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On The Absence of Anonymous  
Private Legal Corporations in China

J. Ray Bowen II and David C. Rose

ON THE ABSENCE OF ANONYMOUS PRIVATE LEGAL CORPORATIONS IN CHINA

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## **On the Absence of Anonymous Private Legal Corporations in China**

### **ABSTRACT**

In a recent paper, Kirby (1995) examined the evolution and effects of China's Company Law. Among other objectives, it was hoped by the Qing Reformers of the period that the Company Law would foster the emergence of Western style corporations in China. Almost a century later not a single large, anonymous private legal corporation has emerged in China. This paper provides an answer to this puzzle. In short, we show how the practice of using discretionarily applied fees rather than explicit (and stable) tax rates to raise government revenues attenuates the private property right to being a residual claimant to income, making truly private stocks an exceptionally poor investment in China. This means that in China the costs of the corporate firm structure are not offset by the benefit of low cost of raising equity capital.

## I. Introduction

In a recent paper, William C. Kirby (1995) provides an historical analysis of the development of China's Company Law. The Company Law, which was originally crafted in 1904 to promote industrial development by codifying a commercial code, was aimed at achieving the following three broad objectives. First, it was hoped by the Qing Reformers that the Company Law would lead to an abolition of extraterritoriality. In the Sino-British Treaty of Commerce of 1902, Great Britain linked the termination of its extraterritorial claims to the adoption of legal institutions, such as a formal commercial code, which would obviate the need for extraterritoriality. Second, the Company Law was to serve as a tool for maintaining central government control over the economy. Put simply, the Chinese central government saw no reason to promote industrial development over which it had no control.

The third objective, which is the focus of this paper, was to provide institutional support for the emergence of what Kirby refers to as "anonymous private legal corporations on a Western model." Kirby noted that it was a widespread belief among the Qing reformers and the Ministry of Commerce that "Modern industrial capitalism . . . demanded Western corporate structures to do business." (Kirby, 1995, p. 43).

Kirby argues that after numerous revisions it has become clear that while the Company Law has achieved the first two objectives, it has clearly failed to promote the emergence of private corporations. Given China's rich commercial tradition and its rapid economic growth over the last two decades, the absence of even a single large, *anonymous private legal corporation* (APLC) in China is indeed a truly a baffling puzzle for China scholars.

In this paper we advance an answer to what we shall refer to as "The Kirby Puzzle." Our explanation for the absence of APLCs is based on the impact that government opportunism has on the choice of an optimal governance structure for the firm. Our analysis provides a relatively simple answer to the Kirby Puzzle which is also quite consistent with Kirby's own suspicions. Kirby posits that the absence of APLCs is probably due to either the lack of trust and predictability of the government or the sheer success of indigenous family firms. In this paper we go a step further, showing how the lack of trust in the government actually contributes to the success of the family firm while thwarting the emergence of APLCs at the same time. Finally, this paper also contributes to the property rights literature by showing precisely how government opportunism attenuates private property rights and how this blocks the emergence of institutions which are necessary to enjoy the full measure of benefits of the market economic system.

If, as the Qing reformers of the period suspected, the absence of APLCs is an insurmountable impediment to a full realization of the benefits of a market economic system, then the Chinese leadership should have been interested in exploring reforms which might better promote the emergence of APLCs. Consequently we begin our analysis with an examination of the developmental benefits of the corporate governance structure. We then document the Chinese government tradition of relying principally on discretionary fees as a source of government revenues rather than explicit taxes. What has been well-understood by Chinese citizens for centuries is that this way of raising government revenues inevitably invites opportunism, devolving into a simple rent-seeking exercise. We explain how this form of opportunism significantly attenuates the private property right to being a residual

claimant to income generated by the firm. We then show how this makes the corporate governance structure an unattractive choice relative to that of family firms, ultimately driving all significant private economic activity into family firms.

The introduction of stock offerings by state enterprises has been interpreted by many China scholars as a logical first step to promoting the emergence of APLCs. In this paper we show that the Shanghai and Shenzhen stock exchanges and stock-offering state enterprises are not, in fact, bridging institutions to APLCs and may actually impede their emergence.

