The Compatibility of Public Ownership and the Market Economy: A Great Debate in China

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Since China started its economic reform in 1978, profound changes have taken place in almost every aspect of its economic system. But changes in one aspect is more conspicuous and more significant: the composition of ownership. The non-state sector has grown tremendously in the last fifteen years. As Table 1 shows, the state sector's share in industrial output fell from 77.6 percent in 1978 to 52.9 percent in 1991, which was even lower than the level of 53.8 percent in 1957 when the "socialist transformation" had just been completed. In terms of the total retail volumes, the share of the state sector shrank from 54.6 percent to 40.2 percent in the same period. The non-state sector's share here was only three percentage point lower than it had been in 1957. In China the state sector has never been in a dominant position in employment, due to large agricultural population. However, even in non-agricultural employment, the share of the state sector has experienced a large decline, from 60 percent in 1978 to 43 percent in 1991. In other words, the non-state sector employed more people than the state-sector did in both urban and rural areas. Table 1 suggests that the relative size of China’s state sector is currently at about the same level as it was in 1957 and could dwindle further. In this sense, China has, in the course of its reform, "denationalized" what it had nationalized in the previous decades. Overall, China's state sector generated only about a third of the country's gross output value in 1991, which, according Nicholas Lardy's calculation, was approaching the level "of both Italy and France, where state-owned firms produce a third of national output" (Lardy 1991).

(Table 1 about here)

The relative decline of the importance of the state sector in China's economy has long been applauded by some while deplored by other Chinese economists. However, the composition of ownership did not really become a hot issue until 1992, when the Chinese Communist Party defined, for the first time, the establishment of a "socialist market economy" as the object model of the country's reform. The official sanction of the concept "socialist market economy" implies that existing socioeconomic institutions should be remoulded and new institutions established to facilitate the proper function of the market. Then many questions arise: Is the market economy is compatible with public ownership? If the answer is "yes," what institutional changes are necessary to make public enterprises competitive in markets? If the answer is "no," how should China proceed its privatization program? A great debate on those issues is currently raging among Chinese economists and policy makers.

All participants of the debate agree that the market mechanism would not be able to allocate resources efficiently unless economic agents are willing and able to respond to price signals "rationally." In other words, even if prices correctly reflect the relative scarcities in the economy, the resource allocation could still be suboptimal if enterprises do not have incentives to maximize their profits. All of them also admit that China's state enterprises have failed so far to act as profit maximizers. No one denies the fact that one-third of China's state-owned firms are insolvent, another third suffer large hidden losses, and only about one-third are profitable. What is at issue is how to make a diagnosis from the "symptoms" of the ailing state sector and how to treat such institutional defects. Three distinct views on this issue have emerged.

Socialist Marketeers

By "socialist marketeers" I refer to those economists in whose understanding of "socialist market economy," the adjective "socialist" is more important than the noun "market economy." Traditionally, socialism was believed to be based upon three "pillars:" state ownership, central planning, and the elimination of income from property. Socialist marketeers are willing to do away with the central planning, because they are convinced that what caused low efficiency in the classic command economy was excessive centralization, which exceeded the capacity of the central planners in collecting and processing the flow of information. But they don’t want to give up the remaining two "pillars" of socialism. Especially, the state ownership of the means of production is seen as the cornerstone of the socialist economic system. Therefore, no compromise should be made in this regard (Hu 1993).

They have no objection to the growth of private businesses, much less to the development of collective enterprises, as long as the state sector can keep its dominant position in the national economy. By "dominant," they mean both "quantitative" and "qualitative" superiority. In other words, the state sector needs not only to keep its control over so-called "commanding heights" of the economy, but also to maintain its leading position in industrial production and commercial activities. For them, it is an ominous sign that the share of industrial output originating from the state sector has fallen to just above 50 percent. If the trend continues, they worry, China's economy would soon become indistinguishable from a capitalist system (Guo, *et al* 1992, Ning 1992, Luo 1992).

