulations which are relevant to an examination of Chinese privatization within the context of state sector ownership reform.

Because China remains ideologically confined by market socialism, privatization of state enterprises has involved only a minority portion of state enterprise shares. The government has been very careful to maintain majority ownership in those state enterprises which it has chosen to privatize. Thus, capital markets in China have not been permitted to develop or proliferate in a way that will tip the balance of power away from the state's dominant role in the economy. As a result, China's shareholding system and its securities exchanges are designed more to serve the state's financing needs and to reinforce the state's position as majority shareholder than to create greater transparency of privatized enterprises for the benefit of shareholders. In this respect, privatization of the state sector has not meant the creation of a class of independent capitalist investors but instead, the subordination of private capital by the state.

Chinese legislation classifies shares by their holders rather

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Stocks) in Shenzhen City, Dec. 16, 1991, *reproduced and translated in* CHINA ECON. NEWS, Feb. 3, 1992, at 7; Interim Procedures on Control of Shenzhen Special (B-Type) RMB Stocks, Dec. 5, 1991, *reproduced and translated in* CHINA ECON. NEWS, Jan. 27, 1992, at 7.

199. Legal drafters have been working on national securities legislation for more than two years, and the document has been through more than ten drafts. "Confusion has been compounded by an array of overlapping administrations overseeing the markets. These include China's central bank, the China Securities Regulatory Commission and the various stock market officials." Andrew Browne, *Arguments Hold Up China's Securities Law*, Reuter Asia-Pac. Bus. Rep., Nov. 29, 1994, *available in* LEXIS, WORLD Library, TXTLNE File.

200. The Interim Regulations supplement the Shanghai and Shenzhen regulations and consist of eight chapters dealing with issuance and trading of shares (Chapter 3: Trading of Shares); takeovers (Chapter 4: Takeover of Listed Companies); custody, clearance, and registration of shares (Chapter 5: Custody, Clearance and Registration); information disclosure (Chapter 6: Disclosure Obligations of Listed Companies); inspection and penalties (Chapter 7: Investigation and Penalties); and dispute resolution (Chapter 8: Arbitration of Disputes).

than their characteristics: state shares, legal person shares, individual shares, (collectively, "A shares"), and foreign investment shares (domestically-listed but overseas-invested stocks, known as "B shares").[201] State shares[202] are purchased with state assets by governmental departments and usually constitute 50% or more of all the shares issued.[203] Because the government has reconciled itself to the separation of management from ownership, the governmental department holding the state shares does not become involved in the day-to-day management of the enterprise.[204] Legal person shares are owned by entities such as companies and institutions.[205] Individual

201. *See* Shenzhen Regulations, *supra* note 198, art. 33.

"A" shares are held by domestic investors whereas "B" shares are held by foreign investors. Until the beginning of 1992, shares on both the Shanghai and Shenzhen stock exchanges were denominated in the local currency, the renminbi, and were open only to Chinese entities and individuals. In early 1992, both exchanges allowed foreigners to invest in Chinese enterprises through special issues of B shares. While A shares are sold in renminbi to Chinese nationals only, B shares, denominated in renminbi, are subscribed for and traded in foreign currency.

While both shares are subjected to the same obligations, dividends on B shares must be paid in foreign exchange (U.S. dollars in Shanghai and Hong Kong dollars in Shenzhen). Dividends on A shares are paid in renminbi. At the present time, there is no provision for the conversion of A shares to B shares or vice versa, and the government has indicated that this will not be possible until the yuan is fully convertible. It must be noted that although the new company law adopted on July 1, 1994, does not specifically abolish the share distinction system, it does not call for specific share legislation.

202. The question that China has wrestled with from the outset, as reflected in an internal report to the National People's Congress Standing Committee, is the following: "state-owned enterprises are gradually changing to the shareholding system and are listing one after another. Given the fact that 'state-owned shares' are tokens of public ownership, should we legislate to protect them to prevent the state from losing controlling power over those enterprises?" *Article Views Debate on Formulation of Securities Act*, British Broadcasting Corp. Summary of World Broadcasts, Mar. 9, 1994, *available in* LEXIS, News Library, TBBCSW File.

203. Qian, *supra* note 91, at 87.

There had been some rumors that state officials might be willing to allow state enterprises to be "quasi-privatized" once the enterprises change from state to shareholding status. Quasi-privatization would mean that the state would make radical concessions on the question of property rights and ownership. In that case, state holdings in the new shareholding company could be as little as 20% or even 15%. *See China to Cut State Holdings to 20%, Paper Says*, Japan Econ. Newswire, Dec. 7, 1993, *available in* LEXIS, ASIAPC Library, JEN File.

204. *See, e.g.*, Christine Chan, *Calls Growing to End China's Share Classes*, S. CHINA MORNING POST, Dec. 3, 1993, (Business), at 1, *available in* LEXIS, News Library, SCHINA File. Matthew Bersani, *Stock Companies in China: An Alternative Format for Foreign Investment?*, E. ASIAN EXECUTIVE REP., July 15, 1993, at 9.

