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Introduction

Why has economic transition led to rapid economic growth in China and a sharp initial contraction in Eastern Europe and the former Soviet Union? We argue that the answer, in part, is stronger state control of state enterprises and the privatization process in China where the government had a strong interest in economic growth. Furthermore, in pursuing growth the Chinese government recognized that it had to establish institutional arrangements that constrained its own power, an important requisite for successful governance.

Under central planning, the objectives for enterprise managers were laid out in the central plan. As the transformation process unfolded, the goals for enterprises and the incentives directing managers changed. In an important sense the transformation of enterprises was a two-stage process: (1) Since it was not possible to apply 'shock therapy' to turn over property rights to private citizens overnight, there had to be a stage where state enterprises operated in an environment where they were released, at least to some degree, from the constraints of the central plan. During this period, state enterprises were subjected to external pressures different from what they faced under central planning as the environment became more market oriented. This first stage period varied considerably across transition countries and even within countries across sectors; (2) The second stage was the establishment of private property rights. A variety of methods were used to release state assets into private hands. All had implications as to how the wealth represented by state ownership was distributed among citizens.

Privatization, as one of the defining characteristics of the transition process, entails both the emergence of new owners and a fundamental transformation in the role of the state (Brada, 1996). While the two issues (a) the importance of ownership and (b) the role of the state have each generated an extensive literature, the interactions between the two have received relatively less attention. Is the reform of the state a pre-condition for successful privatization or is privatization the most effective mechanism to start the process of state reform? How does the political process influence both state reform and ownership changes?

1 The authors would like to thank seminar participants at Columbia University and the University of Delaware for helpful comments.
In these, as in other aspects of the transition process, China and Eastern Europe offer contrasting experiences. It has always been a problem incorporating China's experience in ownership and state reform in a common framework including other transition economies. As an outlier, however, China is, perhaps, the most influential observation in the transition data set. As such it is potentially a very valuable observation and a better understanding of China's experience will lead to improvement in our implicit "model specification" of the reform process.

We argue that there are sharp contrasts between the perceived role of government in Eastern Europe and China and these contrasts led to very different economic outcomes. Eastern Europe followed an "orthodox" weak government approach while the Chinese adopted a strong government approach. These differences are apparent in both the first stage of transition when state enterprises were still controlled by the state and in the second stage during the privatization process itself. Under the Orthodox approach, state ownership is an obstacle to the introduction of market forces because it is seen as a channel through which the state will use its power to coerce enterprises to pursue non-economic objectives. Privatization is seen as a solution to the problem of state power. Under the strong government approach in China, the government envisioned an important role for itself in managing state enterprises and their reform. Private ownership, at least initially, was seen as a byproduct of enterprise restructuring, not as a separate goal in and of itself.

In the next section we discuss why private ownership is not a panacea for weak government. Then we compare the role of government in China and in countries following the Orthodox model. This is followed by an analysis of what happened with state assets in the two sets of countries. Then we discuss the issue of Chinese enterprise reform. Since enterprise reform in China is still incomplete, many analysts questions whether the reform will succeed. The last section illustrates the process of building regulatory capacity with examples from capital market reforms in China.

**The Problem with State Ownership and Government Intervention**

The problem of state ownership is typically viewed as emanating from the use of the coercive and redistributive powers of the state to make state-owned enterprises (SOEs) pursue non-economic objectives and to isolate them from the disciplining effects of contractual and regulatory constraints. It is believed that under state ownership the autonomy of the firm will inevitably be undermined (Dahl, 1985). Establishing property rights is therefore to a large extent equivalent to reducing political control (Shleifer, 1994). The problem is perceived as an intrinsic property of state ownership.

In this formulation, however, the problem is a manifestation of the so-called "paradox of power"\(^2\). Its root can be traced ultimately to the inability of the government *cum* owner to pre-commit itself not to abuse its monopoly over coercion. In the orthodox approach to transition, privatization is seen as a pre-commitment device. The government like Ulysses realizing its weakness enters into a Ulysses-type contract with the electorate and binds itself to the mast by privatizing the state-owned companies, establishing in the process a boundary to its control. Privatization, it is believed, thus solves several problems simultaneously. It creates efficient ownership rights, a real government and real markets all in one go. Who exactly the initial new owner is does not matter as long as it is not the state because Coasean bargains will quickly reallocate property rights to the individuals that value them most.