In their judgment, abandoning the central planning and granting a greater degree of autonomy to state enterprises are sufficient conditions for the vigorous operation of a market. State enterprises are in financial trouble not because they are inherently inefficient, but because they have borne a disproportionally large share of the social costs of system transition (He 1991, Guo, et al 1992). Those costs include:

<u>Much heavier tax burdens</u> 1) State enterprises have to pay seven to eight different types of taxes, while its non-state counterparts only have to pay three to four. 2) Both nominal and effective rates of corporate income taxes are higher for state enterprises than for non-state enterprises (see Table 2). 3) Township and village enterprises and foreign-funded enterprises are often granted various forms of tax holiday, tax exemption, tax reduction. 4) Tax evasion is much more pervasive in the non-state sector than in the state sector. In this sense, the state sector has been subsidizing the development of the non-state sector (Hu, et al 1992).

(Table 2 about here)

<u>Much heavier burdens of social responsibilities</u> Chinese state enterprises have undertaken many responsibilities that, in other countries, are provided by governments. Examples are day care, health care, housing, and

social security benefits. Collective enterprises have in general provided a much narrow coverage, and private enterprises tend to cover nothing at all. In particular, old-age pension is worth notice. Because most of the large and medium-sized state-owned enterprises were set up in the 1950s and 1960s, they now have a large number of retirees on their payrolls. The number of retirees has increased from 2.8 million in 1978 to 17.4 million in 1990, and their pension expenditure has grown from 1.6 billion yuan to 38.2 billion in the same period. The pension expenditure has now become the single most expensive item in state enterprises' total fringe benefit expenditure. To the extent that state enterprises are paying for more than four-fifths of the nation's total pension funds (National Statistics Bureau 1992, Labor Ministry 1989), it is obviously much harder for them to make profits than their non-state-owned counterparts.

The costs of "reform insurance" In 1987, China passed its bankruptcy law. If the law were to be rigorously enforced, an estimated 20 million of state employees would have to be laid off. If that had happened, the reform process would probably not have been as peaceful as it has really been. To maintain social stability, governments from the Center to the grass-roots level would rather have enterprises keep and feed their idle workers. As a result, few state-owned enterprises have ever fired workers and even less have gone into bankruptcy. It is an "insurance" for a peaceful market transition. State enterprises alone bear the social costs of the "reform insurance."

Less opportunities for making profits State enterprises concentrate in sectors that produce capital goods and raw materials. Those sector are generally subject to more severe price control. The prices of energy, transportation, raw materials, for instance, have long been kept artificially low. As a matter of fact, a half of the total subsidies for state-owned enterprises have gone to energy and raw material industries (Xun 1992). Non-state-owned enterprises, on the other hand, generally produce consumer goods, the prices of which have been largely liberalized. Thus, non-state-owned enterprises can capitalize on the pricing disadvantages of state-owned enterprises, because the former are given freedom of action while the latter are not.

Socialist marketeers believe that state-owned enterprises have in a sense been "discriminated against" in the course of China's reform. They therefore are calling for equal terms of competition for both state and non-state sectors. More specifically, they suggest to set a unified corporate income tax rate for all enterprises regardless their ownership, to conduct a housing reform, to establish a national social security system, and to gradually liberalize state price control over all producer goods.[1] In one word, all enterprises should be allowed to benefit if the reform brings about gains; and all enterprises should be required to pay if the reform incurs costs.

Socialist marketeers don't deny that state-owned enterprises need to be reformed. But they think that what needs to be changed is not the nature of their ownership, but their "operational mechanism." At the core of transforming the operational mechanism of enterprises is to delegate more decision-making power in production and management to enterprises. In the last decade, China has adopted many forms of enterprise reform designed to give enterprises greater autonomy. The dominant form today is the "contracted management responsibility system" (Lee 1993). Socialist marketeers are aware that the results of the "separating-state-ownership-from-management-control" experiments have been far from satisfactory. But they blame local governments for having refused to let go of the power they have over enterprises. In late 1992, the State Council promulgated the "Regulations Concerning the

Transformation of the Operational Mechanism of Industrial Enterprises Owned by the Whole People," which delegated fourteen kinds of decision-making power to enterprises. It was hoped that the new initiative would be able to break resistance by local bureaucrats and invigorate state firms. This, however, has not yet happened. Despite continuous pushing by the central government, "there is still a considerable gap between the work of many localities and the demands of the central authorities" in this regard (Commentator 1993).