205. Legal persons shares are frequently held by local governmental organiza-

shares are owned by either the employees of the company or by third parties in the general public. The classification of shares based on the identity of the shareholder has allowed the government to ensure that its dominance will not be threatened by other holders of stock. As a result, the securities market has resulted in majority ownership by the state and a maximum of 35% ownership by foreigners.[206]

To further ensure state majority ownership remains intact, only individual shares of listed companies can be traded on the exchanges.[207] Clearly, the illiquidity of state owned shares "makes it difficult for stock markets to exercise their function of adjusting state owned assets structurally."[208] This problem

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tions or subsidiaries of state enterprises. Roberta S. Karmel, *Tossing Capitalism in Shanghai*, N.Y. L.J., Aug. 19, 1993, at 4.

206. By contrast, the Polish plan for privatization, having made a decisive break from the vestiges of socialism, consists of a shareholding system in which the state is expected to retain but a minority interest. Each of the 500 largest state enterprises scheduled for privatization, for example, will be converted into a shareholding format; 10% of the shares will be given free of charge to the workers, 30% retained by the state, and the remaining 60% transferred to new owners through privatization vouchers. FRYDMAN & RAPACZYNSKI, *supra* note 14, at 63. Under this model, free vouchers received by the populace will be used to "purchase" shares in a number of intermediary institutions such as investment and restructuring funds. Once the vouchers are transferred to the intermediaries, the companies will then be sold at an auction. The intermediaries which win the bid become legal owners of the shares of the privatized enterprises. The individuals, in turn, hold the shares of the intermediaries. *Id.* at 30. The state's shares will be deposited with the intermediaries who will be charged with selling those shares, either by private placement or in the open market. *Id.* at 64.

207. Andrew Browne, *China Announces Stock Market Rescue, Prices Surge*, Reuter Asia-Pac. Bus. Rep., Mar. 14, 1994, *available in* LEXIS, ASIAPC Library, REUAPB File; *see also* Ren Kan, *Domestic Investors to Get Share of Huge Stock Issue*, CHINA DAILY, Feb. 5, 1994, *available in* LEXIS, WORLD Library, TXTLNE File. An additional means for ensuring that the state retains its dominance is a restriction on the number of shares individual shareholders are allowed to purchase. Under the Shanghai rules, one single individual shareholder cannot purchase shares equaling more than .5% of the total shares issued. Qian, *supra* note 91, at 87 n.102.

208. Foo Choy Peng, *5.5b Shares Planned for Mainlanders*, S. CHINA MORNING POST, Jan. 20, 1994, (Business), at 4, *available in* LEXIS, WORLD Library, SCHINA File. As the above quote by Liu Hongru, chairperson of the China Securities Regulatory Commission, reveals, Chinese officials *do* in fact realize that public listings would "enhance the transparency of the market by ensuring the full disclosure of information." *Id.* However, the "problem must be gradually solved because it has a bearing on the property rights system of state-owned assets and the business administration system." *Id.*

A proposal has been put forth that would allow state-owned shares to be traded yet at the same time protect the state's interest in retaining control. Under this plan, state-held shares can be traded, but the state retains the right to recan easily be solved by allowing state owned shares to be traded. However, despite repeated suggestions that shares owned by the state and by legal persons be merged with shares owned by individuals,[209] and presumably publicly traded, the government has steadfastly held to the original design, except in one rare instance.[210] Hence, although the majority of A

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deem the shares within five years. "[T]he proposal would enable state-held shares to effectively realise their value, improve a company's shareholding structure and avoid loss of state-owned property." Chan, *supra* note 204, at 1. Should the state elect not to exercise its right to redeem the shares within the allotted time period, it would do so because it believes a better return could be achieved on other investments. *Id.*

209. Browne, *supra* note 207. Legal persons are among those most eager for the merging of shares. Originally promised at the time of purchase that their shares would be eventually listed, they have been anxious to cash in on their stock investments. *Id.*

China has been studying the possibility of listing corporate-owned shares. Although only individual shares are publicly traded on the securities exchanges, a small number of corporate-owned shares have been listed on the Securities Trading Automated Quotations System (STAQ) and National Electric Trading System (NETS). Kan, *supra* note 207. Because speculation about the possible listing of state-owned shares and corporate shares have continued to fuel investors' worries that such listings may result in another dive in share prices, the government publicly announced in January of 1994 that such listings will not occur in the near future. Liu Weiling, *China: Wariness Reigns Among Stock Investors*, BUS. WK. (China Daily Supp.), Jan. 30, 1994, *available in* LEXIS, WORLD Library, TXTLNE File.

Calls to allow the free transfer of state shares and to abolish the distinction between the different classes of shares have not been directed only at the current distinctions *within* the A shares market. There have been suggestions calling for the merger of A and B shares as well, which would require a freely convertible yuan. Until the yuan can be made freely convertible, however, it has been suggested that Chinese investors holding foreign currency should be allowed to buy B shares and vice versa. Chan, *supra* note 204, at 1.