Although we will argue that the answer to the Kirby puzzle is fairly simple, the impediments to the emergence of APLCs in China are nevertheless fundamental. No amount of incremental reform will generate the APLCs that China's leaders so desperately desire. What is needed, we will argue, is a system of property rights which can protect residual claimants from government opportunism. While in other countries external factors have provided a measure of assurance that property rights will be respected, in China this can be credibly implemented only by reforms which introduce some degree of accountability on the part of the central government. As for this we are not optimistic; it is not for nothing that the Chinese post-1978 reform program has been exclusively economic reforms, not political reforms. Almost a century has passed since the Chinese introduced the Company Law to promote the emergence of APLCs. It appears likely that without fundamental political reform, the prospects are no better for the next century.

## II. Does the Absence of APLCs Impede Economic Development?

Although never specific, Kirby does imply that the absence of APLCs may be problematic for continued Chinese economic development. The Qing reformers clearly believed so almost a century ago (Kirby 1995; Li 1974) and the prominence of APLCs in modern industrialized nations seems to confirm this view. But given the rapid rate of economic growth China has been experiencing for almost two decades, concern for the continuing absence of APLCs is itself something of a puzzle. Has not China shown that rapid economic growth need not be based on Western style institutions such as APLCs?

There are several problems with the view that China should be content to continue to develop the "Chinese Way."<sup>1</sup> The most obvious problem is that China's growth comes immediately after lifting a number of socialist controls that can be shown to reduce economic efficiency.<sup>2</sup> The devolution of central planning to local governments and the acceptance of market prices rather than government determined prices will lead to rapid growth wherever such constraints had long been in place. Moreover, before the economic reform program China was essentially closed to foreign trade. This artificially restricted China's extensive growth prior to the economic reform program. As a result, the opening-up of China to foreign trade has produced Ricardian efficiency gains which, in turn, fueled even more extensive growth. In short, a country with a number of impediments to economic deve-

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<sup>1</sup> Official jargon of economic policy holds dear the idea of a unique Chinese way, and many foreign analysts have entertained this idea during successive policy periods. During the post-1978 reforms, this view continued to be promoted with terms such as "Socialism with Chinese Characteristics," and "Socialist, Commodity Market Economy." See Hsu (1991).

<sup>2</sup> For a discussion of the centrality of restraint-lifting to the philosophy and blueprint of China's reforms see Lin (1981).

lopment will always move closer to fully attaining the goal of being a modern developed economy upon the removal of particular impediment, but the resulting growth spurt may mask the deleterious effects of the remaining impediments for quite some time.

Recent advances in the institutionalist literature suggest that the absence of an institutional environment capable of inducing the emergence of APLCs may well be a very significant impediment to development. North and Wallis (1994) have advanced the argument that institutional innovations such as the creation of a commercial code or the provision of support institutions such as courts to adjudicate contractual disputes can dramatically reduce transactions costs and, hence, make economies more productive. Such institutional innovations can therefore be a source of intensive growth and may be every bit as important as technological innovations for becoming a fully developed economy. The absence of APLCs suggests the absence of requisite support institutions which make possible their natural emergence. It is likely that the institutions that support the emergence of APLCs in Western nations support other aspects of economic development as well. If this is the case, then the absence of APLCs in China may signal very fundamental deficiencies in the Chinese economic system.

Jensen and Meckling (1979) have argued that in addition to the obvious technological aspects of production, the property rights structure within the firm is also an important determinant of productivity. Firms that do a better job aligning worker incentives with firm owner objectives will, for example, produce more output with the same amount of inputs. This benefits both the firm owners and the workers. Although difficult to model mathematically, this means that the structure of property rights within the firm is also an essential

aspect of the firm's production function.

