

CORPORATISATION OF CHINA'S STATE-OWNED ENTERPRISES AND CORPORATE GOVERNANCE

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Abstract

This paper reviews the notable Chinese State-Owned Enterprises' (SOEs) low efficiency and shows that the agency problems with SOEs constitutes the characteristics of corporate governance - insiders' control, soft budget constraints, managerial slack and lack of competent managers. It is this corporate governance structure that results in SOEs' inefficiency. The paper further argues that the current corporatisation of SOEs in China through share issue does not improve corporatised SOEs' performance because it has not effectively dealt with the agency problems associated with public ownership, and, therefore, falls short in addressing the critical issue of corporate governance. The creation of an effective corporate governance mechanism requires the development of the country's market-oriented institutions. It is difficult to prescribe what type of governance structure China should adopt, although it is argued that for former SOEs a neo-corporatist approach with a two-tier board structure may have advantage over a neo-liberal approach with a single board. For China, the most important issue is not to find a fixed set of governance models from which to copy, but to develop institutions that are conducive to effective corporate governance.

Keywords: China, SOE, agency problem, corporatisation, corporate governance.

1. Introduction

One of the most important aspects of Chinese economic reforms has been the reform of state-owned enterprises (SOEs). Unlike most former centrally planned economies, China has tried to avoid privatising SOEs and instead sought to reform them through piecemeal measures, such as by increasing managers' decision-making autonomy, introducing financial incentives, and bringing in performance contracts between the government and SOEs (Naughton, 1995; Shirley and Xu, 2001). These reform measures resulted in improved productivity of SOEs; SOEs accounted for most of the extraordinary growth of Chinese industry during the 1980s and the early 1990s (Groves et al., 1994; Zhuang and Xu, 1996; Li, 1997; Jefferson and Rwasiki, 1999). However, the performance of SOEs has since steadily deteriorated. Much literature on Chinese SOEs, reports that productivity is growing, yet profitability is declining, and the number of loss-making SOEs is increasing (Mckinnon, 1994; Nolan, 1995; Sachs and Woo, 1997; Jefferson and Singh, 1999; Cao, Qian and Weingast, 1999; Cook, Yao and Zhuang, 2000; Lin and Zhu, 2001).

Faced with mounting losses in the state sector, in the middle 1990s, the Chinese government began to shift the focus of SOE reform to privatisation of small SOEs and corporatisation of larger ones (Cao, Qian and Weingast, 1999; Zhu, 1999; Lin and Zhu, 2001; Chen and Wills, 2002). Research has shown that it is not realistic to entirely privatise all SOEs considering the important roles they have played in the national economy and the social responsibilities they have undertaken (Jefferson and Singh, 1999; Cook, Yao and Zhuang, 2000; Liu, 2000; Chen and Wills, 2002). Corporatisation is hoped to be an achievable and effective way to improve the performance of large SOEs. The corporatisation strategy aims to turn SOEs from public sole proprietorships controlled by industry-specific government agencies at various administrative level into shareholding companies that are, at least in theory, independent in decision-making and diverse in ownership by share issuing.

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The existing empirical literature on the relationship between ownership effect and firms' performance in China is not always conclusive given the short history of China's stock market and data constraints. Some studies document a linear relationship between ownership concentration and firms' performance (Xu and Wang, 1999; Chen and Gong, 2000; Gul and Zhao, 2000). However, research using larger data sources suggests that the performance of SOEs has not been improved by share issue corporatisation (Wang, Xu and Zhu, 2001; Hovey, Li and Naughton, 2002). Wang, Xu and Zhu (2001) argued that the effects of public listing on performance are not significantly affected by the percentage of shares held by the state or by large top shareholders. Hovey, Li and Naughton (2002) reported that ownership concentration does not affect listed firms' performance but ownership structure sometimes matters. Overall, most research findings seem to suggest that ownership is not a major factor in improving firms' performance in the current process of share issue corporatisation. The overall poor effects of share issue corporatisation as experienced by Chinese firms imply that share issue corporatisation does not work as a way to reform SOEs; the corporate governance structure has not functioned effectively.