One reason for allowing domestic investors to buy B shares would be to add some fire to the cool B shares market. Some discrepancy in valuation has arisen between the two shares, so that while A shares of a company trade at a certain point, B shares of the same company trade at a much lower value. Chinese investors with an excess of yuan are eager to invest in almost any financial instrument—thus demand far outstrips supply. By contrast, foreign investors graced with a wide range of investment options are less likely to put up with the inadequate regulations governing the Chinese market. *Inefficient Markets?*, ECONOMIST, July 31, 1993, at 70.

While China's legal scholars and economists debate the point, classifications based on the identities of shareholders remain.

210. When Shanghai Dazhong Taxi announced a novel scheme to convert some of its legal person shares into B shares for foreign investors, the plan was at first rejected by the China Securities Regulatory Commission. Browne, *supra* note 207. The state's initial rejection reflects the state's fear that foreign firms would gain too much control of an enterprise. Conversion of legal person shares into B shares

shares in most listed companies are state owned, they are not traded.[211] Legal person shares held by institutions can only be traded on a separate, electronic network.[212] Individual shares can be traded, but they constitute only a fraction of shares issued by a listed company.[213] Clearly, ensuring state dominance is much more important to the government than ensuring the efficient and transparent workings of a capital market.

Aside from the separation of shares by reference to their owners, China has been tenacious in protecting the state's interest in other respects as well.[214] When reformers consid-

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would increase the supply of B shares by 37-40% on both the Shanghai and Shenzhen exchanges—hence the fear expressed by a spokesperson for the China Securities Regulatory Committee that "opening A shares to foreigners amounted to a sell-out of state property rights . . . . " Ivan Tong, *Dazhong's B-share Plan Vetoed*, S. CHINA MORNING POST, Feb. 27, 1994, *available in* LEXIS, News Library, SCHINA File.

However, in the end, Dazhong Taxi did win approval to test the controversial conversion of legal person shares into B shares, a move which will give foreigners a majority stake in the company. *Id.* The Shanghai Securities Administration has noted that foreigners must still comply with existing regulations and that although the merging of all shares is inevitable, there is a long way to go because many important details still need to be worked out, the most important of which is a freely convertible yuan. Zheng Jie, *China: Swap of Corporate Shares into B is Only Experiment, Reuter*, SHANGHAI STAR, July 5, 1994, *available in* LEXIS, WORLD Library, TXTLNE File.

It should also be noted that Dazhong Taxi won the right to convert legal person shares into B shares only because as a taxi operating company, it was not considered a key industry. *Id.*

211. One reason for state majority ownership and nontransferability of state shares is to prevent buyout by foreign firms. Chan, *supra* note 204, at 1.

212. Kan, *supra* note 207.

213. Another trade-off that results from the illiquidity of state shares is the small number of shares that are actually traded, potentially resulting in a market more susceptible to manipulation. *See* Andrew Browne, *Currency Fears May Stall Chinese Share Reform*, Reuters World Service, Jan. 14, 1994, *available in* LEXIS, ASIAPC Library, REUWLD File.

214. Beijing issued a circular requiring publicly listed companies to safeguard the interests of the state when issuing new shares. According to the circular, state shareholders, usually an administrative organ or a government department, were being discriminated against by companies which asked the state shareholders to relinquish their right to buy new shares. While other shareholders were entitled to bonus issues, state-owned shares were only awarded cash bonuses, resulting in a dilution of state shares and state control. *State Defends Rights as Shareholder*, S. CHINA MORNING POST, April 12, 1994, *available in* LEXIS, News Library, SCHINA File.

State shareholders were also admonished that "'[w]hen there is a decision for a bonus issue or placement during a shareholders' meeting, government representatives who hold shares must safeguard state interest—they cannot blindly ered other experimental measures inimical to the principle of majority state ownership, the government did not hesitate to exercise its central authority to ensure the primacy and sanctity of state shares. When Shenzhen issued a regulation allowing state enterprises to trade their 1994 bonus shares six months after issue, the central government quickly moved to quash the brazenly renegade move. As Zhu Li, spokesperson for the Securities Regulatory Committee said, "trading in shares other than those held by individuals is banned because it involves aspects of transfer of national property rights."[215]

Not only has the state maintained control over state enterprises listed on the stock exchange, it has also carved out a role for itself as architect of the stock exchange. Thus, under current Chinese practice, it is the state which controls the number and type of enterprises that will become shareholding companies, and which among those shareholding companies will be allowed to be listed.[216] It is no surprise that under the present rules, each Chinese province is allocated a strict annual quota of shares for listing in Shanghai or Shenzhen.[217]

Despite strict state control, China's securities market has performed its designated fundraising functions[218] by absorb-

agree with the decision.'" *Id.* (quoting circular issued by the State Assets Administrative Bureau of Beijing).

