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Karbowski, Adam

Warsaw School of Economics

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The corporate governance implications for China

Adam Karbowski[1]

Summary
The following paper applies agency theory to China's current economic reform program. The financial and regulatory structures necessary for an efficient corporate governance system in China are discussed. The analysis is focused on the Chinese state – owned enterprises (SOEs) and township and village enterprises (TVEs). The first section of the paper seeks to review the essence of the principal – agent problem. The second section explains the 'success story' of the Chinese TVEs. The final part of the paper assesses the efficiency of SOE corporate governance mechanisms in China.

The principal – agent theory

The 'principal – agent problem' term was coined by Stephen Ross in 1973 to refer to the general problem of creating a contract to ensure that the agent pursues the principal's goals as efficiently as possible (Ross, 1973; Alexander, 2006). In a principal – agent relationship a principal delegates some rights to an agent who acts on behalf of the principal in return for a payment. The principal – agent problem arises from two sources: (1) imperfect information and (2) misaligned incentives between the principal and agent (Alexander, 2006).

The principal – agent problem can be alleviated by the employment of an efficient corporate governance mechanism. According to Zhang (2006) corporate governance mechanism governs relationships between different factor-owners of the firm, in particular, between capitalists and managers through allocation of residual claim and control rights by contracts.

Efficient corporate governance implies the following rules:

[1] Department of Economics II, Warsaw School of Economics.

- the matching between residual claim and control rights to the highest possible extent[2] (Knight, 1921),
- managerial remuneration should be closely linked to performance of the firm (Zhang, 2006),
- the authority of selecting and monitoring management should be assigned to capitalists (Zhang, 1994),
- concentration of ownership with large investors is preferred (Shleifer and Vishny, 1997).

Today's China in the post-Mao reform era struggles to employ an efficient corporate governance system. The picture of current economic reforms is however ambiguous. Whereas rural enterprises prosper, state – owned industrial enterprises (SOIEs) in the urban areas bear losses (Zhang, 2006).

The key explanation of this phenomenon can be understood under the principal – agent framework. Only the Chinese township and village enterprises (TVEs) managed to alleviate the agency problem to the considerable extent. SOEs have failed to solve the long-term managerial incentive problem and the management selection problem (Zhang, 2006). The detailed justification of the above thesis will follow.

Corporate governance in rural China

The importance of the township and village enterprises to the Chinese economy is steadily rising. The share of the TVEs in the gross industrial output value of the country rose from 16,3 per cent in 1984 to almost 56 per cent in the nineties (Kwong and Lee, 2000). Annual per capita net household income in rural China rose from 133 yuan in the late seventies to 1926 yuan in 1995 (Kwong and Lee, 2000). When we compare the growth rates of output (Y), capital (K), labor (L) and total factor productivity (TFP) of the TVEs and SOEs from 1979 to 1991, it becomes evident that these indices are much higher in rural areas than in urbanized China (Table 1).

Table 1: Differences in productivity between the Chinese SOEs and TVEs (1979-1991).

	SOEs				**TVEs**			
Factor	Y	K	L	TFP	Y	K	L	TFP

[2] Full matching is impossible, otherwise there would be no agency problem at all.

Growth rate	8,4	7,8	3,0	4,0	25,3	16,5	11,9	12,0

Source: M. Weitzman, C. Xu, "Chinese township-village enterprises as vaguely defined cooperatives", *Journal of Comparative Economics, 18*, 121-145.

One of the explanations of the success of the Chinese TVEs is derived from the principal – agent theory (Kwong and Lee, 2000). The township and village enterprise formally is owned to the local community (the principal) which is acted on behalf of by the township – village government (TVG). In practice, the local community is unable to effectively motivate the TVG. However, the motivational pressure comes from the very top of the Chinese political hierarchy, i.e. higher-level governments (county, province and central governments).

The primary goal of the Chinese central government is to keep stable flows of fiscal revenue from the local areas. The prerequisite for high revenues from taxation is to facilitate economic growth in the localities. The motivational pressure directed at the TVG comes then from the top of the Chinese political hierarchy instead of from the bottom (local communities).

The central government in order to enforce efficiency at the local level has developed the fiscal contract system. The system requires the local governments to submit a portion of local fiscal revenue to the higher-level governments. These fiscal duties motivate the TVGs to offer support and assistance to the TVEs. The local governments provide then technological backup and expertise[3], assist the TVEs to secure bank loans, grant various tax concessions for the TVEs.

Within TVEs, there is another type of principal – agent relationship, i.e. between the TVE managers (principal) and the employees (agents). The managers face two objectives:

- they have to fulfill the financial targets set by the supervising TVGs,
- they strive to maximize their own welfare through the positions they hold in the Chinese economy.

The employees, on the other hand, pursue their own wage maximization and enhancement of the communal welfare.

The system of incentives directed at workers is successfully injected into a reward scheme. According to Dong (1998) the employment and reward of the employees are directly related to the financial conditions of the TVEs. It means that the TVEs work as real market

[3] Transfers of engineers working in SOEs in the urban areas to the TVEs.

and performance based enterprises. Dong (1998) used a panel data of 10 provinces with 200 TVEs from 1984 to 1990 to look into the correlation between financial conditions of the enterprises and the employment and rewards of the employees. It turned out that the wages are responsive to the dominant market salary pattern and the financial standing of the enterprise.

Due to the fact that the profitability of the enterprise determines the size of employment and the benefits of the workers, there is motivation on the part of the employees to work hard. What is more, some portion of the after – tax profits of the TVE is to be used to enhance the communal welfare. This creates an indirect incentive for the staff to work hard in order to contribute to the local area development.