There is growing interest in the study of corporate governance of Chinese SOEs. Most of the research is limited to the issue of which Western model of corporate governance Chinese firms should adopt (Tam, 2000), and, at the firm level, issues such as corporate board structure, CEO terms and compensation (Tam, 1995; Xu and Wang, 1999; Wen, Rwegasira and Bilderbeek, 2002). However, there is a lack of comprehensive comparison at the macro-level to illustrate the important elements constituting effective corporate governance, and the essential institutional conditions China needs to develop in order to establish effective governance mechanisms. This paper attempts to fill this void. The research hypotheses are set as:

- (1) The current share issue corporatisation does not work as a way to reform SOEs since it fails to address the critical issue of corporate governance.
- (2) Improving China's institutional environment is the pre-requisite for creating effective corporate governance.

The remainder of this paper is organised into four sections. Section 2 discusses the fundamental reasons for the poor performance of Chinese SOEs before corporatisation. Section 3 reviews the development of Chinese corporatisation and China's stock markets. Section 4 reveals the effectiveness of current corporatisation programme. Section 5 investigates the current corporate governance status in China as compared with the Western modules of corporate governance. Section 6 studies the institutional requirements for an effective governance mechanism and suggests what China needs to do to meet these requirements. Section 7 concludes with implications of the findings.

2. Pre-Corporatisation: SOEs' Inefficiency and the Corporate Governance

Most literature on the reforms of Chinese SOEs reported the notable SOE efficiency problems - declining profitability and increasing loss making (Mckinnon, 1994; Nolan, 1995; Sachs and Woo, 1997; Jefferson and Singh, 1999; Zhu, 1999; Cook, Yao and Zhuang, 2000). SOEs' low efficiencies and the increasing losses were often attributed to excessive welfare burdens (Broadman, 1996; Hu 1996; World Bank Country Study, 1997), increasing competition (Jefferson and Rawski, 1994), and, more importantly, the built-in agency problems associated with public ownership in a centrally planned economy (Qian, 1996; Chen and Wills, 2002). As the Chinese economy has become increasingly market oriented, it is natural to expect that the artificial profit for SOEs as guaranteed by the planning system in the past would decline owing to the increasing competition. Since the late 1990s, measures have been taken to socialise SOEs' welfare burdens by privatising housing and medical benefits and laying off redundant workers. However, these measures have not necessarily improved the intrinsic efficiency of SOEs, but acted at the expense of the workers and the society without being accompanied by measures addressing SOEs' agency problem. The size of the pie has not increased; it has only been redistributed. Moreover, the effort to 'break the iron ice bowl' has backfired because it has caused tremendous uncertainty among workers about their future job security and hence has greatly depressed consumption demand. This has further weakened the profitability of SOEs. China still lacks a social security system to deal with these social burdens. It put the SOEs' accounting costs more in line with the real society's economic costs.

Both theory and empirical evidence have suggested the most important reason for the increasing loss in pre-corporatised SOEs was the agency problems (Qian, 1996; Chen and Wills, 2002). The agency problems with SOEs were twofold: on the part of enterprise managers on the one hand, and on the part of government bureaucrats on the other hand. SOEs, in principle, were owned by the state, but control rights were divided or shared between government bureaucrats and enterprise managers. Although bureaucrats were supposed to act as owners, they were not legally entitled to be the residual claimants as owners of private enterprises would normally be. It was this lack of real owners combined with an inadequate governance structure that distinguished a traditional SOE from a Western-style public corporation and made the agency problems with SOEs far more serious.

Red tape, soft budget constraints, and corruption were all manifestations of the agency problem on the part of bureaucrats. A particularly serious agency problem with the bureaucrats was in their choice of managers. Personal connections, seniority, political loyalty, and factors other than management ability were often the criteria used for the promotion of SOE managers.

The agency problems in SOEs resulted in a monitoring problem, managerial slack and a lack of competent managers. In the absence of owners and of managers who possessed the authority and faced the incentives to monitor the input of key factors of production, and lack of reward systems for their hard work, opportunistic behaviour motivated managers, workers, and public officials to take more from the enterprise than they gave. The result was persistent losses and a corporate governance structure characterised by insiders' control, soft budget constraints, managerial slack and lack of competent managers. This was the fundamental reason for SOE's inefficiency.

