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Harold Demsetz On Development: A Comment

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Professor Demsetz has called to our attention an important but largely ignored issue: the role of wealth and its distribution in effective control of enterprises in reforming socialist economies.

Based on studies of developed market economies, Demsetz argues that inequality of wealth distribution facilitates effective control of large enterprises by a few major shareholders. Since effective control of enterprises is necessary for efficient production of outputs, it is important to put wealth distribution into the production function as an input. More specifically, a reasonable (but not extreme) degree of inequality is conducive to effective control of large enterprises and is useful for the development of modern industries based on large enterprises. The relatively equal distribution of wealth (diffuse ownership of privatized enterprises) in the reforming socialist economies weakens effective control of large enterprises and hinders their economic development.

The incentive effects of acquiring wealth on production have been well emphasized by economists of the property rights school and widely recognized by other economists now. This "incentive principle" may be concisely characterized as a productive matching of effective control and the associated high returns. However, the positive role of having wealth on

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[1] This is a comment on a paper titled "Putting Wealth and Enterprise Control in the Production Function with an Emphasis on Economic Development" by Harold Demsetz. I would like to thank Chris Hall for helpful discussion and comments on the draft.

effective control of enterprises and indirectly on economic development (let's call it "wealth-control principle") is something new and needs more discussion.

Having wealth (or inequality) may be a necessary condition for effective control but may not be a sufficient condition. It is hard to see how a randomly distributed inequality among citizens could have any positive effects on an effective control of large enterprises. Wealth together with control skill of the wealth owner may be sufficient conditions for effective control. But, wealth and control skill may not reside in the same person. Whether the skill for controlling large enterprises can be acquired through training is an empirical question. Also, even if training is effective for acquiring control skill, there is an empirical question of how much an effective training of control skill would correlate with great personal wealth. There is an old Chinese saying that a rich family shall not last beyond three generations. Unlike an input of resources, inequality by itself seems hardly able to generate effective control of large enterprises and raise output. Instead of as an input, the degree of inequality seems better regarded as a constraint on output possibility. Restrictions on inequality of wealth may eliminate high output production alternatives.

A substantive question is to what extent the wealth effects on enterprise control are different and can be separated from the incentive effects of acquiring wealth. The same question can be asked in alternative but equivalent ways: Is the "wealth-control" principle a necessary condition of the "incentive principle"? Will a breakdown of the "wealth-control" principle necessarily lead to a collapse of the "incentive principle"? If major shareholders are barred from effective control of large enterprises, will a productive matching of effective control and high returns fail?

If plausible answers to the above questions are all "yes", a policy of tolerating inequality will be a pre-condition for a full practice of the "incentive principle." If the answers are the opposite, then tolerating inequality may bring about something that the "incentive principle" is not able to do. In this comment, I will show that the answers to the above questions are likely to be "yes" for developed market economies and "no" for transitional socialist economies. The way institutions and forms of wealth differ in the two system explains the different answers.

As Professor Demsetz has demonstrated forcefully, empirical studies do not show any serious separation of ownership and control in large corporations of developed market

economies. On the other hand, the Chinese authorities have pushed forcefully a separation of state ownership and state control in the state-owned enterprises since the start of industrial reform in early 1980s. As a result, a sort of Berle-and-Means separation thesis has been revived in China in theory as well as in reality. Many economists in and outside of China have argued that the separation of state ownership and state control in China is a positive step toward a more efficient market-oriented system.

Two major reasons are behind the support for the separation thesis in China. First, the State is ineffective in monitoring mis-management of the state-owned enterprises but is a source of administrative intervention to normal enterprise activities. The separation thesis serves to reduce the disruptive intervention by the State. Second, there are many alternative ways to delegate control to managers and reward effective management of the state-owned enterprises through profit contracts, bonuses, in-kind benefits such as housing, future business opportunities, and even bribery from private sector. Hence, the "incentive principle" may be practiced by specifying property rights and enforcing contracts without an explicit ownership structure modelled on the Western style.

In a typical state-owned enterprise in China, the State or the Chinese people as the major shareholder is largely separated from control of the state-owned enterprises. This separation, however, does not violate the "incentive principle". The State does not get the amount of profits it might as an owner but nor does it apply any effective monitoring effort to generate profits.

