

By Geng Xiao

Background paper for the World Bank project on the *State Asset Management in China*  
November 1996

---

## Clarification of SOE Property Rights

### 1. Introduction

There are a lot of confusions about property rights in the Chinese state-owned enterprises.

For example, many Chinese policy makers and scholars claim that property rights for Chinese SOEs are very clear. They belong to the whole people of China. The State Council, on behalf of the Chinese people, is the ultimate representative of the owner of the SOEs. The State Council delegates managerial autonomy to the state-owned enterprises for efficient decision-making.

Others claim that property rights for the SOEs are not clear because the state-owned enterprises do not have as much managerial autonomy as in private enterprises. There are still a lot of government interventions to SOEs.

Some of these confusions are a matter of terminology while most of them are due to the transitional nature of China's formal and informal economic institutions. It is useful to clarify these confusions on property rights before discuss in detail the practice and policy reforms of the state asset management in China.

### 2. The concept of property rights

Like most economists in and outside of China, here we use the term property rights in a more general sense than in the legal research and practice. According to Armen A. Alchian in the *New Palgrave dictionary of economics* (page 1031), "A property right is a socially enforced right to select uses of an economic good." Here, economic good covers not only real property but also other economic resources such as financial assets, human capital, and intangible assets.

Hence, legally, the property rights or more accurately the ownership of the Chinese SOEs are clearly defined. In economic sense, however, property rights for the Chinese SOEs are not as clearly defined as private enterprises in a mature market economy.

It is important to note that property rights imply both internal and external (or social) aspects of control over economic goods. On the internal aspects, the owners have rights to use the owned resources, derive income from them, and exchange them for other resources. They also spend efforts to enforce privately their rights such as putting locks on door, hiring private security guards, and relying on relatives and trusted friends in doing business.

On the external (or social) aspects, property rights, when not able to be enforced privately by the owner, ultimately have to be enforced by the society through formal laws and regulations or informal customs and ideology. The degree of social enforcement of property rights in many cases is more important than the assignment of property rights to individuals and social organisations, especially in the transitional economies.

In the case of China, the enforcement of formal laws and regulations and informal practices has relied heavily on the influence of the Chinese Communist Party since the birth of the People's Republic. The pervasive influence of the Party substituted to some extent the enforcement of property rights by an independent legal system. This substitution has brought about many complications and confusions in the assignment and enforcement of property rights in China, especially in the state-owned enterprises.

Because of the external (or social) aspects of property rights, it is important to look at the property rights issue from a macro or system-wide point of view. This has not always been emphasised in the academic and policy debates in and outside of China.

For example, many academics and policy-makers in China have the view that property rights and especially privatisation are not important and competition is the key for economic growth and development. They tend to focus only on the assignment of property rights and ignore the social enforcement of the rights and obligations.

If property rights is compared to chicken and market competition to egg, the debates on the importance of property rights and market competition are like those on "the origin of chicken and egg". Do well defined and enforced property rights lead to free market competition or the other way around? Do we have "chicken" first or "egg" first? A system-wide macro approach would emphasise that it is the general institutional environment, like the biological environment of air, temperature, and humidity for a healthy production of chicken and egg, that are the key to both well defined and enforced property rights and free market competition.

A glance over economies around the globe and over time reveals that economies with mature market (capitalistic) institutions have both well defined and enforced private property rights and free market competition while those economies with immature market (socialist or central planning) institutions lack not only clearly delineated private property rights but also free market competition. What is the most important elements of mature market institutions? At the top of the list would be hard liabilities constraints or an absence of "soft budget constraints," a term used and popularised by Janos Kornai in his study on socialist economies.

### **3. The nature of unclear property rights**

Many problems of the state-owned enterprises and state asset management such as bad loans, bad inter-firm debts, and difficulties to shut-down loss-making state-owned enterprises, can be

traced back to the lack of a general institutional environment for enforcing contracts and property rights, especially the enforcement of the liabilities implied in the contracts and property rights.