3. China's Corporatisation and the Development of Stock Markets

The more difficult and more fundamental task for reforming SOEs is to address the agency problems. The question, therefore, is: can corporatisation effectively deal with the agency problems associated with public ownership resulting from a centrally planned economy?

3.1. China's Corporatisation Programme

The central goal of corporatisation is to establish a system in China, through share issue privatisation, featuring corporate governance structures that separate the government from enterprises. It is hoped that corporatisation will transform an SOE into a modern-form corporation that features both significant state and significant non-state institutional shareholders in addition to small individual shareholders. The separation is deemed necessary both for enterprises to achieve full autonomy in structural and operational decisions and for government to limit its liabilities to the enterprises, hence hardening the budget constraints. It is also hoped that corporatisation will improve managerial incentives by installing shareholders with incentives and abilities to monitor the managers. Public listing of SOEs in the domestic stock exchanges is a key measure of corporatisation. Indeed, the vast majority of China's publicly listed companies are formerly SOEs, mostly large and better-performing ones (Lin and Zhu, 2001).

Share issue privatisation has been one of the major forms of privatising SOEs around the world since the 1980s with many successful cases in developed countries (Megginson and Netter, 2001). Evidence from developed countries also indicates that corporate governance has a significant impact on the performance of public listed firms (Jensen and Meckling, 1976; Shleifer and Vishny, 1986, 1997). The objective of such an action in China is also expected to introduce elements of corporate governance that facilitate improvements in firm's performance. However, it should be noted that China's case is different from those in developed countries. It is not the market, nor does the motivation to obtain private benefits that determine the presence of blockholders. Ownership structures are largely determined by government. At listing, a significant proportion of shares are held back by government (state-owned), and a large proportion of shares are transferred to state-owned investment trusts and asset management companies (legal persons owned). The distinction between state and legal person shareholders is in many cases superficial. The state and legal persons owned shares account for about 70% of the total share issuance (China Securities Regulatory Commission web site). Institution share holding according to the Western definition is rare. Therefore, it is hard to see what the transfer from the state to legal persons would have done for the potential monitoring effect. The

public listed shares are dispersed and minorities have little legal protection. Whether a company can make an IPO is still determined largely by an administrative process rather than the market process seen in developed economies. When an SOE wants to go public, it must seek permission from the local government or/and its affiliated central government ministries, which receive an IPO quota from the China Securities Regulatory Commission.

3.2. The Development of China's Stock Markets and the Institutions

As a result of China's corporatisation drive, two capital markets, Shanghai Stock Exchange and Shenzhen Stock Exchange, began to emerge in the early 1990s and have developed rapidly since the late 1990s. Table 1 outlines the development of China's stock markets. At the end of 2000, 1088 firms were listed on the two stock exchanges, with a total market capitalisation close to 5 trillion yuan (about US\$0.6 trillion), or 54% of China's GDP. The stock market has also become an increasingly important means of raising capital for China's SOEs, resulting in more than 480 billion yuan new equity issuance in 2000 alone. However, at present, China's capital markets are immature and have not been properly regulated. This is reflected by scandals of insider-dealing and large capital gains in secondary capital markets (He, 1998; Chen and Zhang, 2002).

Table 1. Development of China's Stock Market

Year	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total number of listed firms	53	183	291	323	530	745	851	949	1088
Capital raised (billion yuan)	9.4	31.4	13.8	11.9	34.1	93.4	79.5	100	142.8
Market capitalisation (billion yuan)	104.8	353.1	369.1	347.4	984.2	1752.9	1950.6	2647.1	4809.1
Market capitalisation /GDP (%)	3.9	10.2	7.9	5.9	14.5	23.4	24.9	32.3	54.0
Number of investors (million)	2.2	7.8	10.6	12.4	23.1	33.3	39.1	44.8	58.0
Total book value of assets (billion yuan)	48.1	182.1	330.9	429.5	635.2	966.1	1240.8	1610.7	1796.0
State share as a % of total shares	41.4	49.1	43.3	38.8	35.4	31.5	34.3	36.1	38.9
Legal person shares as a % of total shares	27.9	23.1	23.5	25.0	28.4	32.7	30.4	27.7	24.5

Source: China Securities Regulatory Commission, *China Securities and Futures Statistics*, China Finance and Economic Publishing House, Beijing, 1999, and CSRC's Official web site <http://www.csrc.gov.cn/CSRCsite/deptlistcom/stadata.htm>.