North's insight suggests that the reason why APLCs haven't emerged might be China's failure to embrace one or more institutional innovations that are already common among nations where APLCs exist. Jensen and Meckling's insight suggests that the failure to provide such institutional support may then affect the feasible set of property rights structures within firms in such a way as to make them less productive than would have been possible under an alternative institutional landscape. This raises the possibility that while family firms are the most productive firm form given China's institutional landscape, firms in China might nevertheless be much more productive if they could allocate property rights along the lines of a corporate firm. The absence of the corporate firm must therefore not be taken as *ipso facto* evidence of the fact that corporations are destined to suffer lower productivity in China since it is yet to be demonstrated that the institutional support mechanisms that would support corporate firms are impossible to implement in China.

In nations where there is much institutional and political support for the creative and confident allocation of property rights within the firm the corporate firm emerges as the dominant firm form for large scale production. If such nations are competitive in output markets where corporations tend to dominate, this implies that corporate firms must be more productive than alternative forms. In other words, the property rights structure associated with corporate firms must increase productivity more than the corporate form decreases productivity through other effects.<sup>3</sup>

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<sup>3</sup> There is a substantial literature on the downside of corporate structure. The most prominent set of problems are those that arise from the separation of ownership and control.

The preceding discussion outlines cogent economic arguments for why China's inability to foster the emergence of APLCs may significantly retard China's economic development. We therefore believe that the corporate firm should not be dismissed as being irrelevant to China because it is nothing more than an alternative way--in this case the Western way--of organizing production. Given requisite institutional support it is more likely that the corporation is, in fact, simply a better way to organize production regardless of culture. This also raises doubts about the argument that it is the sheer success of family firms that explains the absence of APLCs in China. But if corporations really are better, then something fundamental must be at work to thwart their emergence in China. So why don't Chinese businessmen choose the APLC form? In what way has the reform program failed to provide the institutional landscape needed to foster the emergence of APLCs?

### **III. The Role of State Opportunism in China**

While it is natural to think that the reform program has failed in some way to provide the institutional changes that are needed to support the emergence of APLCs, another possibility is that something has impeded their natural evolution. The central thesis of this paper is that the practice of using discretionarily determined fees to raise government revenues might be such an impediment. In this section we document the practice of using fees to raise government revenues in China.

It is common knowledge in China and among China scholars that fees are widely used as a means of raising revenues.<sup>4</sup> This form of revenue generation differs markedly from

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<sup>4</sup> A description of this practice and its affect on firm organization during the late Qing and early Republican era is found in Gardella (1992).

explicit taxation because such fees are levied and altered at the discretion of government officials. This discretionary authority invites opportunism, which takes the form of adjusting fee rates in response to changes in extractability. Consider, for example, a firm which normally earns of profit of \$100 per week. Through various fees the government might extract \$50 of this profit, leaving the balance of \$50 because anything less than a \$50 "after-fee" profit might compromise the firm's viability. Now suppose profits rise to \$200. If government revenues were generated by taxes this would imply an increase in revenues to \$100 (based on the implicit tax rate of 50%). In China, however, the government revenues generated by fees would rise to \$150, because the government has no incentive to leave anything but the \$50 in profit (for the firm to remain viable).

The use of fees to raise government revenues and the opportunism this invites has a long tradition in China. The expectation that government officials will exploit any new information to increase their ability to extract economic rents is widely understood and accepted as nothing unusual by Chinese citizens. Indeed, one could argue that it is an ubiquitous expression of Chinese culture.

If the Chinese central, provisional and village governments are so willing and able to be opportunistic, then why is the government's share of total output so low? Researchers examining the role of government in various periods from the late Qing Dynasty onward have come to the conclusion that government collections amount to a relatively small proportion of total output.<sup>5</sup> We believe that it is a mistake to conclude that because revenue collection is low, opportunistic vigor is also low. While it is certainly true that the amount

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<sup>5</sup> See Rawski (1989).

of revenue generated through fees is an increasing function of government effort to extract rents, it is also a decreasing function of the firms' ability to hide profits. In short, a low level of revenue extraction is at least as likely to be the result of an evolved response on the part of family firms over the past two millennia to be as secretive as possible as it is to be a reflection of extraction incompetence on the part of Chinese government officials. This is an important point, for it suggests that if extractability were to rise because firms reorganized themselves in some way, revenue extraction would also rise; presently low levels of rent extraction notwithstanding.