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\(^2\) The "paradox of power" says that as the power of the government grows, the government can act more easily upon its own will, which renders its promises less credible. If economic agents do not believe in the government's policies, they will not have incentives to invest. On the paradox of power in connection with establishing a rule of law see Qian (2000).
Liberalize and privatize and all the problems will be solved. This was the promise sold to governments and electorates in transition economies in much the same way as nationalize and control was sold as a recipe for prosperity in the socialist experiments of the last century.

Expectations were in most part disappointed. Private ownership, it was found, was not sufficient and some would argue not even necessary, to establish an effective boundary of government control. Under new property arrangements, enterprises continued to be common pool resources and their values dissipated. Markets as a result were largely dysfunctional, especially in the early years of reforms.

The disappointing results suggest that the problems of the state that were supposed to be solved by privatization are not orthogonal to the process and outcomes of privatization. Lack of ability to credibly pre-commit itself reflects serious issues with the internal incentive structure of the government. These issues are likely to have a major impact on the process and outcome of privatization. A government that cannot commit itself not to abuse its coercive and redistributive powers will find it difficult to attract serious investors. The adverse selection problem of a weak government, "weak" government defined as a government that cannot credibly pre-commit itself, reduced the options for privatization: only economic actors that have de facto physical control over state assets, as was the case with SOE managers in Russia and other transition economies, or were in a position to eliminate downward risks by "investing" other people's money, as was the case with the investment funds in the Czech Republic, were willing to become owners. Or state assets had to be given away. This is largely what happened in a number of transition economies that followed the orthodox approach.

The problem of state ownership is not, therefore, so much an intrinsic problem of state ownership as such but a problem with the incentive structure of the government. The orthodox approach assumes an inherent conflict between state and society. However as Olson and others have shown, there are no intrinsic conflicts between the collective interest of the government as an organization and of the society overall. The government as a collective entity also suffers from the deadweight loss its excessive interventions impose on society in the form of a shrinking tax and regulatory base. Excessive interventions arise in the first place because various government agencies responsible for designing and administering various interventions typically bear only a small fraction of the costs that these interventions impose on the economy. McGuire and Olson have shown that, if the government has a sufficiently encompassing interest, it will be led as if by an "invisible hand to maximize social welfare". Such a government will be able to exercise restraint over the degree of its interventions, including the scope and scale of state ownership, and will also provide, from a social point of view, an optimal amount of public goods.

Thus the causes of abuses and inefficiency associated with state ownership are not fundamentally different from the causes of excessive government interventions. If a rational and pragmatic government internalizes the negative externalities that its interventions impose on the economy, then this government should find it in its interest to refrain from excessive intervention and to stimulate the growth of the economy by the provision of productivity enhancing public goods. Such a government is likely to also recognize its limitations to ensure an effective use of state assets under its control and is likely, as a result,

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3 See Nedelsky (1988), for a discussion on the disintegration of private property as an effective boundary of political control in the United States.

4 See for example, Mikhail Gorbachev's advice to US firms: "Those companies who are with us now have good prospects of participating in our great country {whereas those who wait} will remain observers for years to come—we will see to it" (International Herald Tribune, 1990, p.5).
to try to reduce the extent of state ownership to a level that is more compatible with economic efficiency. With a government whose interests are aligned with the interest of the public, the paradox of power disappears and the differences between the predictions and the outcomes of the helping and grabbing hand models of the government vanish.\(^5\) Thus an alternative approach to the orthodox approach is to give a high priority to improving the incentive structure of the government. In other words, to make the government a real "owner", not only of the enterprise assets under its control, but in general with respect to the impact of its actions on the government's domain.

The State in Transition: Contrasting Outcomes of the Political Process in China and Orthodox Transition.