China's legal and institutional framework has become increasingly incompatible with a modern market economy. Establishing the rule of law has been largely ignored or deliberately avoided. Despite the passage of numerous commercial laws, their enforcement is still lacking. The judicial system is insufficiently independent of the Party and the government. China's company law lacks specific rules governing the corporatisation of SOEs, the transfer of state assets and, particularly, rules clarifying the autonomous rights of companies, which would prevent arbitrary administrative interventions (World Bank, 1997). It is also ambiguous about the debtholders' rights. There are no specific rules about what debtholders can do in the case of default by a company. It is seriously flawed in giving shareholders and government agencies too much power in bankruptcy procedures. The law stipulates that liquidation teams be composed of 'relevant' shareholders, government agencies and professionals. Debtholders are not given any control rights in liquidation.

China's accounting system and auditing system are also under reform. Since 1998, Chinese listed companies are required to reconcile accounting earnings from Chinese Generally Accepted Accounting Standards (GAAP) to international accounting standards (IAS). This regulation is the

most comprehensive effort so far at harmonising Chinese GAAP to IAS. However, developing the accounting system is more than introducing good accounting standards. Harmonisation of accounting standards may not necessarily lead to harmonised accounting practices and comparable financial reports. Chen et al reported that the Chinese government's efforts have not eliminated the gap between Chinese and IAS earnings despite harmonised accounting standards because of the lack of adequate supporting infrastructure manifested in excessive earnings management, preparers' low professionalism and low quality auditing (Chen, et al, 2002). Furthermore, agency problems between the accountants and the listed firms prevail due to lack of monitoring systems. This may tempt companies to falsify statements of capital, budgets, costs, and profits.

4. Has Corporatisation Improved Corporate Governance?

It is hard to see that the corporatisation programme, so far, has tackled the agency problems with the former SOEs. It is hoped that through corporatisation, SOEs will finally be separated from the government. But, in the meantime, the government still retains a majority shareholding in the large SOEs. However, unless the state only keeps a passive ownership, it is not clear how the government can be truly separated from enterprises. If the state indeed withdraws its control over corporatised enterprises, currently, there is no mechanism in place to prevent enterprise managers from abusing their newly acquired power. In fact, many managers of corporatised SOEs tend to use their new independence to pursue reckless operations or engage in self-seeking activities (He, 1998). For example, the CEO of one of the largest department stores in Zhejiang Province caused huge losses to the company by 'blindly providing credit guarantees' without the consent of the board of directors due to lack of monitoring and supervision (Beijing Youth Daily, December 13, 1997). Neither the employees as shareholders nor the board of directors had the ability or motivation to exercise any control over major business decisions and to monitor the chairman and the CEO of the company. A more serious misbehaviour by managers of corporatised SOEs is asset stripping, which for many is the quickest way to get rich. He (1988) provided several detailed cases that illustrate vividly some of the methods used by managers to divert state assets into their own pockets. In addition, if corporatised SOEs are not performing, the government will still bail them out, while in developed countries they will go into bankruptcy.

Managerial autonomy in the listed SOEs has not really been fulfilled. This problem is manifested in the fact that government bodies are still using their power as the 'owners' of enterprises to interfere with operational decisions, typically through their control over investment, finance, and personnel decisions and through making regulations. Many shareholding companies still operate like traditional SOEs, and their management teams are appointed by the government and often composed of government officials and the same senior managers from the pre-corporatised SOEs (He, 1998).

From the above analysis, it can be seen that corporatisation of SOEs in China so far has not effectively dealt with the built-in agency problems associated with public ownership resulting from a centrally planned economy, but in some cases, is even worsening those problems. There are two problems with the corporate governance structure in corporatised SOEs. On the one hand, managerial autonomy has not really been fulfilled; on the other hand, there is a lack of effective monitoring of management due to the fact that the state is still the major stakeholder, and there is little legal protection for small individual shareholders; and there are few independent institutional shareholders. The private property rights and property rights markets for these minorities have not been established.