For a variety of ideological and pragmatic reasons, the Communist Party of China (CPC) effectively eliminated much private business and commerce during the first thirty years of its rule. During this period, a substantial source of fiscal revenue in the PRC was the remittance of "profits" (roughly speaking, the net of sales at state-administered prices minus the costs of factors at state set rates of factor return). A key feature of this was the manipulation of administered prices so as to concentrate these accounting profits in sectors where the probability of success in extraction was highest, namely urban industrial enterprise under state control. Much of such revenue was collected from activities under the auspices of the central government: state-owned enterprises and relatively large scale provincial and local enterprises, generally also linked to the central government by formal ties to State industrial and commercial ministries. Profit remittance as a vehicle of revenue collection was, of course, done in a way which was quite consistent with the Chinese tradition of collecting revenues in an opportunistic manner.

Following the waves of decentralization of economic autonomy after 1978, the discretionary assessment of fees assumed a degree of importance reminiscent of the late Qing dynasty. This is well documented by Oi (1992).<sup>6</sup> The post-1978 reforms induced local government officials to establish industrial and commercial enterprises.<sup>7</sup> The ensuing growth in production by Township and Village Enterprises (TVEs) became a major force behind the sustained phenomenal growth of GDP and income per capita since the 1980s.<sup>8</sup> This resulted in a massive shift of the share of total revenues collected by all levels of government toward the more local units.<sup>9</sup>

Some of the revenues are collected as taxes.<sup>10</sup> However, a larger share of government revenues is collected through "extra-budgetary revenues," "contracted profits," "management fees," and other *ad hoc* charges including assessments for pension funds and other employee benefits.<sup>11</sup> These various extractions are negotiable through a number of mechanisms, which makes this system all the more discretionary in nature.<sup>12</sup> Altogether, amounts ranging from 30% to 70% of accounting profits from TVEs may be taken by the

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<sup>6</sup> This section draws heavily on the evidence assembled by Oi (1992).

<sup>7</sup> See Granick (1990).

<sup>8</sup> The output of TVEs grew tenfold from 1980 to 1990.

<sup>9</sup> Naughton (1992).

<sup>10</sup> Such taxes include the income tax, product tax, turnover tax, industrial-commercial tax, circulation tax, and value added tax.

<sup>11</sup> Oi (1992) pp 105-6.

<sup>12</sup> Oi (1992) pp 106-111.

local government, but this continues to amount to only a small percentage of the flow of overall economic activity.

The practice of discretionary fee extraction has a long and deep-rooted history in China, continuing into the post-1978 reform period. It is a well-known aspect of Chinese culture and an accepted fact of life among Chinese citizens. While the amount of government revenues raised as a share of total economic activity is low by Western standards, the discretionary nature of this form of revenue generation nevertheless has profound implications for the development of Chinese business practices. To be specific, all significant economic activity has been driven into either state-affiliated enterprises or highly secretive family firms. Although the stated purpose of the reform program was to modernize the Chinese economy by introducing new institutions such as APLCs, in reality the decentralization of government authority under the post-1978 reforms has actually increased the scope of state opportunism.

In the next section we argue that state opportunism afforded by discretionary fees is responsible for thwarting the emergence of APLCs. It is for this reason, we suggest, that the Chinese governments' use of fees to raise revenues should be recognized as a fundamental obstacle to China's continued economic development.

#### **IV. The Costs and Benefits of Firm Structure**

The hallmarks of the modern legal corporation are that: 1) corporations are juristic persons apart from their owners, 2) owners of corporations can only be held liable for the actions of the firm up to their personal investment in the firm, and 3) corporations can anonymously raise capital from equity markets. The Qing reformers were aware of the importance of these attributes and therefore addressed these issues in the 1904 Company Law. The law already explicitly provides, for example, for juristic person status and limited liability. But the third hallmark, that of being able to raise private capital anonymously, is not something that can be legislated into existence. True capital markets emerge spontaneously and do so only when it is in both the firm and the potential investor's best interest to buy and sell shares of firm ownership.<sup>13</sup> This, we will argue below, is not the case in China.