To paraphrase Schumpeter, reforms are accidental to the struggle for political leadership in the same way production is accidental to the pursuit of profit. In post-Mao China, the state was "valuable" in the light of the chaos that reigned during the Cultural Revolution. After Mao's death reform initiatives to please the provinces became the main currency in the competition for political leadership.\(^6\) In this political struggle, the Chinese discovered the winning properties of marginalism and residual claims in the form of the dual track approach to reforms.\(^7\) The dual track approach of reform was first introduced in rural areas in 1979 along with the household responsibility system. It was later applied to industry contract responsibility system, fiscal relationships through the fiscal responsibility system, through the external trade and payments, through the sharing of foreign exchange between central and local governments, trade contracting, and foreign exchange trading centers, and labor markets through the contract system for new hires in the state sector. Creating the residual in fiscal relationship had an important impact on the incentives of local governments. It transformed local governments into owners motivated to promote the economic developments of their domains.\(^8\) The reform initiatives leading to congruence of interests among various levels of the governments and the enterprise sector infused reform commitments with credibility.

Orthodox transition presents a contrasting picture. In many communist countries, a weakening of the implementation capacity of the state marked the years preceding the onset of transition. Litwack (1991) observes that the most common critique of Soviet reform is the "reluctance of the leadership to decree large-scale non-government property rights." He argues that inability of the Soviet leadership to infuse reform proposals with credible commitments is the main problem: "The history of reform in the USSR has featured a continual of broken promises by the government." (Litwack, 1991, p. 84). The political revolutions of the late 1980s and early 1990s further weakened the state. This created an environment where privatization and liberalization were used as weapons in an antagonistic political struggle against the old elite. Bureaucracy was viewed as an inhibitor of market developments. There was a general and strong distrust of the state and its potential positive, constructive contribution (Klaus, V., 1999). The state apparatus was associated with the old regime; it was something that had to be destroyed and replaced by markets. In such an environment, strengthening the implementation capacity of the state received a low priority. Destruction dominated creation in the early transformation of the state in orthodox

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\(^5\) For a discussion on the helping hand and grabbing hand models of government see Shleifer and Vishny, 1998.

\(^6\) For an excellent account of how political competition shaped China's economic reforms see Shirk (1994).

\(^7\) Contrast this with Klaus' remark: "We should be aware of the fact that the country in the moment of transition does not make marginal changes (as a non-transition country), that it makes substantial changes. This is a crucial difference." (Klaus 1999).

\(^8\) See David Li (1998), for other initiatives to change incentives in the bureaucracy.
transition. A number of post-communists societies, such as Russia, designed and undertook mass privatization programs while in a crisis of statehood.

State Assets in Transition: Contrasting Policies in China and Orthodox Transition

In all transition economies irrespective of the speed of transition there was a relatively long period of co-existence between a large state sector and a newly emerging private sector in an environment of expanding economic freedoms. Citizens were allowed to engage in private commercial activities. Managers of state enterprise were given autonomy to undertake key economic decisions including investment, pricing, hiring and other decisions. Economic freedom engendered spontaneous processes in the economy.

A de novo private sector emerged. After certain prohibitions on private activity were lifted, the private sector began to grow quite spontaneously with "individual enterprises sprouting up like mushrooms in a forest after rainfall" (Kornai, 1990). The emergence of a private sector does not put significant demands on the regulatory and implementation capacity of the government in the initial phase of its development. A nascent private sector needs very little in terms of legal, financial and regulatory infrastructure to sustain its development. Private entrepreneurs finance their undertakings primarily through personal savings and other informal ways including through family and friends. They rely on informal means to enforce their agreements; they use existing premises to start a business, etc (Rapaczynski, 1996). As the private sector evolves, grows and becomes more sophisticated, it typically runs against constraints, and its institutional demands increase. Entrepreneurs need to access external financing to finance their expansions and further growth, they need to purchase or rent land to build factories, as they expand their operations geographically. They begin to engage in less personalized transaction and need the assurance of legal enforcement to engage in contractual relations with unknown parties.9

The type of spontaneity that accompanies private sector development forms an interesting contrast with the spontaneous processes that accompany liberalization in the state sector. State-owned enterprise managers who have been given significant control but no ownership rights face a large discrepancy between control and cash flow rights. The discrepancy leads to perverse incentives, which if not checked by the state, the owner, can cause asset stripping and destruction of value. Given the prolonged co-existence of a relatively large state enterprise sector and de novo private firms, private enterprises may become an important vehicle for asset stripping and spontaneous privatization of state assets if the control over state assets is lax. This may lead to a private sector that is parasitic in nature, focused on redistribution rather than wealth creation because asset stripping and stealing of state assets typically offer much higher returns than the alternatives. Therefore an interesting contrast with the spontaneous emergence of the private sector is that the new economic freedoms given to state enterprise managers pose considerable demands on the government to develop new regulatory capacity to enforce its ownership rights and protect state assets in an environment of significant state enterprise autonomy. Thus a critical task of the state in an economy on the path to reform is to protect state assets. State property is the weaker property in the initial period of transition.