In China, due to the influence of Marxist economic theory and ideology, capital or property is regarded as the means of production that generates positive surplus value for the capitalist or owners of the capital. The emphasis of Marxist ideology is on redistribution of this positive surplus value from the capitalists to working class people through ownership of the capital by the whole people. As a result, property rights in China are often regarded as rights to positive profits streams derivable from the assets. The possibility of negative profits streams or liabilities or obligations associated with the ownership of assets in the real world has been overlooked in government policy-making and enterprise management until very recently.

This possibilities of negative asset value may not be a serious social problem in a mature market economies where property rights over assets in corporation include claims only on any positive residual profits. When the present value of residual profits streams become negative or zero, the owners of the corporation's assets would lose all of their investment but would not incur any more liabilities than their original investment in the corporation. This is what known as the limited liabilities feature of modern corporation.

Any negative present value of residual profits streams in a mature market economy would have to be shared by other stakeholders in the corporation, including banks, bond holders, suppliers, customers, and employees. A negative asset value for a corporation would trigger a legal process of corporation bankruptcy. The complicated legal procedures followed are used to define how liabilities would be shared among the stakeholders. The expected dynamic delineation and enforcement of liabilities and credits are important part of a clear property right. Property rights and liabilities over the corporation's assets would not be clearly defined until this mechanism of dynamically delineating and enforcing liabilities among shareholders and stakeholders is created and working properly.

Property rights in the Chinese state-owned enterprises are not clearly defined exactly because the mechanism for defining and enforcing liabilities, when present value of the enterprise residual profits streams is negative, is not yet established. As a result, private taking of valuable SOE assets and socialisation of SOE liabilities happens. In the end, the state as the owner of SOEs often assumes unlimited liabilities of the loss-making SOEs.

Unlike the situation in a corporation in the mature market economy where the liabilities of negative asset value are actually absorbed by specific individuals in a localised circumstance, the liabilities of a profit-losing SOE in China may not be effectively allocated to any specific individuals and may not be absorbed in a localised circumstance. Instead, the almost unlimited liabilities of profit-losing SOEs are transformed into inflation and national debts through subsidies from the government budget and the state banking system. Compared with the original liabilities of profit-losing SOEs, the costs of rising national debts and especially inflation would

be much higher due to many harmful macroeconomic effects of debts and inflation. The society as a whole then have to bear not only the liabilities of SOEs but also the extra costs of macroeconomic instability. Only a small group of people could benefit from the private taking of valuable assets from SOEs, although they are likely to be politically more powerful persons in the society.

The above macroeconomic consequences of unclear property rights are largely due to the factor that the state is a dominant owner in significant amount of enterprises and banks, which tend to facilitate socialisation of SOE liabilities.

It is worthwhile to note that private ownership of enterprises and banks would work against socialisation of liabilities through a self-enforcing mechanism of liability delineation. In an environment of well defined and enforced private property rights, any individual shareholders or stakeholders' attempt to escape their liabilities arising from the negative present value of corporation's assets, would violate other shareholders or stakeholders' property rights. All of them have strong incentives to monitor each others fulfilment of their liabilities and obligations.

Some commitments of liabilities and obligations may not materialise even under well defined and enforced property rights regime. The shareholders and stakeholders may find it profitable to revise their contractual relations. However, whenever they revise their contractual relations through bankruptcy or other procedures, the negative (or positive) present value of assets are allocated and absorbed internally among the shareholders and stakeholders of the corporation. Property rights and obligations are delineated dynamically with little chance for socialisation (or externalisation) of liabilities.

This mechanism of self-enforcing contractual relations and dynamic delineation and internalisation of liabilities under private ownership of enterprises and banks are either absent or weakened when the state enters the enterprises and banks as a dominant owner of assets and as an ultimate enforcer of contracts and property rights. The state as a fictional owner does not has as strong incentives and as much information as a real individual owner in monitoring and protecting his property rights. The state as a political institution may not set wealth maximisation as its objective and may not implement effectively its decisions smoothly due to bureaucracy. In summary, the state does not have a comparative advantage in exercising property rights at the firm level. As a result, the stakeholders in state-owned enterprises and banks may take advantage of the fictional owner of the state asset through private taking of state-owned assets and socialisation of liabilities committed by the state-owned enterprises and banks.