In what follows we will show why it is not in any existing family firm's best interest to adopt a corporate governance structure and, even if it were, why it would not be in any investor's best interest to buy the shares of such a firm. On both counts the corporate governance structure is simply a poor choice for existing firms in China.

#### **Why Chinese Family Firms Don't Choose the Corporate Governance Structure**

In the previous section we discussed the degree to which government revenues are raised in a discretionary manner in China, particularly the levying of fees. This degree of discretion invites opportunism, a fact of life that is well-understood by Chinese citizens.

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<sup>13</sup> There is, of course, a stock market in Shanghai. In the next section we will discuss why this does not qualify as a "true" capital market.

What the Qing reformers did not realize when drafting the Company Law was that the traditional practice of using fees to raise government revenues would prove to be a fundamental obstacle to the adoption of the corporate governance structure by existing family firms.

Government officials who raise revenues through discretionary fees have a simple optimization problem to solve: maximize economic rent extraction from any given firm subject to the constraint of not "killing off" the firm.<sup>14</sup> To employ a metaphor from biology, this defines a classic parasitic relationship where the parasite might reduce the welfare of its host, but a successful parasite does not kill off its host. Similarly, extracting so much economic rent that the firm is no longer viable is not in the best interest of the government or any government official, so we can safely assume that this is a self-imposed constraint on fee setting behavior.

The implication of the characterization above is that if government officials had perfect information, they would extract every last yuan of rent short of killing off the firm. This means that the more information government officials have about the firm's profitability, the more effectively they can maximize rent extraction. From the firm's point of view, then, the less information government officials have about the firm's profitability the better, since imperfect information drives up the risk to government officials of over-extracting rents. If government officials are risk averse, it follows that government officials, in the absence of perfect information, will err on the side of failing to extract as much rent as was in fact possible. This, we believe, explains the Chinese family firm's

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<sup>14</sup> This is an application of the well known idea of rent-seeking which was first popularized by Gordon Tullock. For a review of Tullock's work on rent seeking as well as work by others in the public choice literature see Mueller (1989).

obsession with secrecy.

Truly anonymous private legal corporations disperse their profits to firm owners through dividend payments. As a result, anyone who owns even a single share of the corporation knows what the firm's dividend payment per share is at any point in time. In a nation where firms value secrecy because of the ubiquitous opportunism discussed in Section III, the disbursements of profits through dividend payments presents an obvious problem. Just as dividend payments signal financial markets of the firm's financial health, in China they signal government officials of the firm's extractability. The higher the firm's profits, the higher the firm's dividends will be and, hence, the more fee rates can be adjusted upward to raise more government revenue. This is very different than in modern industrial nations where government revenues are generated by explicit tax rates. In modern industrial nations higher dividends do engender higher tax payments to the government, but the tax rate does not continue climbing until it reaches an effective rate of 100%.<sup>15</sup> Moreover, after corporate taxes are paid, all of the after-tax profits wind-up in the hands of the shareholders, whether this amounts to a dividend payment of \$5 per share or \$500 per share.<sup>16</sup>

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<sup>15</sup> This is not to say that modern industrial nations don't have progressive tax rates. The key point here is that even for nations which highly progressive corporate tax rates, the highest rate is not 100%. Yet in a nation where government revenues are generated by the discretionary application of fees we argue that once a firm has earned what government officials deem is a very high rate of after tax income, the rest can be taken by the government.

<sup>16</sup> Some after-tax profits might not be dispersed. Such retained earnings will, however, increase the value of firm and will be capitalized into the firm's share price. Openly traded share prices are every bit as observable by the government as dividend payments, so a strategy of hoarding retained earnings and benefitting the shareholder through capital appreciation rather than dividend income doesn't solve the problem.