In orthodox transition countries, the ideological climate and the political process, as described in the previous section, were not favorable to the task of protecting state property rights. State ownership rights were equated with the absence of clearly defined property rights. Establishing property rights was "to a large extent equivalent to reducing political

9 See Koford and Miller (1994) for an analysis of this process during the earlier phase of transition. As firms began to expand their market reach, the lack of legal support became a serious problem. For a similar analysis of markets in Vietnam, see McMillan and Woodruff (1999).
control” (Shleifer, 1994). And reducing political control was, to a large extent, equivalent to privatization. The implication: state assets were viewed as an open domain, as a new territory waiting for the private pioneers to appropriate. This was reinforced by "assessments" that state enterprises had little value; the dominant view was that the majority were actually subtracting value. The implication was that the faster you destroy them the better off everybody will be. These ideological beliefs created a favorable environment for asset stripping. Stealing of state assets occurred in many transition economies on a massive scale, and, in the process, a significant part of the new private sector became rent seeking and redistributive in its formative period.

There is an obvious parallel between what happened with the state and what happened with state assets in orthodox transition. The process is perhaps best summarized by George Soros who stated at a 1998 conference on Russia (in Hedlund, 2001) that first "the assets of the state were stolen, and then when the state itself became valuable as a source of legitimacy, it too was stolen." The macroeconomic consequences of this development were negative or low economic growth accompanied by significant growth in inequality (Ivaschenko, 2002; Milanovic, 2001).

China again presents a contrasting picture. Asset stripping occurs in China and on a significant scale. The new private sector has also been a vehicle for this asset stripping through the so-called hybridization process. Through joint ventures with domestic private or foreign companies, state assets have been separated from the ultimate owner. This has often resulted in loss of control and dissipation of state assets. Still, while based on anecdotal evidence, one can argue that China was able to avoid massive destruction of value in its state enterprise sector that has been evident elsewhere in transition economies.

Various institutional characteristics of the Chinese reform process have limited the extent of asset stripping. Ideological bias against the private sector acted as a deterrent for asset stripping. In orthodox transition, trade between state enterprises and parallel firms was an important channel for asset stripping. In China, private firms were not allowed for a long time to engage in trade activities and entry barriers continue to be high for private firms to enter trade activities even today.

On the state enterprise side, party control over managerial appointment has been an important factor in controlling asset stripping. For a long time, state enterprise managers were not given the right to decide on investments and other activities without approval from the state. An elaborate system of approvals related to various aspects of foreign direct investment and joint ventures between foreign companies and SOEs had, among other things, the purpose to ensure that the value of state assets is preserved. Areas of conflicts of interest of state enterprise managers and government officials with respect to state property rights were given special attention. The State Council has issued numerous circulars trying to

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10 The Treuhand experience in Germany may be of relevance in assessing how valuable state assets were since East Germany’s privatization was comprehensive, fast, market-based and done without prior restructuring. Out of some 17,000 enterprises under Treuhand’s authority only about 3000 were liquidated (Dyck, 1997).
11 “The ability to enforce the law and to protect property rights seems to be a key reason why central Europe recovered from their fall in output, while Russia and other countries not facing the prospect of entry to the European Union experienced a much more prolonged decline of output.” (Roland, 2002).
12 Only recently has the Chinese media begun to discuss the problem of the declining value of state assets as the government keeps holding them. Recently the Official Economic Daily reported that, the net worth of local SOEs in Heilongjiang province is probably negative, as the book value of owners’ equity of RMB36bn is offset by accumulated losses of RMB38bn.
13 While private ownership was allowed and encouraged for a long time in China, the private sector achieved a formal parity with state ownership only with the constitutional amendment of 2004.
14 See various articles in Naughton and Yang (2004) for a more detailed analysis of the appointment system. They argue that the system has become even more centralized since the Tiananmen Square incident in 1989.
define the legitimate business scope of officials. According to Article 166 of the Criminal Law, any employees who take advantage of their positions, turn management of their units over to their relatives or friends, purchase commodities from units managed by their relatives or friends at prices higher than the market price, sell commodities to such units at prices lower than the market price, or purchase commodities that are not up to standard from units managed by their relatives or friends face up to seven years in prison.