215. *Beijing Slaps Southern Bourse on Rogue Reform*, Reuter Eur. Bus. Rep., Mar. 7, 1994, *available in* LEXIS, BUSFIN Library, REUEUB File. "Allowing state-held bonus shares to trade on the open market would inevitably erode the state's holdings and eventually could undermine its majority ownership[.]" *Id.*

216. Kan, *supra* note 207. The state selects which domestic firms are allowed to list A shares on the domestic as well as which domestic firms are allowed to list on overseas exchanges. *Id.*; *see also* Peng, *supra* note 208, at 4.

The state also sets the total number of shares that can be issued to domestic investors. According to Ma Zhongzhi of the State Council Securities Policy Committee, "'[t]he figure [is] set after fully considering the stock market's capacity.'" Kan, *supra* note 207.

217. Browne, *supra* note 207.

218. For example, when Shanghai Vacuum Electron Device Co. issued one million B shares on the market in December 1991, the shares were sold within one day. Schell & Lappin, *supra* note 7, at 739. The supply for B shares could barely meet the demand. Shenbao Industrial Corporation's issuance of $1.34 million worth of B shares on the Shenzhen Securities Exchange in June 1992 was immediately over-subscribed. Overseas investors flooded the market with $112 million in subscription funds, or about 80 times the par value of available securities. *Id.*

When the securities market was opened to foreign investment at the end of 1991, foreign investors reacted enthusiastically by launching over 20 China funds by the first half of 1992, raising more than $1 billion for investment in listed securities as well as securities in unlisted companies. Julia Sze, *The Allure of B* ing capital into enterprises steadfastly controlled by the state. Regardless of whether the purpose of the securities system is to raise capital for the state, to control renegade private capital, or to convert inert mattress money into investment resources, the system has accomplished its objective with distinction.

Established for the purpose of pursuing very specific economic goals, the securities system has been driven by a set of economic imperatives forced upon the state by a bloated and constantly cash-starved state sector.[219] The issuance of A shares has allowed the state to privatize by offering shares to domestic investors while the issuance of B shares has attracted much needed foreign exchange from foreign shareholders. When the B share market did not attract as much foreign exchange as originally contemplated, China swiftly acted to increase its access to foreign money by listing Chinese state enterprises on the stock exchanges of Hong Kong[220] and New York.[221] Thus, it is interesting to note that the government's

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Shares, CHINA BUS. REV., Jan.-Feb. 1993, at 42, 42.

It has been estimated that there is $1.6 billion in stock market capitalization for Chinese equities. *The Rise of the Red Chip*, EUROMONEY: INTERNATIONAL INVESTORS' GUIDE TO ASIAN ISSUERS & CAPITAL MARKETS, Dec. 1993, at 23, 23 (Supp.).

219. Of course, fundraising by attracting domestic and foreign capital will also mean by necessity increasing productivity and boosting profits. Particularly, attracting foreign capital will have to mean a revamping of the current system to a more transparent one more capable of producing solid financial data that meets international standards of disclosure, all of which would, theoretically, result in more shareholder protection.

220. In an effort to expand fundraising potentials, in October 1992, China released a list of nine companies chosen as the first mainland-based companies to seek direct listing in Hong Kong. Sze, *supra* note 218, at 48. In 1993, China earmarked another 22 companies for international listing.

Maanshan Iron & Steel Company was one of the nine chosen to issue what has become known as "H" shares in Hong Kong. Instead of accessing foreign capital either through government loans or joint ventures with foreign investors, the company was allowed to list in an overseas market. In one of the largest public listing for a Chinese company in Hong Kong, the company raised $505 million. *The Rise of The Red Chip*, *supra* note 218, at 23.

221. In October 1992, China Brilliance Automotive became the first Chinese company (though registered in Bermuda) to list on the New York Stock Exchange. By year's end, its stock price climbed 80%. Sze, *supra* note 218, at 48.

The first company registered in China to be traded on the New York Stock Exchange was Shanghai Petrochemical, the largest petrochemical enterprise in China, which processes crude oil into a broad range of synthetic fibers and plastics. *See* Michael Hirsh, *Anatomy of a Privatization*, INSTITUTIONAL INVESTOR (Int'l Ed.), Apr. 1994, at 86.

solution to foreign reluctance to purchase B shares is not necessarily to improve the B share market or the Shanghai and Shenzhen stock exchanges. Rather, the government's solution is simply to find another way to access foreign capital. This is in stark contrast to the fact that no foreign company has been allowed to tap into China's domestic capital and list on China's exchanges.[222]

State dominance of the securities market has resulted in a number of severe distortions. The financing functions of the securities market which are designed to serve solely the state's financial needs have been overemphasized at the expense of other objectives. For example, the need to establish a competent and well-regulated system of corporate governance, the implementation of an effective ownership structure, and management accountability are all areas which have been ignored while the state continued its fundraising campaign.[223] In this

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Chinese companies, such as China Tire and Rubber, China Erfangji and Shanghi Chlor-Alkali, and other companies who are B share issuers in the China market, are presently looking for avenues besides the issuance of B shares to tap the U.S. market. For example, these companies conduct offerings to qualified institutional buyers in the form of American Depository Receipts using the 144a exemption to the U.S. federal securities laws. *The Rise of the Red Chip*, *supra* note 218, at 24.