Nevertheless, socialist marketeers still place their faith in the creation of independent operated, yet government-owned, enterprises by perfecting the existing contracted management responsibility system. Beijing's Capital Steel Corporation has been seen as a successive model (He 1993).

Privatization Advocates

Privatization advocates don't believe that state-owned enterprises are capable of fully fledged market behavior. While socialist marketeers insist that public ownership is the untouchable cornerstone of socialism, privatization advocates contend that private ownership is the indispensable cornerstone of the market economy. Privatization advocates can be found in almost every government think-tank or academic research institute that is related with economic reforms. In China’s political environment, it is of course still too sensitive for someone to openly condemn public ownership and glorify private ownership. Therefore, privatization advocates have to be not too forthright in their publications. However, they have no lack of forums to express themselves. Conferences and internal journals are where they can be heard. The strength of privatization advocates thus is much stronger than it appears to be.

Privatization advocates base their criticism of public ownership, or more specifically, state ownership, on two grounds: theories of property right economics and the contrasting performance records of the state sector and the non-state sector.

To prove that a market economy is not compatible with public ownership, privatization advocates advance the following arguments:

1. The market exchange is not merely the transfer of things from one person to another; rather, it is the transfer of the property rights designating the ownership of those things.

2. Without a well-defined and enforceable system of property rights, third parties can receive some of the benefits, or have to bear some of the costs, resulted from economic transactions. In other words, externalities would be pervasive if property rights are too obscure.

3. Efficient markets cannot operate unless the costs and benefits of transactions are internalized to a substantial degree by the agents engaging in them. That is to say, an important precondition for the efficient operation of a market economy is that property rights are well specified and enforced, and lodged in the hands of those who make economic transactions.

4. Property rights cannot be made sufficiently clear unless there are ultimate private owners. Private ownership thus is the only ownership form in which property rights are genuinely clear.

5. The critical deficiency of state property lies in the impersonlization of ownership: state assets belong to everyone and to no one.

6. The communal nature of state assets makes it impossible for individual economic agents to "internalize" many of the costs and benefits of economic transactions. People working for state enterprises, ordinary employees and managers alike, thus have little incentive to maximize profits

and minimize costs. As a result, economic agents tend to ignore price signals, no matter whether they are "right" or "wrong."

7. The phenomenon of "soft budget constraint," the fatal weakness of socialist economic system, is caused by the absence of well specified and enforced property rights.

8. The separation of ownership from management control can be realized only in an economy where the private ownership is predominant (e.g. joint-stock companies in the West), because there such a separation is in the final analysis backed up by an interest by ultimate private owners. It is not feasible, however, to separate management control from ownership in a socialist economy, for property rights of state ownership are by definition unclear.

The logic conclusion from the above arguments is two-fold: private property rights are the foundation for a market economy; and it is a dead-end to seek to salvage state ownership by trying to reform it (Fan 1992, Fang 1993, Wang 1993).

To support their theoretical arguments, privatization advocates often use examples to show that public ownership is really hopeless and incurable. Their favorite examples are:

1. The non-state sector has grown faster. In the twelve years between 1980 and 1991, the national average annual growth rate of gross industrial output was 16.7 percent, in which the state sector grew at 13.0 percent, collectives at 21.2 percent, private business at 99.4 percent, and "other types of ownership" (which include foreign-funded enterprises) at 46.9 percent (Fang 1993).