In China however, the main principal-agent conflict has not been between the state and the state enterprise managers, but between local governments and the central government. Historically, the preferred channel of loss socialization used by local governments has been the financial system. Local governments looking for ways to socialize liabilities related to SOEs under their control have targeted the national banking system and the national stock markets. Reforms initiated by Zhu Rongji in the 1990s have made this more difficult.

China's Enterprise Reform

It has been a common belief that enterprise reform, and in particular the reform of large state-owned enterprises, has been the failure in China's overall very successful experience with market reforms. Qian, an influential observer of China's reforms, notes: "In one notable area reform has not worked in China. This is the reform of large-scale state-owned enterprises" (Qian, 2002, p. 43). The reform of the Chinese state sector has been going on for more than two decades. However, over the last four to five years there have been some significant changes. The process has accelerated and has acquired some qualitatively new features. First, the scale of change is remarkable: every kind of SOE—small, medium, and large, both under central and local control, has been affected. Second, the extent of ownership transformation has been dramatic. One can argue that the wholly state-owned non-financial company in China has become an endangered species. Third, every known method of restructuring has been or is being used: bankruptcy, listings and de-listings, debt-for-equity swaps, sales to private parties both domestic and foreign, and standard corporate governance techniques. Finally, mass layoffs, something unheard of just four or five years ago, have become a widespread phenomenon. Thus, the scale and scope of the transformation is impressive.

There are several relatively distinct restructuring initiatives that illustrate the scale and scope of the change. At the grassroots level, local governments have been particularly active in implementing corporatization and ownership diversification in SOEs, the most decisive actions to grapple with the financial burdens and unemployment pressures resulting from loss-making SOEs. Close to 90 per cent of the small and medium sized SOEs under local governments' control have been restructured. Reforms have been most dramatic in the industrial sector where the number of SOEs has declined from 114,000 in 1996 to 34,000 in 2003. About half of the decline is due to privatizations. Privatization in China has not been limited to small enterprises only: the average privatized SOE has about 600 employees.

Local governments are trying to reduce their liabilities related to these enterprises realizing that their capacity to monitor and control is declining with the continuing marketization of the economy. For local governments, the main concern as state assets are divested is to minimize social dislocations that could lead to social unrest. China is unique in that local governments are responsible for all social welfare expenditures. This leads to significant variation at the local level in terms of the pace, speed, and form of the changes. In poorer

15 Blanchard and Shleifer (2000) analyze the sharp contrasts between federalism in China and Russia. They argue that, without a stronger central government in Russia, federalism cannot succeed.
16 Qian attributes the failure to the Party's control over the appointment of SOE managers.
provinces the pace of privatization has been slower, as such provinces lack the financial resources to absorb the social costs of restructuring.

Another important aspect of enterprise reform in China is the public listing of large state companies. About 1400 large state-owned companies have been listed on the two domestic exchanges and on exchanges offshore. Their market capitalization is about 50 percent of GDP and they have about 65 million individual shareholders. The majority of Chinese listed companies have been carved out of SOEs in a process known as "packaging for listing". They have strong linkages to local governments and are integrated with their SOE parents. For example, listed companies typically make regular payments to their parents to cover social obligations to existing and retired workers. Expropriation of minority shareholders through related party transactions has been pervasive in China and the Chinese Securities Regulatory Commission (CSRC) has stepped up efforts to curb such activities.