222. Reports of planned listings by blue chip firms such as Germany's Daimler-Benz and Hong Kong's Bank of East Asia have piqued mainland investors' interests. After years of negotiations, Daimler-Benz finally confirmed its plans to become the first foreign company to list on the Shanghai Stock Exchange. As a general rule, however, China, does not currently allow the listing of foreign firms on the mainland, nor will the much-awaited national Securities Law cover such listings. Christine Chan, *Mainland Stock Markets Fear an Exodus of Funds*, S. CHINA MORNING POST, Feb. 1, 1994, (Business), at 7, *available in* LEXIS, News Library, SCHINA File. Zhang Ning, vice director of the Shanghai Securities Administration Office, said there were mixed feelings about allowing foreign companies to list in Shanghai: "'We don't have much investment capital in China. If companies are looking to raise cash, it would make much more sense for them to do it in the West.'" Browne, *supra* note 213.

223. Reports of "unorthodox" practices (to put it euphemistically) on the state's part, have been rampant. For example, according to officials of the Shanghai Vacuum Electron Device Co., although the Shanghai municipal government owns 75% of its stock, it has never paid for the shares. Nonetheless, it has received dividends on them! Schroeder, *supra* note 178, at 21.

Numerous complaints about company compliance with standard and basic regulations have also been received by the China Securities Regulatory Commission. Commission chairperson, Liu Hongru, acknowledged that "'[c]omplaints have been received on companies failing to make improvements on their operations as promised in their listing prospectuses.'" Christine Chan, *Quality of Listed Stocks Must be Raised*, S. CHINA MORNING POST, Mar. 22, 1994, *available in* LEXIS, respect, state sector privatization has been a disappointment, primarily because it has been constrained by the ideological dictate of state majority ownership and motivated by the overriding belief that private shareholders exist to serve the state's needs.

4. Future Privatization in China

While "better" privatization is obviously called for, should the government opt for more privatization? The answer to this question depends on the following fundamental factors: (1) what will more privatization achieve, or what does the government hope to achieve with more privatization; (2) whether the purpose can be accomplished by means other than more privatization; and (3) what the costs of more privatization may be and whether they are palatable to the Chinese government.

At the present time, China has flatly ruled out any large-scale privatization of the kind that exists in Eastern European countries.[224] More privatization has been suggested because it is believed that it is the only solution to the problem of soft budget constraints. Yet if feasible alternatives to privatization, such as increased marketization, competition, and innovation, can harden the budget, then perhaps more privatization is not necessarily the first and only solution to severing the vicious cycle of enterprise loss and government subsidies.

In this regard, there are some positive signs that Chinese state enterprises have responded competitively to the injection of market forces into the economy. Additionally, Chinese provinces have become progressively less willing to expend precious

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News Library, SCHINA File. "'To most of the companies, issuing and listing shares is solely with the aim of raising cash. Improvements in the management structure and obligations of shareholders are always thrown behind.'" *Id.*

Other shareholder complaints include ignoring original plans for share issue proceeds, failing to keep shareholders informed of company developments, *id.*, and paying shareholders very small dividends despite highly priced rights issues. Weiling, *supra* note 209.

224. As early as 1991, the Communist Party announced that it would oppose such sweeping economic restructuring. *See* George White, *Chinese Economic Reform: Is It Enough?*, L.A. TIMES, Feb. 11, 1991, at D3.

The state has been more willing to sell small and medium-sized enterprises. In 1993, about 10,000 were sold, transferred, or merged, according to the State Commission for Economic Restructuring. *China: Struggling Firms Sold to Increase Efficiency*, CHINA DAILY, Feb. 26, 1994, *available in* LEXIS, ASIAPC Library, TXPRIM File.

funds to subsidize bankrupt state firms. The growth of markets and the mounting pressures posed by competition have meant that government intervention through subsidies is no longer automatic. For example, Chinese provinces must now compete with one another for access to domestic and foreign capital.[225] Since expenditures for subsidies mean that less money will be available to finance profitable and investment-friendly ventures such as airports, telecommunications, and other necessary infrastructure projects, subsidies as a solution to inefficiency have progressively less appeal. The message to state enterprises is, of course, to look to the market and not the government for financial salvation.

Furthermore, if limited state sector privatization can generate sufficient capital to make up for the losses sustained by money-losing enterprises, then perhaps more privatization is not required. This, of course is a big "*if*."

Even if more privatization is economically mandatory, the social ramifications attached to such an endeavor could be so great that the government may be unwilling to tolerate them. After all, state companies still employ more than 100 million workers and function like "virtual mini-welfare states"[226] providing cradle-to-grave social services for workers and their families. Even if privatization is done in the name of compassionate destruction, legitimate fears exist that it will inevitably lead to a showdown between cost cutting on the one hand and

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225. Rawski, *supra* note 148, at 40.