2. The non-state sector is more efficient than the state sector. To my knowledge, there has been no empirical study on the efficiency differences

between the two sectors published in China. But a number of studies on this issue done abroad are available to scholars in China. And, in fact some Chinese scholars participated in some of those research projects (Xu 1991, Chen, et al 1992, Xiao 1991, Jefferson, et al 1992, Woo 1993). The results of those studies vary widely. Some claim that the annual growth rate of the total factor productivity of non-state enterprises was as much as ten times higher than that of state enterprises (Qian and Xu 1993). Others conclude that the gap is as small as less than one time (Jefferson, et al 1992). In any case, those studies are oftne cited to support the assertion that the non-state sector is more efficient than the state sector.

3. The non-state sector is full of vitality. The strongest evidence of its vitality is that it is able to develop under difficult circumstances. During the recent retrenchment period of 1988-1991, whereas the state sector stagnated, the non-state sector continued to grow at high speed.

4. The state sector has become a burden of the economy. Two thirds of state-owned enterprises are making losses overtly and covertly and can only maintain their existence with "paychecks from the government." The total amount of subsidies to loss-making state-owned enterprises reached 50 billion in 1991, which accounted for 2.5 percent of China's GDP (National Statistics Bureau 1992).

Based on those observations, privatization advocates claim that the rise of the non-state sector is the most important achievement of the economic reform process so far. Most tangible changes one has witnessed have been brought about by this healthy part of the economy. Moreover, they contend that disparities in the performance of the state and non-state sectors are due to ownership differences and differences in incentives intrinsic therein.

If their theoretical reasoning is sound and their empirical observations accurate, it is futile to expect that minor modifications of the state sector would be sufficient to make state-owned enterprises spontaneous market-oriented economic agents. As long as firms remain in state ownership, no change could make them to act as if they were privately owned. To build a market economy, China thus has to privatize its economy rather than continue following Lange’s model of "market socialism" (Wang 1993). It is interesting to note that, in the writings of privatization advocates, the adjective "socialist" is rarely used to qualify the noun "market economy." This is probably not an accident. Obviously, in the minds of those authors, a market economy cannot be compatible with public ownership.

While advocating privatization, Chinese privatization advocates don't favor a big-band approach, though. Nor do they recommend an outright privatization program to denationalize existing state-owned enterprises. In their view, the privatization of the economy doesn't have to take the form of transfer to the private sector of state-owned enterprises, a form that has been adopted by Eastern European countries and the states of the former Soviet Union. An alternative way of privatization is to nurture non-state enterprises and encourage them to compete against state-owned enterprises. As far as state-owned enterprises are concerned, privatization advocates suggest that different methods are to be used to deal with different types of enterprises. 1) State enterprises should be allowed to keep their dominant position in areas where natural monopolies are likely to exist or externalities are pervasive. 2) The government should gradually "withdraw" from areas in which state-owned enterprises are competing with non-state enterprises by reducing and eventually stopping its investment in those areas. 3) Even in the areas where the government is obligated to provide public goods, it should try to contract out such publicly financed services to the private sector, instead of solely relying upon state-owned organizations to perform those functions (Fang 1993).

The essence of this strategy is to do away with the dominant state sector not by "smothering" it, but by "breeding" new elements to replace it. Given the allegedly contrasting performance records of the state and non-state sectors, privatization advocates are confident that if their strategy were to be adopted, over time, the state sector would fill a continually decreasing share of the market, while the non-state sector eventually become dominant. Once state enterprises become "a small islands in the sea of the private economy," they will be compelled to behave like other economic agents in the market. Besides, this strategy is believed to be a less painful way of transition to a real market economy (Wang 1993, Fan 1993). As for the question if the end result such a transition would bring about is a "socialist market economy," privatization advocates would not bother to answer.

Market Socialists

Like "socialist marketeers," "market socialists" are socialists in the sense that they still stick to public ownership and "distribution according to work," the remaining two pillars of "socialism." However, their writings often give one an impression that they put "market" before "socialism." They have no objection to fundamentally remoulding public ownership and to redefining the principle of "distribution according to work," as long as such changes are necessary for making the economy more efficient.