Compare this to the situation facing the owners of a family firm in China who are considering the adoption of the corporate governance structure. In this case the owners of a family firm which currently earns a significant "after-fee" profit might, after incorporation to obtain access to cheap equity capital, find that the gains of lower financing costs are more than wiped-out by the government's improved ability to extract rents. Indeed, by adopting the corporate governance structure the firm's "after-fee" profit might fall very near zero even though its "pre-fee" profits rose substantially because of the efficiency gains of the corporate structure.

The preceding discussion suggests that family firms could attempt to secure the benefits of a corporate governance structure without incurring the cost of a higher rate of extraction by government officials by recapitalizing all of their income (that is, by never disbursing any of it as dividends). But the more effectively a corporation hides its profitability by reducing its dividends, the less any potential investor is willing to pay for a share of ownership since the equilibrium price of the firm's shares is determined precisely by expected dividend payments. As a result, avoiding government opportunism by limiting dividends also lowers share prices which, in turn, increases the cost of raising equity capital. The effect of this strategy is to wipe-out the low cost of equity capital advantage promised by the corporate governance structure.

To summarize, Chinese family firms don't reorganize themselves as corporate firms because in China it is impossible for firms to enjoy the biggest benefit of corporate structure--that of being able to raise large amounts of capital anonymously and cheaply in equity markets--without also enabling government officials to more effectively extract rents from the

firm. This means that in addition to extracting any increase in profitability that results from the inherent advantages of the corporate governance structure, government officials will also more effectively extract economic rents that would have been concealed under the family firm governance structure.

### The Investor's Perspective

The preceding explains why existing family firms would not want to adopt a corporate governance structure. We now turn to the issue from the investor's perspective, showing why even if some firms were to adopt a true APLC governance structure there would be little demand for the shares of such a firm in China.<sup>17</sup> The lack of investor demand is crucial since low investor demand implies low share prices and, hence, a high cost of raising equity capital. Since the prospect of enjoying a low cost of raising equity capital is the only feature of corporate structure left to be satisfied in China (the Company Law already provides for juristic personage and limited liability), this is likely the missing piece of the Kirby puzzle.

What makes a corporate firm's shares worth owning is that, as a shareholder, one has a residual claim on the firm's profits. This means that as a part owner of the firm the shareholder is entitled to share in the profits of the firm, net of debt obligations, in direct proportion to the number of shares owned. The ownership of shares also implies a measure of political power in that shareholders have the right to elect the corporate board. Since each

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<sup>17</sup> The absence of demand for shares issued by an APLC firm in China is not to be confused with other peripheral issues. Among these issues are the huge excess domestic demand for wealth-holding assets in China, and a certain amount of international demand for Chinese assets as stores of wealth and generators of income.

share counts for one vote, this political power is also in direct proportion to the number of shares owned.

Shareholders (who are residual claimants) differ from bondholders (who are not residual claimants) in the following way: bondholders are guaranteed a certain rate of return, but even if the firm does very well they will be paid no more than this rate of return. Shareholders are not guaranteed a minimum return on their investment, but as residual claimants they do share in the firm's profits no matter how high the profits rise. Although shareholders may get nothing from their investment if the corporation does poorly, they can potentially earn an extraordinary return on their investment since dividend payments are unbounded. Since shareholders are residual claimants, the greater the likelihood a given firm will enjoy high profits and the higher future profits may go, the more investors are willing to pay to own shares of the firm.

Opportunistically imposing fees or increasing fee rates in response to increased dividend payments has the effect of making the government the residual claimant rather than the firm's shareholders. The more aggressively the government adjusts fee rates or levies new fees to extract firm profits, the less valuable is the property right to being a shareholder in the firm and, hence, the less one would be willing to pay for such a privilege. Put another way, potential investors--especially Chinese investors who are familiar with the opportunistic nature of the Chinese central government--anticipate an opportunistic response to high dividends and therefore discount their willingness to pay for such shares.

What the Qing reformers did not realize is that the practice of using discretionary fees to raise government revenues would have the effect of dramatically increasing the cost of

raising funds anonymously through private equity markets because potential investors would anticipate that government officials would be induced to opportunistically adjust fees upward in response to high dividend payments. This dramatically reduces the value of firm ownership and, hence, any potential investor's willingness to pay for the right to such ownership.