The management largely controls the enterprises and derives returns for themselves in many forms other than ownership entitlement. Although two thirds of the state-owned enterprises implicitly or explicitly lose money, most managers and supervisors of these enterprises are able to generate handsome streams of cash, consumption, and other benefits for themselves and their friends year by year. These cash and consumption streams are a sort of restricted wealth. This restricted wealth has been rooted in the control power of the managers and supervisors. Part of the wealth accumulation may be regarded as implicitly sanctioned stealing of the State property. But, this stealing is perfectly consistent with the "incentive principle." The acquiring of this restricted wealth in China, whether by stealing or by hard work and talent, is indeed consistent with the "incentive principle". After all, the more "able" supervisors and managers have done their job of "enlivening" the state enterprises and got

compensation from it. The ability of the supervisors and managers may include the skill and knowledge of manipulating the current but transitional rules and personal connections. The enlivened enterprises may not maximize profits but would certainly like to maximize cheap loans from the state banks. In summary, de facto ownership of control rights has led to accumulation of restricted wealth.

The distribution of the restricted wealth is highly unequal. However, unlike pure private wealth, this kind of restricted wealth can not easily be mobilized to form concentrate ownership as to acquire control in other large enterprises. Inequality in the distribution of this restricted wealth may not help effective control of large enterprises.

The situation of the state-owned enterprises in China is a case in which the "incentive principle" has been practiced but the "wealth-control principle" has not. When the State as the major owner is barred from effective control of the state-owned enterprises, a productive matching of effective control by the managers and high returns to them in the form of restricted wealth becomes possible. However, the restricted wealth does not have the same control function as pure private wealth has.

Hence, at least in China's transitional economy, wealth, the distribution of wealth, and the restrictions and rights associated with wealth, do have important effects on enterprise control that are independent of the incentive effects of acquiring wealth.

If major shareholders of a U.S. corporation are barred from effective control of the corporation, is it possible for the management to take control of the corporation and get high returns from their work like the Chinese managers? A "yes" answer would imply separation of ownership and control, -- a possibility for managers to take advantage of the major shareholders (stealing or opportunistic behavior). Developed market economies can not eliminate these opportunistic behavior. But the probability that it happens would be much lower than that in a transitional economy with a dominant state ownership. The major shareholders deprived of control rights would not sit idle to allow the stealing. The stealing, shirking, or opportunistic behavior is not inconsistent with the "incentive principle." However, the restrictions on major shareholders' realizing returns from their active and effective monitoring and control are contradictory to the "incentive principle". In the case of the Chinese state-owned enterprises, the State (or diffuse owners of all Chinese people) is not able

to monitor or control effectively and should not get the associated returns, according to the "incentive principle".

Hence, in developed market economies, a violation of the "wealth-control" principle is more likely to lead to a breakdown of the "incentive principle" than in transitional socialist economies. This seems being driven by the difference in permissiveness and protection of private property rights, private wealth, unequal distribution of wealth, legitimate rights associated with wealth between the two economic systems.

Demsetz is right that wealth and distribution of wealth (I would also add the rights and obligations associated with wealth) have more important effects on enterprise control in transitional socialist economies than in developed market economies.

A state ownership system may practice the "incentive principle" and implicitly favor the more able individuals but is not able to protect the less able ordinary Chinese people, or diffuse owners of the state property. So, the more able may easily "exploit" the State or the less able Chinese people.

On the other hand, a private property system protects private wealth and the associated rights of both the able and less able wealth owners while practices the "incentive principle" at the same time. So, the more able may have higher income than the less able but may not easily "exploit" the private wealth of the less able.

In current Chinese system, how well a state-owned enterprise is run depends heavily on its managers. But, the competition for managerial position is not in an open market and has no stable rules. Owners, when they are governments at various levels, do not usually select the best managers. Realizing this hazard of being fired in the future, the more able managers now start to select board of directors and owners (governments at various levels with state assets and other state-owned enterprises). One of the latest innovation in the competition for managerial power is to form a new type of joint-stock companies that include individual shareholders as well as a large number of "legal person" shareholders of state-owned work units. These state-owned work units together usually hold more than 50% assets of a joint-stock company although each unit owns only a few percentage of the company. As a result, the managers in this kind of companies have effectively established a truly diffuse ownership structure and also kept state ownership dominant. Unlike an equitably privatized enterprise in Eastern Europe, this Chinese state-owned enterprise is tightly controlled by the

core management group through their own personal influence. These managers have strong incentives to steal as well as to perform well in their managerial responsibility. It is difficult to distinguish stealing from performing duties. But, it is obvious that at present this kind of companies provide these managers a golden opportunity to accumulate wealth and develop a successful career. It is understandable that they will not shirk prematurely as much as to destroy their bright future. On the other hand, the control and ownership are separated in this kind of companies and may generate unproductive consequences. A simple solution for the problems of the separation of ownership and control is to translate the entrepreneurial skill of managers into formal shares of the company assets. If this becomes possible, the current Chinese enterprise system may provide an alternative way of wealth accumulation according to entrepreneurial skills and may facilitate effective enterprise control in the future.