Market socialists accept the criticisms of state enterprises made by privatization advocates, and they also pay a great deal of attention to the issue of property rights just as privatization advocates do. But they don't share the latter's conviction that competitive markets cannot operate properly in the absence of the domination of private ownership. Indeed, privatization advocates' faith in the superiority of private ownership is probably ill-founded for a number of reasons.

1. The non-state sector should not been mistakenly represented as predominantly privately owned. In fact, China’s non-state sector is made up mainly by urban and rural collective enterprises.

2. So far there has no empirical study comparing the performance differences between the state-owned enterprise and the private-owned enterprise in China. The assertion that private ownership is superior to public ownership in China needs solid evidence to back up.

3. The non-state sector’s faster annual growth rate of output and productivity doesn’t mean that the non-state sector has attained higher levels of productivity than the state sector. Their low starting point might be an explanation of their high growth rate. Even if the non-state sector had surpassed the state sector in productivity, this, as Gary Jefferson points out, cannot be automatically attributed to pure ownership differences (Jefferson 1993).

4. The evidence that private ownership in a competitive environment is sufficient to induce innovation, cost minimization, and the like does not contradict the conjecture that competition may be a more important influence on efficiency than ownership. In fact, a number of studies done outside of China have shown that in situations in which publicly-owned firms were subject to competitive conditions similar to those facing private sector counterparts, their performance was not necessarily inferior (Caves and Christensen 1980, Vernon and Aharoni 1981, Vernon 1987). In other words, public ownership is not inherently less efficient than private ownership.

Market socialists apparently believe that competition rather than ownership per se is the key to efficiency (Zhou 1993). Thus, China's task in the 1990s is two-fold. On the one hand, a more competitive environment should be created to build growing external pressures on state-owned enterprises. On the other hand, efforts should be made to inject the competitive vigor that we have observed in non-state enterprises into state-owned enterprises.

The key to creating a competitive environment is to forcefully develop the non-state sector of the economy. Market socialists advocate the development of the non-state sector, not because they are convinced that sector should replace the state sector to become the leading force of the economy in the future, but because they hold that pressures from the non-state sector are vital for pushing state-owned enterprises to throw themselves into market competition. Without pressures from outside, state-owned enterprises may never change their habitual behaviors.

Should not-state enterprises' economic activities be confined within a certain boundary? No, market socialists answered. In their opinion, such activities should be allowed and encouraged to compete with state-owned enterprises in all areas. Should a limitation be set so that the share of the non-state sector in the economy would not surpass that of the state sector? To this question, again, market socialists give a negative answer. In terms of employment and gross output, the non-state sector already exceeded the state sector 1991, and its share of industrial output topped the state sector in 1992 (Gong 1993). If a quantitative upper limit were to be set, there would not be much more space for the non-state sector to grow. Market socialists believe that the state sector should play a leading role in China’s "socialist market economy," but they refuse to accept the proposition that the "leading role" should be understood in terms of quantitative superiority.

Instead, they suggest that the "leading role" is a qualitative concept. "The superiority and guiding role of the state sector do not depend on its proportion of total output(say, over 50 percent) in the economy, but on its vitality and competitiveness, on its ability to influence the decision-making of economic entities in which the state holds some of the shares, and on its control over a few strategically important industries" (Liu 1993).

External pressures, however, are a necessary but not sufficient condition for making state-owned enterprises "profit maximizers." To improve the performance of state-owned enterprises, Chinese authorities have in the last decade continuously tried to change their incentive payoffs so that they would be willing to act as "profit maximizers." In the early years of enterprise reform, it was thought that the inefficiency of state-owned enterprises was due to insufficient delegation of decision-making power to managers and inadequate material incentives for workers. Early reforms thus concentrated on devising schemes that allowed enterprises to retain more profits and expanded enterprises' operational autonomy. The results of those reforms, however, have been disappointing. On the one hand, managers are still complaining that the amounts of retained profits are too small and their decision-making powers too limited. On the other hand, the retention of more profits and the expansion of enterprise autonomy have not brought about corresponding increases in productive effort (Aram and Wang 1991). There seems to be a dilemma: if a manager doesn't have sufficient discretion, her firm cannot act as a "profit maximizer" in markets; if she is given considerable discretion, she may use the discretion to pursue goals other than profit maximization.