226. Hirsh, *supra* note 221, at 86. Yizheng Chemical Fiber Co., for example, earmarked for privatization, that is, for a private placement of a 29.4% stake of the company in Europe, the United States and Japan, has performed many of the traditional social welfare tasks for its workers, such as running schools, a day care center, a park, and a hospital. *Id.*; *see also Privatizing China's State Sector: Another Long March?*, INSTITUTIONAL INVESTOR, May 1993, at 74.

Only the best companies can be earmarked for listing. "Best" is equated with biggest, according to Rolf Gerber, president of the Hong Kong based investment bank SBCI Finance Asia. The biggest companies in China will also be companies that are "'half cities, with hospitals, fire departments and schools,'" or companies that also perform "auxiliary services" such as employing surplus labor, not just the "productive core" that foreign investors want to privatize. *Id.* at 75.

The Chinese government and international investors have sought to control the problem of "corporate mini-welfare states" by restructuring the enterprise to be listed and splitting the business function of the enterprise from its social services sector. Thus, the investor is buying a new, restructured company, which contains only the actual business operations. The social sector of the old corporation is also restructured into a new entity, which is still wholly owned by the state.

full employment on the other.[227] Thus, more privatization, or, at least, more responsible privatization, may be a viable option only after the construction and institution of a social safety net.[228]

State sector privatization has presented especially difficult questions for China's interior provinces which attract much less foreign investment than its more prosperous coastal areas.[229] The reluctance to subject the state sector to market discipline has meant that of the more than one-hundred thousand state companies in China,[230] 45% of which are losing money,[231] fewer than five-hundred firms have been allowed to

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227. As noted, Beijing is "showing an unapparent unwillingness to suffer capitalism's downside: unemployment." *Privatizing China's State Sector: Another Long March?*, *supra* note 226, at 74. Bruce Murray, the Asian Development Bank's program manager for China, stated that "'[d]ealing with redundant labor is a major problem. The Chinese are taking a step-by-step approach, as opposed to the "big bang" seen in Eastern Europe and Russia.'" *Id.* at 75.

Currently, however, as the government is beginning to implement reform measures which include allowing state enterprises to become bankrupt, workers have staged sit-ins and other protests, testing the government's resolve to balance reform with social stability. Mark O'Neill, *China Workers Protest at Bankruptcy*, Reuter Asia-Pac. Bus. Rep., Oct. 28, 1994, at 8, 8, *available in* LEXIS, ASIAPC Library, REUAPB File.

228. As Wang Shiyuan, Secretary General of China's State Commission for Restructuring the Economic Systems reported in a government publication, "'Only when the social security system is established and perfected can enterprise reform be further deepened and a system realized in which efficient enterprises prosper and inefficient ones fail.'" Blustein, *supra* note 27, at A27.

When Chongqing, a city located in the interiors of Sichuan Province, laid off 2,000 workers from the largest state-owned knitting mill as part of a restructuring and reorganization effort to bring the factory out of insolvency, the workers marched on city hall and threatened to riot. The city responded by hiring 800 of the jobless workers as street sweepers. Patrick Tyler, *Overhaul of China's State Industry at a Standstill*, N.Y. TIMES, Dec. 16, 1994, at A12.

229. For example, Sichuan Province which is located in China's inland, attracted $850 million in pledged foreign investment in 1993. By contrast, Guangdong Province, which is located along the coast adjacent to Hong Kong, attracted $9.65 billion. Tyler, *supra* note 228, at A12. Yet, when Sichuan Province sought to divest itself of the financial burdens linked to its money-losing state enterprises by proposing to privatize thirty-three state firms, the plan was not approved by Beijing, which feared worker unrest and political instability. *Id.*

230. Depending on the source and the manner of classification, the number of state companies has fluctuated. It has been estimated that China still has more than 400,000 state-owned enterprises employing 80 million workers. The largest of the state enterprises, 11,000 of them, cost the state approximately $26 billion a year in subsidies, more than China spends on public health and education. Blustein, *supra* note 27, at A27. It has been estimated that state subsidies constitute approximately 14% of the government's revenue. *A Survey of China: When China Wakes*, ECONOMIST, Nov. 28, 1992, at 63, 10.

231. Official statistics may actually understate the problem. While it has gener-

go bankrupt,[232] although a bankruptcy law was passed as early as 1989.[233] Also, only four-thousand state companies have become shareholding enterprises as of the end of 1993, and only 200 have been allowed to list on the Shanghai and Shenzhen exchanges.[234]

However, the government has earmarked state sector reform as the number one priority for 1995. It has vowed to use the bankruptcy law as well as other devices to prod sluggish enterprises into either profitability or extinction.[235] Clearly, the government is trying to deal with the problem that haunts Eastern Europe and Russia today, namely what to do with state enterprises that were once national treasures but

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ally been acknowledged that approximately one-third of China's state enterprises are chronically losing money, the actual number of losses, disguised by accounting methods, may be twice that amount. *A Survey of China: When China Wakes*, *supra* note 230, at 9-10.