On the other hand, the state does have many advantage in helping state-owned enterprises and banks through fiscal, monetary, and banking policies. Unlike individual private enterprises which are subject to bankruptcy, the state is able to borrow and print money to finance the liabilities of the state-owned enterprises and banks through its monopoly of political and economic authorities. A paternalistic and strong government may use its available capacity to subsidise the

state owned enterprises and banks and indirectly encourage and prolong private taking of state assets and socialisation of liabilities in the enterprises and banks.

In summary, clear property rights over firm's assets require not only clear assignment of ownership titles but also dynamic enforcement of rights and obligations so that assets and liabilities, when their value fluctuates, would still internalise among the specific and localised shareholders and stakeholders of the firm. The unclearness of property rights over the Chinese state-owned enterprises is largely due to the absence of a mechanism in enforcing and internalising dynamically the liabilities of loss-making enterprises.

#### **4. Clarifying property rights through corporatisation**

The Chinese policy makers have clearly recognised the substantial problems of unclear SOE property rights although they may describe the problems in a different way from the previous section. This can be seen from the government's determination to transform the Chinese SOEs, especially the large ones, into modern corporations. A company law was passed by the People's Congress on December 29, 1993 and put into effect on July 1, 1994. The company law is basically copied from those in mature market economies with modifications to fit special Chinese circumstances such as in the area of wholly state-owned companies.

Together with this corporatisation initiative, the government also changed its policy objective from enlivening individual state-owned enterprises to maintaining and increasing the overall value of the state-owned assets. Hence, small and medium-sized SOEs may be sold or rented to private individuals. Even for the large enterprises, the non-state shareholders are allowed to share their equity with the state shareholder. One hundred large and medium-sized state-owned enterprises were selected nation-wide in 1994 to carry out intensive experiments in establishing modern corporations. However, the progress in transition from the factory system of SOEs to the system of modern corporations based on the new company law seems slow.

One indication of the difficulties and slowness in transition is the fact that a majority of the one hundred nation-wide experimental SOEs have chosen the wholly state owned company as their legal organisational form under the new company law. Apparently this organisation form gives the company least benefits of the new and modern company law and best opportunities to maintain the old practices under the factory system.

#### **5. The hierarchical factory system under central planning**

The traditional factory system for the Chinese SOEs is fundamentally different from the system of modern corporation based on the company law. It consists of many hierarchical structures similar to and indeed part of the Chinese government hierarchy. The whole industrial sector in the nation resembles a big factory with individual enterprises as workshops distributed across regions and industrial sectors. The directors of the enterprises are responsible for their superiors in the government hierarchy. Indeed, they bear official ranks, which vary with the size and

importance of their enterprises and are comparable to those of government officers at various levels. The directors are delegated with some managerial autonomy by their superiors. However, they are appointed by their superiors and their managerial power comes directly from the hierarchical ranks they hold.

The issue of property rights over enterprises assets is not important in this hierarchical system because the rights to control resources are defined by ranks not by ownership of assets. The salaries and wages of the enterprise managers and workers are also determined by their ranks and seniority and have very little to do with the ownership of enterprise assets. The central planning ensures that resources would be allocated across regions and sectors administratively and accounting profits and losses, assets and liabilities could be shared across enterprises, regions, and sectors. Each enterprise has to submit their own profitability to the national economic plan.

In this system, it makes little sense to establish a bankruptcy procedure for loss-making enterprises since all losses and the resulting negative present value of assets are assumed ultimately by the state regardless how the liabilities are distributed among the stakeholders. In particular, closing specific SOEs does not affect much the salaries, wages, and benefits of the enterprise managers and workers. Loss-making enterprises are simply merged with profit-making ones by administrative order. The managers and workers are also simply reallocated by the party personal department and government labour bureau.

The state banking system also plays only an accounting function and do not need to pay much attention to the profitability and risks of enterprise investment since the banks and enterprises are all owned by the state. There is little sense to spend extra resources and efforts in distinguishing between the losses made by the enterprises, when the loans are paid back to the banks by the enterprises, and the losses made by the banks, when the loans are not paid back.