This process of transformation of China's state sector has been, and will be, socially painful. About 30 million SOE workers have been laid-off since 1998, and, according to official government statistics, 8.7 million of these have not found a new job. Almost every SOE has laid off employees. This has quite understandably led to social unrest, but for the most part labor seems to be accepting these changes. State employees, perhaps the most powerful interest group in China, refused to accept layoffs for a long time, but now accept the severance packages. Two economic factors account for labor's quiescence. (1) In recent years the government has shored up the social security system and increased unemployment benefits with a significant increase in central budget expenditures for social security from 1 per cent in 1997 to 6.3 per cent in 2002. (2) A dynamic de novo private sector has been creating jobs and alleviating the social costs of restructuring.

Privatization and the growth of the de novo private sector have transformed the structure of the Chinese economy. Over the past decade or so, the economy has made the transition from complete reliance on state-owned and collective enterprises to a mixed economy where private enterprise plays the leading role. The private sector, narrowly defined, has become the largest sector of the Chinese economy.

Enterprise reforms have led to a major transformation of the state sector as well. The state enterprise sector has shown consistent profitability in the last four to five years. Analysis of the financial performance of listed companies does not reveal significant differences between state and non-state companies. Return on capital of listed companies has been on the decline in the last few years, but this reflects more truthful accounting rather than a real deterioration in profitability. Overall, economic value added has remained positive, indicating that there is no wealth destruction by listed SOEs (Chan, 2002).

In the strategically important infrastructure and energy sectors, where the regulatory framework is still evolving, state monopolies have been broken up and competition has been introduced among large state companies. Chinese SOEs have shown that they are capable of competing not only in domestic markets, but internationally. China has nurtured over 20 giant corporations and conglomerates that have proven competitive in the international market. Some of these companies are laying off tens, indeed hundreds, of thousand employees, really staggering numbers. They are doing this not because they are in financial distress, in fact some are hugely profitable, but because they want to impress their shareholders and become really first-rate international players.

SOEs have surprised observers who believed that SOEs could not be reformed unless they were privatized. In this aspect, China is not unique. In other transition economies, especially

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17 These are actually accounts and individuals can have in reality several accounts. The active individual accounts in China are about 5 million.
the Czech Republic, Hungary and Poland, after some initial hesitation, many SOEs have responded quite flexibly, more or less along the lines expected of firms whose managers are fulfilling the objective of wealth-maximizing owners. Creation of a hard budget constraint and restrictions on credit for the enterprise sector, along with functioning markets, competition and bankruptcy laws, introduced an indirect, yet effective, form of corporate governance that had been lacking in the centrally-planned economies (Brada, 1996).

Thus significant ownership change has taken place in China. The ownership change was not, however, an end in itself, but the byproduct of restructuring. Institutions, including the corporate form itself, were introduced as solutions to real problems. These new institutions were imperfect, but were generally sensible responses to existing problems. Because China adopted new institutions in response to actual, narrowly defined problems, these institutions were being put to use as soon as they emerged and over time they have evolved, gaining strength, and assuming new functions. This contrasts with the experience in many orthodox transition countries, where new capitalist institutions were introduced in a more or less ritualistic fashion, often as an end in themselves. As a result, many of these institutions were formalistic, and were not capable of performing a useful role (Stiglitz, 2002). In China the emergence of the corporate form, the stock market, and the private wealth accumulated by households and private firms coalesced over time to produce a significant degree of ownership diversification. At this stage, it has become hard in China to tell what is state-owned, a collective or a private enterprise. As a result, it has become equally difficult for the government to discriminate on the basis of ownership.

Building Regulatory Capacity: The Example of Corporate Governance Reforms in China

Is corporate governance reform a meaningful exercise under dominant state ownership among listed companies in China? Skeptics consider state ownership as the root cause of current problems with corporate governance of Chinese listed companies (Zhang, 2002), arguing that government departments and industry regulators cannot appreciate the importance of protecting minority interests. Both theoretical considerations and the actual Chinese experience, however, give reasons for optimism.

Enterprise reforms in China have produced the absentee owner millions of minority investors who are well diversified and are rationally ignorant about the companies they have invested in. With the dominance of passive and absentee owners, the identity of the owner becomes less important, i.e., it does not matter who an absentee owner is. To address the problem of the absentee owner, the global trend has been to shift the costs of monitoring from shareholders to regulators and the courts. Regulation has been substituting for "investors beware". In this context, the identity of the owners is important only to the extent it affects the regulator's capacity to regulate. Is it possible to have a powerful and committed regulator in the presence of dominant state ownership? China's experience so far gives reasons for optimism. Reforms have produced a variety of interests. Different coalitions are possible on various issues affecting the political feasibility of reform measures. It is often hard to establish a strong correspondence between these coalitions and ownership structures. Much also depends on the ability of the regulator to affect the formation of political coalitions on various issues.