232. Bankruptcy would unleash a forceful and tsunamic domino effect. Most enterprises are entangled in a web of interfirm debt, one enterprise owing money to another enterprise resulting in complicated linkages of debt among firms. In addition to interfirm debt within the state sector, the state sector itself is inextricably linked to a primitive and inefficient banking system. In order to keep loans viable, at least on the book, state banks have to keep lending to money-losing state enterprises at low interest, with little prospect of being repaid, so that the banks themselves can appear to be operating in the black.

Privatizing the state sector would require not only reforming the financial sector but the social service functions currently provided by the large state enterprises as well. Eastern Europe and the Soviet Union face a similar set of

> insoluble contradictions. Stabilizing the price level is incompatible with keeping the 'white elephants' alive with unrepayable credits. But closing them could inflame the already smoldering popular discontent, since the state enterprises not only employ a large share of the work force, but also supply much of the social services through job-connected housing, schools, clinics and recreational facilities.

David Felix, *Smith and Machiavelli Go to Moscow: Further Observations on Radical Reform*, 37 CHALLENGE 48, 50 (1994).

The difference between the former Eastern bloc and China, of course, is that a robust nonstate sector is in place in China to alleviate at least some of the shock that state sector restructuring would unleash. China also has established a successful regime of export trade on the one hand and foreign investment on the other, both of which may provide additional sources of employment.

233. Hirsh, *supra* note 221, at 86. A bankruptcy law was adopted by the Sixth National People's Congress on December 2, 1986. *See* Henry R. Zheng, *Bankruptcy Law of the People's Republic of China: Principle, Procedure & Practice*, 19 VAND. J. TRANSNAT'L L. 683 (1986).

234. Hirsh, *supra* note 221, at 86.

235. Jeffrey Parker, *China Told Not to Fear Foreign Stake in State Sector*, Reuter Asia-Pac. Bus. Rep., Nov. 18, 1994, *available in*, LEXIS, ASIAPC Library, REUAPB File.

that are now economic liabilities, without causing a collapse of other institutions. By privatizing its state enterprises slowly and cautiously and allowing private interests only a minority equity ownership, China apparently hopes to retain control over the growth and direction of state enterprises as well as the speed and conditions under which they are privatized.

Like other transitional economies, China finds itself in a catch-22 situation. State sector privatization could be destabilizing but the cost of avoiding it may be even greater. For example, private sector income growth, which enters the state's banking system as savings, is being converted into low-interest loans by the state to subsidize state sector losses.[236] Currently, almost 80% of all bank loans are being fed into the state sector.[237]

For the reasons suggested above, China could improve privatization, both from a fundraising and a market efficiency perspective by implementing a few simple changes in the current securities system. These changes could include allowing more enterprises already converted to shareholding companies to list, permitting private and institutional investors to purchase a greater percentage of shares issued, and increasing the number of shares publicly tradeable on the stock exchanges. If and when the government decides to privatize the bulk of its state enterprises in order to slow the demand for bailouts and subsidies, the institutional framework of the nonstate sector and the market-supportive institutions already established should minimize the shock of privatization as well as maximize the benefits. Market forces already in place and the existing market-responsive environment will no doubt amplify the benefits that privatization itself is supposed to provide.

V. CONCLUSION

The Chinese model of privatization was designed to avoid the institutional vacuum associated with shock therapy reform. As Senator Diane Feinstein has remarked in reference to the Russian privatization model, "I have a basic concern about whether it's practical and even possible to assume that a country can go from a tightly-centralized economy with low produc-

236. Tyler, *supra* note 228, at A12.
237. *Id.*

tion standards to a rapid and total release of centralized control and still maintain its standard of living."[238]

Perhaps because China shared the same doubts, it has decided to privatize in phases and avoid the rapid and immediate privatization of the state sector that has defined the Eastern European model. As such, the Chinese model of privatization means, first fostering the growth of a nascent, nonstate sector which consists of a combination of private, quasi-private, collective, and foreign-invested enterprises. The engine for entrepreneurial innovation and growth is not supposed to come from a collapse of the older order, but from the creation of a sector of newly-formed companies, aided by the removal of governmental barriers as well as the interfirm production chains synergistically provided by the existing state sector. China, in other words, has taken advantage of existing institutional resources founded in the state sector to construct a nonstate sector which has been largely responsible for a spectacular economic growth averaging 8.8% since 1979.

Skepticism regarding the benefits of wholesale privatization and reluctance to absorb large transition costs have led China to explore alternatives to state sector privatization. The introduction of market forces, the reassignment of property rights, the institution of enterprise reform, and the emphasis on managerial incentives and accountability have made state enterprises operate more competitively and efficiently. The interaction of state and private domains has created a transformative process in which institutions themselves have been reshaped and their behavior strategically reoriented in response to an entirely new set of market-oriented rules. Thus, although the goal has not been to reproduce capitalism or Western markets, the reconfiguration process has contributed to the formation of a functioning market which state sector privatization alone is supposed to provide.