The advantage of the factory system is in rapid mobilisation of resources, especially when markets and market institutions are absent. Quite naturally, the government of China adopted this factory system in its drive for industrialisation soon after the People's Republic was established in 1949. The factory system did contribute significantly to rapid industrialisation of China during the 1950s to 1970s although the costs of stagnant living standards for most Chinese people during this period were also significant.

## **6. Reforming the hierarchical factory system by introducing material incentives**

By 1978, after about thirty years of experiments and modifications of the factory system, its problems and weakness in providing incentives for enterprises to make profits were well known. The government led by Deng Xiaoping started a series of reforms, which changed the factory system substantially. A core element of this reform is to provide material incentives to officials, managers, and workers at various hierarchies of the factory system. At the enterprise level, profits are linked to salaries, wages, and benefits of managers and workers. As a result,

property rights become important for managers and workers since their incomes now depend more on the enterprise asset value than on their ranks in the government hierarchy. After the reform, the employee in-kind fringe benefits are usually well above their cash incomes in the state-owned enterprises. Our empirically research also shows that the in-kind benefits per employee are highly correlated with the industrial capital per employees.

Although recent reforms have led to a closer link between property and income in China, indicating increasing importance of property rights, the link is indirect, informal, vague and uncertain, especially in the state-owned enterprises. The managers and workers may derive incomes in the form of bonuses and in-kind fringe benefits from the productivity and increased volume of industrial capital in their enterprises. But they are not the formal shareholders of the enterprises and do not claim formal dividends (or residual profits, use an economic jargon). On the other hand, the state as the formal owner of the SOE assets could not effectively control the residual profits but would have to assume the residual losses or liabilities of the SOEs. These mis-matches between control and claim, assets and liabilities are clear signs of unclear property rights, unclear as defined in the previous section.

Recent reforms have increased significantly both the volume and variety of property rights transactions among state-owned and non-state enterprises. Joint-ventures between state-owned enterprises and foreign investors are one of the key vehicles for property rights transactions, which brings the state-owned enterprises closer to the system of modern corporation. By 1994, about 174 local property rights transactions markets across China were established mainly for de facto sells of assets of small and medium-sized state-owned enterprises. The establishment of formal stock exchanges in Shanghai and Shenzhen also provides opportunities for limited equity transactions to some large and medium-sized SOEs. The stock markets in China however are still far away from a mature capital market due to the dominant state ownership in most of the listed companies in the exchanges.

The increased property transactions provide both opportunities and challenges to the management of the state assets in China. In one of the case study included in this report, we examine in detail how the property rights transactions involving state assets may increase or decrease the value of state assets. The case study makes a clear point that when property rights are made clear through joint-venture, which introduces effectively the institutions of modern corporations, the value of state assets is likely to increase. When property rights are fragmented and unclear due to the remaining influence of the hierarchical factory system, asset-stripping is likely to happen.

## **7. Clarifying property rights and transition to modern corporations**

The Chinese policy makers and scholars understood well the problems of the hierarchical factory system. They also know quite well about the legal and organisational aspects of the modern corporations, at least in theory. However, the nature of the modern corporations as nexus of contracts, which is an important achievement of modern economics of the firm, is not

widely understood. Also the incompatibility between the hierarchical factory system and the institutions and spirits of modern corporations need to be appreciated further by the policy makers. Many difficulties in implementing the institutions of modern corporations come from the sharp inconsistencies between the two systems.

The institutions of modern corporations have existed in China by far only in the form of the new company law and related regulations. The actual experiences have been very limited. There are few Chinese large companies which could match the standard concept of modern corporation. However, the knowledge about the company law and the working of modern corporations in other countries is now quite well known by the Chinese policy-makers, scholars, and managers, thanks to the opening of China since 1978 and the educational efforts by the Chinese economists, lawyers, and practitioners. The problem is that the concept of modern corporations derived from the company law and the working knowledge of modern corporations in other countries could not apply easily to reforming state-owned enterprises in China due to special features of the state as a dominant owner. Let's discuss in detail some of the key difficulties in implementing company law in the context of the Chinese state-owned enterprises.