A major focus of the CSRC's work has been the problem of related party transactions. Here the CSRC has recorded some success. The CSRC has the support of company managers because these regulations made it more difficult for controlling parents to transfer or remove the senior management of listed companies. Shareholders were also supportive of these measures as they were intended to protect their interests. Banks and securities companies with direct or indirect exposure to the stock market are also supportive.
Negatively affected by these measures are parent companies and ultimately local governments that own these companies. For local governments, concerned about social liabilities of companies under their control, cracking down on related party transactions prevents them from using the listed companies as a conduit for funds to ailing companies under their control. However, the dramatic increase in social expenditures from the center to the provinces has helped to placate local governments.

The CSRC has shown a capacity to base regulations on incentives to enforce compliance. For example, the government as owner expects cash dividends from its investments in listed companies. As a result, Chinese companies pay dividends. In some cases, this has led to de-capitalization, but on the positive side, companies now need to go to the capital market more often. Companies therefore need their independent shareholders and this is perhaps the best foundation for minority protection. This dependence on the capital markets has been used by the CSRC to enforce regulations by including various corporate governance provisions in the conditions for listing and secondary issuance. 18

This example highlights the importance of functioning institutions. Chinese capital markets may be fraught with problems, but they perform the basic functions of capital markets: raising capital and, less so, providing liquidity. If firms do not need the market repeatedly either because there are no investment opportunities or because they have soft budget constraints, there is little a regulator can do to improve the markets and protect minority shareholders. Contrast this with the experience in Eastern Europe where stock markets evolved out of mass privatization programs. Forced onto the market by the mass privatization programs, many firms had little incentive to stay public, since the markets were not a realistic mechanism for raising capital. This eventually led to wholesale delisting of firms.

**Concluding Remarks**

The Chinese transition experience and the European transition experience have been starkly different. Rapid growth in China can be contrasted with sharp output declines in the European transition economies during the early transition period. It is unlikely that these differences can be explained by a single attribute, but this should not stop us from looking at important policy differences in these experiences. We have argued that there have been important differences in government’s approach to the transition process in these countries. In the orthodox approach government has been more hands off, and government has had greater difficulty in committing to a policy course. The laissez-faire attitude towards SOEs in orthodox transition countries has also damaged enterprises that have been thrust into a new environment that required new governance arrangements. To argue that these firms should be privatized ignored the fact that appropriate legal and regulatory structures are needed once large enterprises are privatized, and these legal and regulatory structures cannot be created overnight (Murrell, 1992). Liberalization and privatization may help to reduce the scope of the state, but they do not automatically create the state capacity needed to manage a market economy. This highlights the importance of administrative and government reforms in the transition, and indeed, in the development process in general.

In the early stages of transition in China, the governance of state enterprises changed as the environment moved towards greater openness and greater dependence on the market. These changes were not driven by ideological convictions about the intrinsic merits or demerits of various ownership forms, but rather by the pressures of competition, restructuring, social obligations, and hard budget constraints. The gradual build up of regulatory capacity is

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18 The Asset Management Companies have also used the attractiveness of listing and secondary issuance to enhance cooperation from their debtors.
enhancing the government's confidence that it can exercise control without the tools of
direct ownership. Regulatory attenuation of ownership, in line with global trends, in the case
of publicly listed companies is reducing the benefits of control associated with large
controlling stakes. As a result there is a diminishing share of state ownership in the
economy.

As the transition moves forward, some of the issues that led to such varied economic
performance will also influence future economic performance. For example, while state
enterprises will play a smaller role in the future of all these economies, corporate governance
issues will be a continuing challenge, as indeed they are in developed countries like the
United States. The role of the State will also continue to evolve as the Chinese economy
becomes more open, and many of the orthodox transition economies adapt to their new
positions in the EU and others adapt to the new growing EU sphere.

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