As we see the TVEs in China work efficiently and respond to many market mechanisms. This result at first glance seems to be a real economic puzzle. Under a collective ownership with unclear delineation of property rights productivity of the firm should be adversely affected. However, in case of township and village enterprises we observe just the opposite. The TVEs are developing fast and play more and more important role in the Chinese economy.

This puzzle can be solved under the principal – agent theory. Although only one[4] of the four conditions for an efficient corporate governance system (compare Page 1) is here fulfilled, the principal – agent problem is successfully alleviated by:

- overlapping interests of the various principals (local communities, central government, TVE managers) and agents (TVGs, TVE employees),
- linking the benefits of parties involved with the profits of the enterprises.

In a nutshell, the proper design of the business – government relations in rural China gave birth to the efficient corporate governance mechanism in the TVEs and contributed to the overall growth of the Chinese economy.

Corporate governance in the Chinese SOEs

Before we discuss the Chinese corporate governance mechanisms in SOEs, let me briefly point out the prevailing features of the state owned governance. Under this mechanism, assets are owned by the state and controlled by the special ministry (Ewing, 2005). The ministry appoints members of the Board of Directors and usually selects the

[4] Managerial remuneration is closely linked to performance.

management team. Managers exercise control over the company's assets, however the ministries keep an authority over the investment decisions. SOEs raise capital in state banks, though state banks determine the level and condition of enterprise financing.

Look that there are two important differences between free market and state owned governance. First, the ministry has authority over assets that actually are not owned by the ministry. Second, the management team purses the goals of the ministry, not shareholders. These two characteristics constitute possible efficiency losses and create a breeding ground for the agency problem.

Today's China struggles to transition between state owned and free market governance modes. As we shall see this transitory route is not the easiest one. The reform of corporate governance system in the Chinese SOEs is on the political agenda since 1984 (Zhang, 2006). Although the reform is still in progress, the economists assess its current fruits. According to Zhang (2006) the assessments are almost two-point distributed among experts. Some economists (mostly foreign) believe that the reform has been truly successful. They underline steady improvement in productivity of the Chinese SOEs (3 per cent at annual rate on average) since the late seventies.

Chinese economists are much more skeptical. They stress that only one third of all SOEs make profits (the rest bear losses). Chinese economists believe that the problem of SOEs is mainly that of the principal rather than that of agents (Zhang, 2006). In the pre-reform era (before 1979) the residual claim and control rights were in practice held by the bureaucrats. Therefore the Chinese SOE reform was primarily focused on the transfer of decision rights and residual claim from the bureaucrats to the firm level. Firm-level decisions are believed to be much more efficient than those made at the government level mainly because of better access to information.

According to Zhang (2006) the current landscape of corporate governance reform in China is as follows:

- the short – term incentive problem in the SOEs is already solved,
- the long – term incentive problem and management selection problem of the SOEs are still to be solved. However, this requires a rudimentary change of ownership in the Chinese economy.

Short term managerial incentives arose due to implementation of the management contract system (MCS). These contracts are negotiated by the state-owned enterprise and the group of governmental agencies. Usually the contracts are valid for 3 or 4 years (they are short run oriented). The typical management contract specifies: (1) indicators of profit and tax target, (2) utilization of retained profits, (3) debt repayments, (4) asset appreciation, (5) planned technology innovation and (6) planned product quality improvements. Some contracts include output target, production costs' target and, in special cases, fulfillment of the state plan (Zhang, 2006).

Under the MCS there are two kinds of incentives for management. Whereas the first incentive is formal and explicit, the second remains informal and implicit. First of all, managers thanks to the signed contract can legally claim part of the residual. Secondly, by having granted autonomy over business decisions, managers become natural holders of some control rights. As we remember the matching between residual claim and control rights is the first condition for an efficient corporate governance to function (Knight, 1921; Groves et al., 1994). The informal and implicit incentive (Zhang, 2006) exists because managers by manipulating accounts and stripping assets can claim more residual than specified in the contract.

Despite the fact that the MCS has considerably improved the managers' incentives to work harder and to make short term profits, the long term motivation has still to be enforced. Some studies (Huang et al., 1998) show that SOE managers prefer to distribute retained profits to employees or invest in projects which generate 'quick money' rather than invest in long term R&D projects. Asset stripping also boosts current profits, but may put future firm's productivity in serious danger.

The next reason for the managerial myopia is the prevailing uncertainty about the employment. Mangers simply do not know whether they will still hold the position in the next year. Their employment depends on shaky preferences of politicians rather than the performance of the SOE. Here we encounter the second problem which has to be solved, namely, the management selection procedure.

SOE managers are appointed by government representatives rather than capitalists. This violates the third condition for the efficient corporate governance to function. The current appointment system induces the SOE managers to attain average profits. This is because once a firm becomes profitable, bureaucrats immediately replace the incumbent manager with their favorite. That is why, the best strategy for the manager to keep her/his position is to make the SOE not too good and not too bad.

To ensure that the proper people (professional managers) will lead the enterprises, the authority to select and appoint candidates should be transferred from bureaucrats to capitalists. In fact, this means further privatization of the Chinese SOEs.

According to Zhang (2006) the privatization process has been speeded up after the 15th Congress of the Chinese Communist Party. Well – prepared privatization program may successfully alleviate the discussed agency problems in the Chinese enterprises and bring about new efficient corporate governance modes.

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