China's corporatisation scheme is apparently modelled on the Western-style public corporations. But what has been overlooked and poorly understood is the fact that in the West, the emergence of public corporations, characterised by the separation of ownership and control, is a result of an endogenous, evolutionary process based on voluntary exchanges of private property rights in pursuit of gains from specialisation (Fama and Jensen, 1983). In such a process, various governance mechanisms have been developed to safeguard owners' interests from managerial infringement. They include laws against self-dealing activities as well as economic mechanisms such as managerial stock options, independent auditing, bankruptcy, and the market for corporate control (Hart, 1995; Shleifer and Vishny, 1997). Moreover, in even the largest corporations, there are normally shareholders that hold significant ownership stakes and hence have both the ability and incentives to exercise effective control rights and monitor the management.

Further, these governance mechanisms need to be supported by a well-functioning financial market and a sound legal system. Managerial stock options require stock prices to reflect firms' true performance. An excessively speculative market will not serve this purpose. Capital markets are essential for the emergence of nonbanking financial intermediaries that are often needed to increase blockholding. The absence of a well-functioning capital market will also limit the effectiveness of corporate take-overs as a viable governance mechanism. In the mean time, the legal rights of investors and managers should be protected, and self-dealing activities must be effectively prosecuted. The governance function of bankruptcy requires that, on the one hand, debt payment and the transfer of control rights upon bankruptcy be strictly enforced by law, and on the other hand, capital markets are developed so that firms have more choices in the means of financing.

Empirical evidence of Chinese SOEs suggests that the market and institutional conditions in China are very different from those in Western economies. The current conditions need to be improved to meet the requirements for establishing effective corporate governance in the listed firms. Wang, Xu and Zhu (2001) investigated the effect of public listing on performance and suggested that ownership was not a major factor in improving firms' performance in the current process of share issue corporatisation due to the fact that the corporate governance of listed companies is not effective. Wen, Rwegasira and Bilderbeek (2002) provided evidence on the relationship between the capital structure of Chinese listed firms and their corporate governance structure. The result shows that only the board composition and the CEO tenure affected the firms' capital structure decisions rather than the board size and the fixed compensations of CEOs. This suggests that the corporate governance processes in Chinese listed firms are only partly working in the manner that might have been so far assumed on the basis of Western models. Chen (2002) studied the determinants of the capital structure of Chinese listed firms and found that none of the capital structure models derived from the Western settings provided convincing explanations for the financing decisions of the Chinese firms. This is attributed to the fact that the fundamental institutional assumptions underpinning the Western models of financial markets and banking sector are not valid in China, and corporate governance of either listed firms or banks is still inefficient. The effects of costs of financial distress are, therefore, not significant, which shows that the Chinese environment still keeps some features of a centrally planned economy. The study suggests that establishing efficient corporate governance systems and improving the institutional environment to protect debt-holders' rights and small individual shareholders' interest are crucial for the success of corporatisation in China. In short, the current share issue corporatisation has not improved the corporatised SOEs' performance because the critical issue of corporate governance has not been addressed. Establishing effective corporate governance of SOEs is the key issue for the success of reform of SOEs.

5. Lessons Drawn from Established Corporate Governance Models and the Chinese Experience of Corporate Governance

In developed economies, two broad types of governance structure can be distinguished (Shleifer and Vishny, 1997). One is the 'insider' or 'neo-corporatist model', such as the Japanese-Germanic model, that relies on large institutional stakeholders such as banks for effective governance. The other is the 'outsider' or 'neo-liberal model', such as the Anglo-American model, that relies on capital market discipline and the legal system. One should not advocate that China should try to copy micro-level corporate governance models from Western countries, whether neo-liberal or neo-corporatist. Nevertheless, it is argued that for former SOEs a neo-corporatist approach to the structure and composition of the board of directors, with a two-tier board structure, may have advantages over a neo-liberal approach with a single board, particularly when external monitoring devices, such as the stock market, are not well developed.