In short, the practice of using fees to raise government revenues makes it impossible to disburse firm profits through explicit dividends. But it is only through formal, public, explicit dividend payments that the corporate form generates large amounts of low-cost equity capital since only in this way can one raise money from strangers. The lesson is that the Chinese government's tradition of using fees to raise government revenues invites opportunism which is now a prominent feature of the institutional landscape in China. The problem is that this opportunism drives economic activity either into institutions which are protected by association with the state such as state enterprises or TVEs, or into private institutions which are capable of being highly secretive such as family firms. In China there are no private but "open" firms such as APLCs.

#### **V. The Impact of Chinese State Corporatism on the Emergence of APLCs**

The terminology of China's economic reforms has borrowed a great deal from the lexicon of capitalist market economies. This includes many terms commonly applied to APLCs in the US and other capitalist economies.<sup>18</sup> The associations generally drawn

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<sup>18</sup> Jargon borrowed from capitalist business practices include, for example, the terms used in bankruptcy law, copyright law, and the regulations for the issue of "stocks" and "bonds," as officially sponsored by the central government of the PRC. In addition, outside analysts have

between the market and capitalism could lead observers to conclude that APLCs are already in existence or that their emergence in China is inevitable. Upon close inspection, however, the institutions referred to in the case of "state corporatism" and other terms are not, in fact, really corporations at all, nor even close to being corporations in the sense of the functions fulfilled by true APLCs, as discussed above. In most cases the use of corporate jargon turns out to simply refer to aspects of governance structure that differs from previous, more tightly centralized socialist planning. The fact that "officials [are] acting as the equivalent of a board of directors," as put by Oi (1992), does not distinguish the nature of the growing local state business forms so much as the mere fact that reforms devolved economic autonomy down from more central, ministerial levels of government, straight into the counties, townships and villages, thereby lifting a restriction on activity. While the more disaggregated nature of this activity certainly relies upon increased use of market allocation, the fact remains that managerial prerogative continues to lie with *officials*, not private business entities.<sup>19</sup> In this sense, by delegating economic autonomy to local officials, but guarding and preserving the supremacy of the CPC in government at all levels, the central government has simply re-created a socialism at a lower level--creating what one could call *local state socialism*.

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made special use of corporatism, as in "local state corporatism" and "socialist corporatism." See Oi (1992, 1995) and Pearson (1994).

<sup>19</sup> Oi (1992) points out this fact.

Nor are these institutions in China transitional, despite arguments made to the contrary in China and abroad.<sup>20</sup> Consider the interpretation of the TVEs as an alliance with government authority by private interests seeking protection from government opportunism. Are these firms stepping stones to true APLCs as is often implied in the literature? We would argue that they are not; that they are, at best, only devices to ward off higher levels of government opportunism.<sup>21</sup> Indeed, central and local state-sponsored enterprises which exist ostensibly as bridging institutions are actually obstacles to the emergence of true, indigenous APLCs.

State-sponsored enterprises obstruct the emergence of true, indigenous APLCs in at least two ways. First, the most natural market niche for APLCs is a niche where the nature of the production technology confers the greatest advantage to the APLC organizational structure. Historically, in modern, western economies this has been large-scale manufacturing. In China, however, large-scale manufacturing has been promoted, owned and managed by the state; a legacy of the Qing, Republican, and then the early PRC eras.

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<sup>20</sup> For an argument that Chinese local government-owned firms are transitional see Nee (1992).

Note that the term "transitional" is largely absent from Chinese reform literature despite its increasingly widespread use in Western literature on China's reforms. Perhaps Chinese analysts avoid this term because of the historical associations that it invokes. "*Guodu*," the Chinese term for "transition" or "transitional" was broadly applied used in the literature of the 1950s in the context of transforming the received economic institutions into more and more nationalized, state-controlled socialist forms. This, however, simply meant a tightening of state control and extension of its reach until it permeated almost all institutions. Thus, it is antithetical to the idea of opening, reform and the kind of change that is the purported goal of the post-1978 reforms.