In principal-agent relationships, one expects that by promising the agent a fraction of the full value of his performance, the agent would be induced to deliver productive effort. Why hasn't this occurred in China's enterprise reform? There are three reasons. First, the partition of profits is determined by ad hoc bargaining between local state agencies and enterprise managers. Since none of them are residual claimants of the state properties under their control, they are likely to collude to increase enterprises' profit retention regardless of the level of productive efforts. Second, although the government has regulations on how to divide retained profits into accumulation funds, collective welfare funds, and bonus funds, due to information asymmetry, the real control over the division is in the hands of enterprise managers. Because neither they nor the workers are residual claimants, they are likely to collude to spent as much as they can on worker compensation (Lee 1993). Third, the low level of accumulation funds doesn't worry managers and workers. If worst comes to worst---their enterprises suffer heavy losses, they know that the government would bail them out.

Are there ways to break the two types of collusion and to harden enterprises' budget constraints? To find an answer, Chinese economists and policy-makers have in recent years turned to Western market economies for clues. What they have been looking for is an institutional arrangement under which enterprise managers could have sufficient autonomy to take whatever actions necessary for profit maximization, but at the same time their behaviors could be monitored by the state so that they would not be able to abuse their power for pursuing other goals. Among various options, market socialists' favor is the shareholding system. In the West, the shareholding company emerged as a device to pool capitals and to disperse risks. But Chinese market socialists view the shareholding system as a form of organization in which ownership and management are separated but the latter is responsible for the former. If such a separation is really possible, it is hoped, enterprises will act just like their counterparts in capitalist market economies, despite the fact that they are publicly-owned.

However, the separation is by no means an easy task. Market socialists are aware that a number of institutional innovations are required before the shareholding system can function properly.

<u>Property rights</u> There can be no genuine shareholding companies without unambiguously specified proprietary rights. Even if shares belong to the state, the property rights over the assets that those shares represent still need to be specified.

<u>Ownership structure</u> If the state were to be the sole shareholder, no change would occur. Different authors have offered different solutions in this regard, among which "cross-ownership" is most popular. In this scheme, state property rights are rearranged in such a way that the effective ownership of each enterprise would be divided among a number of different public institutions that represent the state. In addition to the state shares, the enterprise is allowed to use its accumulation funds and other sources to acquire a certain amount of stocks, and private individuals may also buy shares as their personal investment. The "cross-ownership" is expected to create an external element of control and pressure for better performance.

<u>Transferability of ownership rights and stock market</u> The pressure and control by shareholders would not be effective if they are not given the freedom to invest and divest in the company's shares. Thus the transferability of ownership rights through a stock market is crucial to the health of the shareholding system.

<u>Managerial labor market</u> The effectiveness of the discipline on managers depends to a large degree on the threat of losing their jobs in case of bad

management. If managers were appointed for non-economic reasons, the threat would not work. The decisions about the appointment and removal of managers thus should be solely based on whether they can operate the firm in the best interests of the shareholders.

Bankruptcy This is also a kind of monitoring device. If profits decline because of bad management, the stock price of the company will fall, which would make the company an attractive target for a takeover. Or the company may go bankruptcy. Either way, the inept managers will lose jobs, and the inefficient company will cease to exist.

Income from capital The shareholding system is necessarily accompanied by various forms of income from capital (e.g., dividend and capital gain), which categorically violate Marx’s teaching that socialist distribution should be according to labor, but not property. Market socialists reinterpret "distribution according to labor." They claim: "that work results are assessed and incomes apportioned through the market can better manifest the principle of distribution according to labor." Accordingly, they suggest that income from labor as well as from other factors of production, such as capital and land, should all be legitimated (Gao Shangang 1993).