According to the company law, a corporation is a legal person who has rights and obligations similar to a real person in entering into contractual relations with equity shareholders, bond holders, managers and workers, banks, suppliers and customers. However, the corporate legal person is after all an artificial entity. It is only a convenient legal and organisational vehicle for putting together the complicated voluntary contracts among the shareholders and stakeholders in the corporation. Hence, the corporate legal person typically should represent the common interest of all shareholders and stakeholders in making profits and increasing the present value of the corporate assets.

In the Chinese context, artificial legal person entity for was introduced the first time in the "General Principles of Civil Law" passed by the People's Congress in April 12, 1986 and put into effect in January 1, 1987. The "Regulation on the Registration of Enterprise Legal Person" was promulgated in May 1988. In the "PRC Law on Industrial Enterprises Owned by the Whole People" passed by the People's Congress on April 13, 1988, the enterprise director is specified as the representative of the legal person. The introduction of enterprise legal person allows the possibility of separating the rights and responsibilities of owners of the enterprise assets from the rights and obligations of the enterprise organisation, which is now a legal person with legal capacity in entering contractual relations with the owners of assets and other stakeholders of the enterprise. This is a significant step away from the hierarchical factory system where the owner of the enterprise assets, the state and its hierarchies, and the enterprise organisation are not clearly separated legally.

However, this legal separation between the state and the enterprises has not been effective in reducing heavy administrative interventions to the state-owned enterprises by the government hierarchies. In particular, in the enterprise law, it is specified that the director of the enterprise, who also represents the enterprise legal person, should be either appointed by the government

supervisory departments or elected by the congress of employees with approval by the government supervisory departments.

To reduce administrative interventions to the enterprises by the government hierarchies, the State Council issued the “Regulations on Transforming the Management Mechanism of the Industrial Enterprises Owned by the Whole People” on July 23, 1992. This regulation gives specifically sixteen autonomous management rights to the enterprise legal person represented by the director, requires the enterprise to be responsible for its own profits and losses, specifies the conditions for property rights transactions applied to the enterprises, delineates the relations between the enterprises and the government, and states the legal responsibilities of the enterprises and the government supervisory departments.

While the implementation of the management autonomous rights to the enterprises has not achieved complete success, new problems of private taking of the state assets in the SOEs, often by the management, have become quite serious in the early 1990s. To control asset stripping in the SOEs, the State Council issued the “Regulation on Monitoring and Management of SOE Property” on July 24, 1994. This regulation states clearly that the role of the government in social and economic management should be separated from the function of the government as the owner of the state property.

This regulation became the regulatory foundation for state asset management in China. The article V of this regulation states:

“The SOE property should belong to the whole people of the nation, e.g. owned by the State. The State Council representing the State should exercise the ownership rights over the SOE property in a unified way.”

The regulation advances a state asset management structure based on hierarchical administrative management by the local governments and specialised monitoring by various government departments. Specifically, at each level of the local governments, the State Asset Management Bureau would be established and responsible for managing administratively the state property. The existing government departments then would specialise in monitoring different aspects of state assets and state assets in different sectors.

Moreover, this regulation creates a Board of Supervisors for each state-owned enterprise, which consists of representatives from the enterprise’s official supervisory departments, the Ministry of Finance, State Economic and Trade Commission, National Bureau of State-Owned Property Management, other government departments and state banks, and experts, managers, workers invited by the enterprise’s supervisory departments.

According to the regulation, the Board of Supervisors is responsible for organising the monitoring of the maintenance and appreciation of the value of state assets in the enterprises. It should not intervene with the enterprise’s managerial autonomy. The enterprise legal person

represented by the director still exercises the property rights over the enterprise assets on behalf of the owner, the State.

It should be noted that the Board of Supervisors here are different from the Board of Directors in the modern corporation. The Board of Directors are selected by the shareholders and represents the owner of equity and can exercise a full range of owners' rights. The Board of Supervisors has only the power to monitor the enterprise management ex post and to report mis-conducts of the management to the owners. The Company Law passed by the People's Congress on December 29, 1993 and put into effect on July 1, 1994 also institutes a Board of Supervisors for the limited liability share-holding companies.