But, there are many problems with this mode of growth, development and wealth accumulation without formal privatization. They include the unfair process of the competition for managerial positions, the cost of uncertain enterprise control, and more seriously the macroeconomic consequences of liberalizing these enlivened state-owned enterprises.

At any particular point in time, the amount of state assets are a fixed amount. If no new investment, there will be a limit to the stealing of state assets by their supervisors and managers. However, the state-owned enterprises are more able to get loans from the state banks than other private or collective enterprises. These new loans to the state-owned enterprises create permanent opportunities for their supervisors and managers to steal state property. The competition for stealing state assets would only reduce the profits of the state-owned enterprises if the Chinese central bank can effectively control money supply. However, the central bank has not been able to control total credits because of (1) heavy subsidies to the state-owned enterprises from both the budget and the bank loans, (2) large amount of low interest policy directed loans to the state-run farm product procurement network and other key state supported projects, and (3) pressures from the local governments and their enterprises for more financial resources. Inflation results. Serious Inflation endangers not only the state sector but also the non-state sector that has been the engine of growth for the Chinese economy in recent years. To deal with inflation, the central government has to face with a powerful group of local and central bureaucrats which have effectively controlled the

enlivened state-owned enterprises. The chance for the central government to succeed on this battle without privatization is slim.

In addition to a general analysis of wealth and enterprise control, Demsetz also suggests in this paper specifically that some Western market institutions, such as a sound security law protecting minority shareholders and a buy-back option of open-ended mutual funds, may enhance the control (or monitoring effectiveness) by diffuse owners. The buy-back option requires that the open-ended mutual funds buy back any shares invested by their shareholders if they are not satisfied with the fund performance and do not wish to hold the shares anymore. The threat of exit from the funds puts pressure on the fund managers to perform well and works as an instrument of monitoring the fund managers. This monitoring instrument is absent in joint-stock companies since the funds raised by the companies can not be withdrawn by their shareholders. The shareholders can sell their shares to other investors. But, the transaction has no direct effects on the size and utilization of the assets already invested in the joint-stock companies.

Demsetz's specific policy suggestion that certain institutions may be used to enhance enterprise control by diffuse owners seems contradictory to his general (philosophical) analysis about the effects of wealth distribution on enterprise control. In general, Demsetz emphasizes the essential positive function of inequality in economic development. However, if the open-ended mutual funds and other institutions are truly able to get around the control problem with the diffuse owners, equal distribution of wealth will not hinder economic development. Diffuse owners of equal wealth will be able to control their open-ended mutual funds, which will then control effectively large enterprises. Profits from these large enterprises will lead to wealth and equal distribution of wealth among the diffuse owners. In order not to misread Demsetz's message, it is necessary to scrutinize this "superficial" contradiction.

The constraint that requires open-ended funds to give back original capital to shareholders if they want will limit opportunism by the fund managers but will also limit their ability and willingness to monitor closely the enterprises they invest in.

In developed market economies, open-ended funds are only one of many alternatives for investment. An array of investment institutions (banks, open-ended funds, close-ended funds, joint-stock companies (diffuse or concentrate ownership) can facilitate various

dimension of investors' preference and endowment (risk, returns, wealth and distribution of wealth, control interest and possibility etc.)

The open-ended funds are more likely to enhance enterprise control by diffuse owners in the advanced market economies, where the demand for its control function seems not so strong, than in the transitional socialist economies, where the demand for its control function seems potentially very strong.

In developed market economies, the control function of open-ended funds works on the top of many private market institutions (private banks, capital markets, markets for fund managers, and other financial markets and institutions). However, China does not even have meaningful private banks.

At the present, the costs of running mutual funds and then using them to monitor large enterprises may be higher than that of managing the large state-owned enterprises through the so called "Contract Responsibility System" which has been fashionable since the beginning of China's industrial reform in early 1980s. However, as China deepens its reform in industrial and financial sectors, the costs of using alternative institutions for enterprise control may change. Lessons about how market institutions work in developed market economies provide crucial insights about problems and solutions of China's present transitional economic system and the emerging market system in the near future.