All those institutional arrangements are alien to traditional socialist canons, but Chinese market socialists are willing to accept them for the sake of salvaging the troubling state sector. To convince their critics as well as themselves that they are still "socialists," they argue that it is because the socialist market economy must adhere to public ownership that "the basic form of the public ownership must meet the needs of market economy." "Otherwise, the vigor of the public ownership will not be brought into full play, and the value of the state-owned assets will not be preserved and increased, and the public-owned economy will not be expanded and strengthened" (Gao 1993).

It is one thing to cast off ideological constraints, but it is quite another to work out a feasible way for rearranging the state ownership. Critics are still skeptical that the shareholding system can solve the problems its advocates--market socialists--have hoped it to solve.

First, market socialists have hoped that the process of establishing the shareholding system will work as a device to clarify property rights in China. But critics call this an attempt "to put the cart before the horse," because a precondition of the shareholding system is well specified and enforced property rights (Xun Yi 1992). Rather than clarifying property rights, the shareholding system in fact may make well specified property rights obscure, at least that was the case when pure private businesses turned into joint-stock companies in the West. The main advantages of the shareholding system are to pool capitals and disperse risks, not the clarification of property rights (Lin and Shen 1992).

Second, in large shareholding companies, if its shares are concentrated in the hands of a few owners, it is almost impossible to separate ownership from management. In case that the few large owners all are the representatives of the state, the relationships between the government and the enterprise will not be very different from what we see now. Moreover, the state pursues many goals other than profit-maximization, including not just macroeconomic stability or balancing of regional economic conditions, but also a broad spectrum of social policies as well. Thus, it is doubtful that institutions representing the state will behave in ways Western institutional investors such as banks, pension funds, and mutual funds act.

Third, if the shares of a company disperse among a large number of small shareholders, on the other hand, it is not cost-effective for individual shareholders to exercise their control power over the management. "Freerider" problem thus would exist for shareholder monitoring. Of course, small shareholders can exert their power through the stock market, where they may "votes with their feet." For them to be able to do so, however, the shareholding system must be accompanied by a series of institutional arrangements to monitor managers' behaviors, such as effective accounting and auditing systems, stock market, managerial labor market, mechanisms of takeover and bankruptcy, and the like. However, those will take years or ever decades to develop. Without them, the shareholding system may cause more problems than it solves (Yu 1992, Liu 1993).

Fourth, even if the above-mentioned institutions are in place, there are doubt about whether the stock market can make company bosses accountable. In theory, the stock market can work as a disciplinary device, but even in such well-functioning market economies as the United States and Great Britain, its record has been poor. That is why shareholders everywhere have recently started to protest that bosses are not serving them as they should (Economist 1994).

Fifth, even if the stock market can work as a disciplinary device for solving the principal-agent problems in the shareholder-manager relationship, it is not clear how the principal-agent problems in the relationship between the "state" as the ultimate owner and the public holding institutions that represent the interests of the state can be solved. Whoever take the positions of state representative in the shareholders' meeting or the board of directors were simply agents for the state. There is no guarantee that they will not collude with the management to pursue their own interests and agenda (Lin and Shen 1992).

Finally, without a well-functioning stock market in place, exactly how buyers and sellers determine the market value of assets in the process of turning state-owned enterprises into joint-stock companies is unclear. Moreover, given the fact that two thirds of the state-owned enterprises are losing money, it is questionable who else besides state holding institutions would like to be the owners of loss-making companies. One may also ask what is the point for the state to turn loss-making enterprises into joint-stock companies, if they, from the economic viewpoint, should have been declared bankruptcy (Fan 1992, Mao 1993).

The Chinese market socialists have generally failed to realize that the shareholding system is not the only way of creating efficient and responsible management. Japan, for instance, has used the bank to monitor the firm's management, and the results are obvious to all. More important, the development of a well-working stock market takes much longer time than does bank-centric monitoring ((Barhan and Roemer 1993). For those reasons, the market socialists should leave their options wide open rather than sticking to a single model.