China is currently in its third phase of reform—state sector privatization. Ownership reform meant restructuring state enterprises into a shareholding system, first to allow the state to absorb and control what it deemed an excess pool of private

238. *Foreign Operation, Export Financing, and Related Programs Appropriations: Hearings on H.R. 4426 Before the Senate Comm. on Appropriations*, S. HRG. NO. 760, 103d Cong., 2d Sess. 54 (1994).

capital; second, to convert idle domestic savings into investment capital; and finally to alleviate the burdens exerted on the state budget. Additionally, equity investment by private shareholders is also seen as a way to make state enterprises more efficient and profitable, and most importantly, more self-sufficient. A functioning securities market and stock exchange is seen as a way of forcing state enterprises to become more transparent, by developing clearly articulated business goals, regularly audited financial reports, a more direct sense of managerial accountability, and other informational disclosure requirements necessary to attract investment from the securities-holding public.

Although the current Chinese securities framework is skewed in favor of state majority interests at the expense individual shareholders, the Chinese model of privatization has succeeded in bypassing the Russian and Eastern European problem of "how to sell property that belongs to nobody and has no value, to people who have no money."[239] Nonetheless, it may be unwise at this time to conclude that either system of reform is better. China has gone about the business of creating economic growth while suppressing debate on any political alternatives that may undermine Party rule. Conversely, the former Eastern bloc has focused on the "political and economic consequences of various blueprints for a final economic transition—in some cases while their economies collapse around them."[240] The purpose of this Article is not to issue a prescriptive conclusion that economic development should take precedence over political liberalization or vice versa. Rather, it is to call into question the current fetishistic role state sector privatization has played in reforming centrally planned economies and to expand the terms of debate by offering alternatives to the dominant Eastern European paradigm.

In this respect, the Chinese model challenges a number of orthodox but unarticulated assumptions. The discourse on transitional economies has occurred within a narrow framework which assumes that the failure of centralized socialism and the seeming economic superiority of capitalism means that

239. Jan Prybyla, *The Interplay of Economics and Politics: The Transformation of Social Systems*, VITAL SPEECHES, July 15, 1993, at 60, *available in* LEXIS, News Library, ASIAPII File.

240. Walder, *supra* note 93, at 64.

the eventual destination for all economies must be Western-style capitalism. According to this orthodox view, even though transitional economies may exhibit differences, they are merely differences in strategy and degree, speed and timing. Ultimately, the common end point is presumed to be the reproduction of some versions of a U.S. or Western-style economy. China's model of privatization presents a contrast to the assumption that all transitional economies are destined toward the same goal.

Additionally, it has been assumed that such an economy can best be implemented by state sector privatization. Although divesting the state of its assets and transferring them into private hands may create a temporary institutional vacuum, the act of privatization itself, it is believed, will put in place mechanisms that make up an efficient market economy. Under this theory, privatization is an absolute imperative, even in the absence of an already established market framework. Privatization is considered a prerequisite for market-oriented reform because it is believed that only privatization can correct the inefficiencies of centrally planned economies. Anything less than a complete rupture of state ownership will result in a mutilated and half-transformed economy.

The Chinese model has proved the above assumptions to be false. Systemic transformation can occur even in the absence of wholesale state sector privatization. Even within the state sector, property rights such as the right to above-quota income among various economic actors can be significantly altered, from the state downward to the enterprise and then to the individual with beneficial consequences. Moreover, contrary to the dominant model of privatization which has widely assumed that state property rights must be divested, sustained growth has been achieved by TVEs founded on a socially-based system of ownership with direct ties to active local governments.

The success of TVEs has in turn called into question neoclassical dogma about the dichotomy between public and private ownership. While China may be an increasingly marketized economy, it is not a predominantly private economy. While reliance on the market has reduced the role of central planning and increased output and growth, reliance on the state, particularly local governments, has contributed to this economic efficacy as well.[241] Just as there are numerous economic models in the West, there is no reason to believe that the same diversity of possibilities cannot exist in transitional economies.

In sum, what the Chinese experience has demonstrated is that the creation of an emerging nonstate sector with new economic entities is a viable alternative to the immediate and mass privatization of the state sector. The Chinese experience has also proved that competitive organization and economic growth can be spawned by an unorthodox public-private model of privatization. Moreover, competitive economic organizations do not have to be either private or public but a combination of the two, and may exhibit peculiarities in form and behavior which may not fit neatly into any blueprint or design. Thus, if growth can be generated by nonprivatized entities with poorly defined property rights, privatization for the purpose of creating clear and well-defined property rights may not be a prerequisite for all transitional economies. China has challenged the assumption that there is but one route to economic productivity for transitional economies. If the end can be achieved by means other than state sector privatization, and if the great social costs associated therewith can be avoided, then the Chinese model has in fact proved that wholesale privatization of state enterprises is not the economic imperative it has been made out to be.

241. In this respect, the Chinese experience is in some ways *not* that radically different from the Western experience, which *also* exhibits a variety of ownership rights and arrangements. Thus, it is interesting to note that the conventional prescription issued by the shock therapists—unbridled, indivisible and private ownership rights—does not even reflect the reality of Western experience.