Under the two-tier structure, the upper (supervisory or oversight) board consists entirely of non-executive directors, with a non-executive chairman. The lower (management or executive) board is composed entirely of executive directors and is chaired by the chief executive, who also attends meetings of the supervisory board but without any voting rights. The supervisory board is concerned with strategy and stakeholder interests. It appoints (and can dismiss) the chief executive, but cannot interfere in the operational management.

The existence of a supervisory board would provide an opportunity for representatives of local and national government and of state-owned investment trusts, as well as those of large private shareholders or groups of shareholders, to play a role in monitoring, without having the right to interfere in operational matters. This two-tier structure would thus provide a basis for managerial autonomy, as well as for monitoring by stakeholders.

The two-tier board system of corporate governance, which is common in the European countries, is highly appreciated by the Chinese and is regarded as a means of enhancing internal unity and performance of the company. China has adopted this system since 1994 for publicly listed companies. However, the Chinese practice is somewhat different from those found in Europe. For example, in Germany, supervisory board members include representatives of banks, which provide share capital as well as loans to companies. For reasons explained above, banks cannot currently play this role in China. Moreover, in Germany, government representatives on supervisory boards play a secondary role in monitoring to that of private shareholders. In the current situation in China, private shareholders are not in a position to play the primary role in monitoring.

Shareholders' meeting

Compared with the function of the shareholders' meeting in the European countries, the shareholders' meeting in China has a wider range of powers. The shareholders' meeting has the power of passing resolutions on mergers, division, dissolution and liquidation, electing and removing directors and supervisors, and amending the articles of association of the company. Beyond that, the shareholders' meeting also has the decision-making powers on a range of financial matters, such as deciding policies on the business operation and investment plan of the company; reviewing and approving the annual financial budget, the final accounts, and the plan of profits distribution; and deciding on the increase or reduction of the registered capital of the company and the issuance of debentures by the company.

There are two types of shareholders' meetings: regular meetings (general meeting) and interim meetings (special or extraordinary meeting). The regular meeting is held once a year. It reviews and approves the annual financial budget and accounts and decides the plan of profit distribution and recovery losses. An interim meeting must be held if the following events occur: the number of directors is insufficient to comply with the law; the company's net accumulated losses have reached one-third of its total paid-up capital; it is requested by the board of directors or the supervisory board. The principle of one share, one vote is included in the 1994 Chinese Company Law. Regarding the voting rights attached to different shares, there were different practices in Western countries. The Chinese remain silent on whether companies can issue non-voting shares or preferential shares and leave room for issuing special kinds of shares, if necessary. However, one of the legislative defects in China is that it fails to stipulate the quorum of shareholders at shareholders' meetings and the minimum holdings of shareholders. Therefore, theoretically, a shareholders' meeting can be held with any number of shareholders holding only one share. The state, even if being a minority shareholding, can still take part in the shareholders' meeting and get involved in decision-making process.

Supervisory Board

China adopted the Japanese model of setting up supervisory boards for publicly listed companies. Both the members of the supervisory board and those of the executive board are appointed by the shareholders' meeting. Both of the boards are obliged to submit their reports to the shareholders' meeting for review and approval. A supervisory board should have no less than three members. Among them there should be an appropriate proportion of employee representatives who are elected by the employees of the company rather than the shareholders' meeting. The supervisory board has the powers of supervising the work of the directors and the manager and proposing the holding of interim shareholders' meetings. However, there is a lack of supplying provisions for implementing the powers and duties. There are no provisions concerning rules of procedure, rules of voting, and rules of proposing and holding meetings of the supervisory board. Moreover, the supervisory board usually consists of quite a few government appointees. Therefore, the supervisory function of the supervisory board in terms of monitoring management and reducing agency costs is very limited. The

Company Law gives supervisory powers to supervisors, but does not prescribe how to exercise the power, or the liabilities of supervisors in case of breach of duty. In a country like China where awareness of shareholders' rights is not well developed among the general public, it is even more important to provide a means of enhancing the supervisory capacity of the supervisory board.