The "Regulation on Monitoring and Management of State Property" is designed primarily for controlling asset-stripping in the state-owned enterprises. It helps a little in separating the government's role in managing the overall economic development from its narrow function in overseeing the value of the state assets. However, it does not clarify who really is in control of the SOE assets as an "acting" owner on behalf of the State.

The real "acting" owners of the state assets under the current institutional setting in China is still to be found somewhere in the government hierarchy. As a result, the decision-making by these acting owners is likely to be constrained by government bureaucracy. In another word, property rights over the SOE assets is likely to be fragmented and distributed among various government departments to ensure adequate checks and balances. Also, the objectives of the "acting" owners may not be profits or wealth maximisation. Moreover, as part of the government hierarchy, the "acting" owners is likely to impose non-contractual obligations and privileges on the enterprises and their stakeholders just like under the central planning regime. In summary, it is difficult to separate the "acting" owners of the state assets from the government. As a result, the limited liabilities to the owner stated on paper for the state-owned enterprises may not be credible. Once the constraint of limited liabilities is loosened, the institutions and spirits of modern corporation would be significantly compromised.

When the "acting" owners are part of the government hierarchy, the managers appointed by them will also be part of the government hierarchy. Other stakeholders in the SOEs such as the workers, suppliers, banks and customers would also see the SOEs and their managers as part of or close to the government hierarchy. It is likely that they all may be able to take advantage of the weakness of the government hierarchy in exercising and monitoring property rights. Private taking of assets and socialisation of liabilities may result and continue.

## **8. Conclusion: policy recommendations on clarifying SOE property rights**

It is useful now to take a brief look at the ideal situation when the owners or the majority of the owners of the enterprise equity are not part of the government hierarchy. Instead, they are profit maximising individuals investing voluntarily in the enterprises under the institution of modern corporations.

First of all, these owners need to follow a one share-one vote democracy on capital to decide on important enterprise governance issues such as selection of the board of directors, top managers, mergers and acquisitions, and important investment plans.

Second, the top manager of the enterprise would be hired by the owners from the market through a voluntary contract, instead of transferred from somewhere from the government hierarchy under the supervision of the party personnel department. He is hired to maximise the present value of the enterprise, which would bring the largest benefits not only to himself and the owners of the equity but also to other stakeholders.

Third, the other stakeholders of the enterprise when entering into contractual relations with the enterprise have to take into account of the possibility that the enterprise may not honour its contractual obligations when bankrupt and they then have to assume the losses of their investment in the enterprise as specified by the bankruptcy procedure. Of course, the shareholders would only assume limited liabilities not more than their original investment.

The above three ideal conditions are essential for delineating clearly the property rights over the assets of the enterprises. They are achievable when the majority of the equity in the enterprises are held by the private investors and the market for capital, managerial talents, labour, and products are free as demonstrated by the success of modern corporations in the mature market economies.

Compared with the ideal situations, the task of the Chinese government in transforming its SOEs from the hierarchical factory system to the modern corporation seems very challenging but not impossible. The key lesson from the above analysis is that the government should focus on establishing limited liabilities for its investment in industrial enterprises. A possible short-cut here may be to free-ride the non-state investors' efforts in exercising their ownership rights by limiting the state investment in individual enterprises to less than 50% or lower through proper legislations and to limit the government owners' function to administrative monitoring of the state's legitimate share of dividends and capital gains from its equity investment. Ironically, according to our analysis, an aggressive approach to state investment in enterprises with the objective of maintaining and increasing the value of the state assets may end up with unlimited liabilities for the government. On the other hand, a passive approach to limit and diversify the state investment with the objective of achieving real limited liabilities for its investment in the enterprises may increase the value of the state-owned assets.

The broad empirical evidences supporting the above analysis can be found in the rapid development of Sino-foreign joint-ventures and the non-state sectors in China since 1980s and the revenues and non-pecuniary benefits they have brought to the Chinese government as well as their contributions to the rapid growth of the Chinese economy. Without much question, the State has played much less a role and has much less stake in the joint-ventures and non-state

sectors than in the state-owned enterprises. However, the two sectors have become now the engine of growth for the overall economy.