<sup>21</sup> This is well documented by Nee (1992) Oi (1992 and 1995), and Pearson (1994).

As a result, state enterprises have pre-empted the most natural market niche of the APLC.

The second way that the existence of state enterprises impedes the emergence of APLCs is that the state enterprises enjoy a competitive advantage over any private firm. The advantage enjoyed by state enterprises and state-affiliated enterprises takes two forms. First is the obvious possibility of outright favoritism and preferential regulatory treatment. It has been well-documented that one of the most important functions of a business in China is to establish network connections with relevant government agencies. The connections are then used to obtain favorable interpretations of the existing rules and to lobby for new rules which confer additional advantages.

The second competitive advantage that state enterprises would have over APLCs is that since the government is the *de facto* residual claimant of the APLC, the effective "after-fee" profit level will be higher for the state firm. In competitive equilibrium with zero economic profits, this implies the non-existence of the APLC form. Similarly, when a state enterprise experiences falling output demand, it will be more likely than its APLC competitor to receive "regulatory relief," which confers a significant advantage to state enterprises.

The existence of the Shanghai and Shenzhen stock exchanges might be interpreted as *ipso facto* evidence of the existence of corporations in China. These exchanges allow trading in domestically issued stocks and bonds and became a prominent feature of the reform programs during the early 1990s. The Shanghai securities exchange opened in December 1990 and the Shenzhen securities exchange opened in July 1991.<sup>22</sup>

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<sup>22</sup> See Prime (1993).

But while reform period experiments in various "shareholding systems" date back at least to 1987, these "securities exchanges" allowed trading by the government only. Moreover, less than one hundred companies actually sold stocks at the new Shanghai and Shenzhen exchanges. Thousands of other companies have sold or issued shares to employees, but the sale of these shares is generally restricted. Of the stocks for sale at the Shanghai and Shenzhen exchanges, "A" shares were designated for sale only to domestic individuals and institutions, while "B" shares were for sale only to foreigners and had to be purchased with US or Hong Kong dollars.

While superficially appearing to be like other stock exchanges, these exchanges could hardly be compared to the NYSE or the Nikkei. Only a limited number of qualified state enterprises may issue stocks for sale on the exchanges--no private firms are represented.<sup>23</sup> Moreover, this is not a process of privatization, for the state retains control of all listed enterprises by holding a majority of shares and by retaining veto power over any decisions made by firm managers. Indeed, Chen (1994, p. 5) states:

"The ownership of a corporation in China remains public. Maintaining the dominant position of public ownership to preserve socialism is strongly advocated by some Chinese leaders and economists, and it is a virtual precondition for China's stock market to emerge."

In short, the Shanghai and Shenzhen stock exchanges are not evidence of the existence of APLCs in China.

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<sup>23</sup> Contrast this to the western world where government institutions do not sell stock, only private firms do.

## VI. Conclusion

China's economic development problems are often characterized as being the result of a lack of well-defined property rights.<sup>24</sup> In this paper we have shown that China's property rights problems go beyond the issue of precision of definition. In short, government prerogative to excise fees at the discretion of government officials has the effect of making the government, and not the firm owner, the residual claimant on the firm's income. This effectively increases the cost of raising equity capital, thereby robbing the APLC of its principle advantage over other governance structures in China.

We have also argued that the existence of state enterprise corporations, local state corporatism, and the Shanghai and Shenzhen stock exchanges should not be interpreted as evidence of the reform programs making progress toward the emergence of APLCs. On closer inspection it is clear that these institutions are corporate in name only and may actually impede the natural emergence of APLCs. But we don't want to overstate this last point. The more fundamental obstacle to the emergence of APLCs in China is government opportunism that is facilitated by the use of discretionary fees to raise government revenues. Until China undertakes political reforms to credibly protect the property right to being a residual claimant of the firm's income, true APLCs will never emerge.

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<sup>24</sup> See Cheung (1982).

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