Board of Executive Directors

It is worth noting that the board of executive directors of a Chinese company is an organ of decision-making for day-to-day business operations, but not an organ for carrying out daily business operations. The manager of the company who is normally appointed by the central government carries out the tasks of daily business management. The board of executive directors together with the manager comprise the managerial capacity of the company. This characteristic distinguishes the board of directors of a Chinese company from that in the European systems where the board of directors is the management organ of a company. Moreover, the board of directors has fewer powers in a Chinese company than it has in the European systems. For example, in Germany, the management board has power over all matters regarding business operations. The shareholders' meeting can deal with those matters only if the management board requests it to do so. In comparison, the board of directors in China only has the power of formulating business and investment plans. The power of approving the plans is in the hands of the shareholders' meeting due to the lack of supervising capacity of the supervisory board. The main task of the board of directors is to implement resolutions passed at the shareholders' meeting. Considering the fact that the government is the major shareholder of the company, the two-tier board system in China clearly shows the government's intervention in day-to-day business operations. Furthermore, the Company Law states that the executive directors and the manager have the duty of upholding the interests of the company, but fails to address the directors' fiduciary duties, the duty of care or the business judgement rule. The absence of such provisions causes some inconvenience in practice (Zhang, 1998).

It should be clear, therefore, that the micro-level adoption of a two-tier board structure in China by itself is no kind of panacea for the macro-level problems discussed above. In fact, discussing the implementation of such a structure serves to highlight issues such as the impotence of the banks, the paucity of private shareholders and the risk of inappropriate appointments of top managers, based on politics or cronyism. But as the macro-level institutional strengthening takes place, a truly effective two-tier board structure is expected to emerge and would be a more appropriate structure to benefit from them at the micro-level, than a unitary board structure. The key condition for success would be the appointment and remuneration of the chief executive and other executive directors on the basis of competence and performance. Moreover, there must be mechanisms preventing the possibility of conspiracy between the supervisory board and the managing board. For example, like in Germany, there should be a law that forbids managerial functions to be delegated upwards to the supervisory board. The board of executive directors should be given more powers over business operations to facilitate the separation of the government from the day-to-day business management.

6. Institutional Requirements for Establishing Effective Corporate Governance

No governance structure is universally applicable. It is difficult either to prescribe what type of governance structure China should adopt or to predict what will actually emerge in China. What is common in countries that have more or less effective corporate governance is that they all have a system of effective institutions, in particular, a system of private property rights, and a relatively well-functioning financial market. For China, therefore, the most important issue is not to find a fixed set of governance models from which to copy, but to develop institutions that are conducive to effective corporate governance and enforce some basic rules of the market game. This section provides suggestions of what China needs to do to develop institutions that are conducive to effective corporate governance.

6.1. Establishing an Effective Monitoring System

It can be seen from the above analysis that the current corporatisation of SOEs has not served the purpose of diversifying the state ownership, because the state is still involved in running business enti-

ties. The ownership is still concentrated state ownership. The institutional stakeholders so far are mainly government agencies, not real institutional investors as in the Western context. Government's role in governance of corporatised SOEs must be limited. The government should act as an unbiased referee and regulator and should not interfere in day-to-day affairs of corporatised companies. However, only when the rule of law is established can the government be truly separated from enterprises.

It is critical for China to establish and, more importantly, enforce workable and efficient bankruptcy rules. This means that opening up of the country's financial sector is required for the success of China's SOE reform and China's entry to the WTO. The government must gradually withdraw its control over the financial sector, otherwise, bankruptcy, even if enforced, may not be very efficient.

China should encourage non-state institutional and international investors to become important players in its national market. Corporatisation in China has created many individual shareholders; most of them are inexperienced first-time buyers who do not have adequate knowledge about the stock market. Currently, they are left unprotected from expropriation by the large state shareholders. A real diversified ownership has an important advantage over concentrated state ownership. That is, no individual shareholder has the dominant control power and hence all are prevented from abusing the power to reap private gains, but each shareholder has a stake that is significant enough for it to have both the incentive and the ability to monitor the firm's performance. Independent institutional investors would serve this purpose. The participation of independent large investors will promote information transparency, production efficiency, and also bring liquidity to the market and sophistication to the business. They are also important players in the monitoring system. These large independent investors should be able to hold large stakes in corporatised firms and be able to exert meaningful influence on enterprise managers. However, in order for both independent institutional investors and individual shareholders to be real players in the market and participate in firm's governance, the current securities law and enforcement need to include rules to protect their interests in the firm. The securities law needs to clarify and define rights and responsibilities of firm's claim-holders, in particular, independent institutional investors and small individual shareholders, such as their rights in liquidation, their voting rights, and frequency and degree of information disclosure available for them. The judicial system also needs to be independent and competent.