It is, of course, not entirely fair to say that the Chinese market socialists have stuck to a single model for rearranging state ownership. They have emphasized the importance of differentiation. They propose to sell and contract out some of small and medium sized state enterprises to private citizens and foreign owners. The former formula is pure privatization (minyou minying), while the latter is call "owned by the state but managed by private businesspersons" (guoyou minying). The shareholding system is also a form of "guoyou minying." As for state-owned enterprises in sectors where natural monopolies are likely to exist and externalities are pervasive, market socialists suggest that those enterprises should be kept under the direct control of the government (guoyou guoying). Nevertheless, the shareholding system is what market socialists believe would bring the state sector out of trouble.

Conclusion

The importance of the state sector in China's economy has declined considerably in the last fifteen years. Meanwhile, the discourse of discussion on property ownership has made an about-face. In the pre-reform China, private ownership was condemned and only public ownership was legitimate. When China started its reform in the late 1970s, whether or not private property should be allowed to exist alongside public property was once a hot issue. Today, however, Chinese economists, liberal and conservative alike, have reached consensus at least on the following five points. First, any form of ownership that appears to hinder the development of market economy needs to be reformed. Second, the form, if not the nature, of public ownership needs to be changed to accommodate to the country's market transition. Third, the existence of the non-state sector in general and the private sector in particular is not only acceptable but also desirable. Fourth, China's future economical system should not be based upon a single form of ownership. Rather, a mixed ownership system should be expected. And finally, all necessary changes should occur in an incremental rather than radical way. What differs the privatization advocate from the socialist marketeer and market socialist is their opposite views on which form of ownership should be given the dominant position in China's future economy. The privatization advocate insists that the private ownership should replace the public ownership to become the base of market economy. The socialist marketeer and the market socialist both agree that the objective of reform is to make public ownership more compatible with market operation, not to abandon it, but they cannot agree on what is the best form of public ownership. The former maintains that state ownership is basically sound and only its operational mechanism needs to be modified, while the latter proposes to transform state-owned enterprises into shareholding companies.

Until 1992, the view of the socialist marketeer had been dominant both in academic discussion and policy-making, but its dominant position began to face challenges in the late 1980s (Hsu, 1991). The market socialist's thesis is prevailing now. China declared that it will carry out an experiment in 1994 to transform 100 large-scale state-owned enterprises into shareholding companies. As it has been in the past, conducting such an experiment preludes an overall orientation change in the government's policy concerning the form of public ownership. Meanwhile, arguments for privatization have found currency among more and more young economists since 1992. Given the constrained nature of academic freedom in China, it is significant that privatization advocates now are able, for the first time, to give voice to their opinion through first-rate economics journals (Wang 1993, Fang 1993). Is this a sign of limited political liberalization, or a sign that China is on the way to eventually give up the dominance of public ownership in its economy? Nobody knows. But one thing is certain: the era of Marxist dogmatism has ended and China's reform has moved beyond the point of no return.

Table 1: The Expansion of the Non-State Sector

	1957	1978	1991
Share of Gross Output Value (%)			
The State Sector		52.4	35.2
The Non-State-Sector		47.6	64.8
Share of Industrial Output Values (%)			
The State Sector	53.8	77.6	52.9
The Non-State Sector	46.2	22.4	47.1
The Private Sector	27.2	0.00	11.4
Retail Sales (%)			
The State Sector	37.2	54.6	40.2
The Non-State Sector	62.8	45.4	59.8
The Private Sector	21.5	2.10	29.8
Total Employment (%)			
The State Sector	10.3	18.6	18.3
The Non-State Sector	89.7	81.4	81.7
Non-Agricultural Employment (%)			
The State Sector		60.0	43.0
The Non-State Sector		40.0	57.0

Source: National Statistics Bureau, 1992.

Table 2: Real Rates of Corporate Income Tax (%), 1990

State-Owned	Urban Co-op	Rural Co-op	Private
38.28	31.39	24.86	less than 20.00

Source: Guo, *et al.* 1992.

Endnotes

[1] All of those demands are high on China's reform agenda of 1994. For instance, on January 1, 1994, China began to implement a new tax law that stipulates that all enterprises pay their corporate income tax at a universal rate of 33 percent.