An effective monitoring system relies on the motivation of managers of the business. To motivate the managers of both state-owned shareholding institutional investors and corporatised SOEs, there is a need to tie their compensation to their performance. Currently, most Chinese managers are provided with little contractual, personal incentive. This makes corruption both inevitable and acceptable. It is more efficient to change managerial incentives from implicit or illegal benefits to explicit and legal forms of compensation. An independent legal system is also crucial for effective corporate governance. It would help to deter misbehaviour by business managers, shareholders, and government officials. Specifically, managers should be required by law to fulfil their fiduciary duty to shareholders. At the same time, enforcement of anti-graft law should be strengthened to punish managerial corruption and self-dealing activities in business transactions. No governance system will work if business and bureaucracy lack a minimum degree of cleanness. If anti-graft law is strictly enforced, monitoring should be much improved.

6.2. Regulating Capital Markets

The capital market is playing an increasingly important role in the corporatisation of China's SOEs. At present, China's financial sectors are still under the strong grip of the state; there is significant amount of bad debt. The bond market has not developed because of lack of creditor protection and control rights in the event of default. Therefore, domestic bank loans are unsustainable. Capital markets are winning the present in financing corporatisation of SOEs.

Stock exchanges should set clear initial, ongoing listing requirements. The government should mandate additional disclosure and other rules by setting independent regulatory bodies, which are separated from business operations. China Securities Regulatory Committee is expected to serve this purpose. It is designed to protect the public and competitors, by regulating share pricing, service levels for utilities and transporting firms, but its role has yet to be enforced. Meanwhile enforcement of antitrust rules will promote competition and discourage collusion.

6.3. Establishing and Enforcing Supporting Institutions

A governance system also involves legal regulatory features. A clean and independent auditing and accounting system is important for effective corporate governance. It is important for domestic shareholders, essential for foreign shareholders, and perhaps most important (and difficult) for banks. Without reliable corporate information, effective internal governance, market discipline and law enforcement would be impossible to achieve. Developing the accounting system, however, is more than introducing good accounting standards. There must be mechanisms to ensure adequate incentives and discipline so that the standards will be implemented in practice. There is also a need for training accounting and auditing professionals.

7. Conclusion

This paper has argued that the current corporatisation of SOEs in China by share issuing does not work as a way to improve firms' performance because it has not effectively dealt with the agency problems associated with public ownership resulting from a centrally planned economy. Therefore, it falls short in addressing the critical issue of corporate governance. The creation of an effective corporate governance structure, in turn, requires the development of markets and institutions. China should learn lessons from the corporate governance systems in developed countries, particular the European systems, to develop its own truly functioning and effective corporate governance.

China's capital markets are still immature and the institutions are incomplete. However, they cannot develop without solving key corporate governance problems. The Chinese government must realise the economic payoff from effective corporate governance. To sustain the economic growth China has experienced, China must develop large and efficient capital markets. This is because domestic bank loans are unsustainable as a result of lack or unenforceability of creditor's rights; they can no longer offer a real alternative to capital markets. Foreign banks' participation in supplying capital for domestic firms is still very restricted and has not played a significant role. Capital markets provide an alternative corporate funding tool. They can also provide a mechanism for cleaning up problem loans. Large stock markets can promote bond markets, thus promoting the importance of corporate governance. Efficient stock markets are important for corporate control and as a compensation tool for corporate managers. Though it is still debatable, efficient capital markets may have decisive competitive advantages over bank or government financing in technological development, developing entrepreneurial growth and venture capital. Foreign direct investment, in particular, has been very important in China's economic development. Foreign capital is better channelled to the country through the capital market than through banks, because the former offers more efficient allocation of risks and rewards. But this requires the capital markets to be based on an effective property rights and corporate governance regime.

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