Lessons from the Rise and (Possible) Fall of Chinese Township-Village Enterprises

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LESSONS FROM THE RISE AND (POSSIBLE) FALL OF CHINESE TOWNSHIP-VILLAGE ENTERPRISES

BRETT H. MCDONNELL*

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INTRODUCTION

China has been one of the great successes in the developing world over the last two decades. A crucial part of the growth of industry in China has been the rapid growth of township-village enterprises (TVEs). The success of TVEs poses a puzzle for a property rights approach to the theory of the firm, since no one really holds well-defined, transferable property rights to control and claim the residual profits of TVEs. TVEs also pose a second puzzle: in the last five or seven years, they have started to experience serious problems, despite reforms which have improved TVEs from a property rights perspective. This Article will take ideas from property rights and institutional approaches to economics and examine whether those ideas can help explain both of these puzzles. In turn, it will ask what light that examination throws upon property rights and institutional approaches, particularly as applied to developing and transitional economies.

China has the world's largest population and one of its largest economies. Many project that within several decades China will surpass the United States and become the world's largest economy.¹ It is both the world's largest developing nation and also the largest nation making the transition from a communist economy. These facts alone would make Chinese economic institutions a matter of great interest for anyone who cares about the relationship between property rights and economic development. China holds even greater interest for such people because it has followed such an unusual path in making its transition. Rather than using a "big bang" strategy and trying to liberalize, privatize, and quickly move to a capitalist market economy, China has taken a much more gradual approach, leaving many of its older institutions at least somewhat in place while introducing new ones and making

¹. For the purpose of these projections, the economy is measured by total Gross National Product (GNP). See Angus Maddison, Chinese Economic Performance in the Long Run 17 (1998). In terms of GNP per capita, China is worlds away from the United States, and no one today can predict with any accuracy when, if ever, China may overtake the United States. See id.; infra note 137.
piecemeal reforms in the old ones. At least as compared with Russia, this gradualist approach seems to have worked well so far.

TVEs have been an important part of this approach. Part I sketches the background facts concerning TVEs and their role within the Chinese reforms. It explains where townships and villages fit within the political structure of China and how the success of TVEs emerged as a largely unintended by-product of deregulation of product markets combined with incentives created by the government's federal structure. The Part presents some figures on the rapid growth of TVEs and the recent slowdown in that growth. It also briefly explains the complex stew of competing types of enterprises in China.

Part II takes up the first puzzle which this Article addresses, namely how TVEs managed to flourish despite being defined by quite ambiguous property rights. TVEs are, in theory, owned by and held for the residents of the township or village in which they are located, meaning that, in effect, local government and party officials have final control rights over them. Managers run their daily affairs. One must thus consider the incentives facing both these managers and the government and party officials. It appears that the partial reforms of the 1980s gave both officials and managers enough of a stake in the success of TVEs that they had decently strong incentives to promote their growth.

Their incentives were better than those facing decision makers in the two main rival types of enterprises: state-owned enterprises (SOEs) and private enterprises. SOEs, which are typically large businesses owned and run by higher levels of government, are controlled by a variety of government agencies, none of which have adequately strong stakes in making the SOEs more efficient. Moreover, SOEs face a serious soft budget constraint as state-run banks guided by agencies provide loans to failing businesses to keep them afloat. Vis-à-vis private enterprises, TVEs had the key advantage that they were better protected from government regulation and predation. The combination of federalism and product market competition in China's political structure was critical in creating the relative advantages of TVEs.

Part II also considers two conflicting accounts of the success of TVEs in the first stages of reform. One account treats TVEs as only
a transitional institution whose advantages over private enterprise arise only because the State could not or would not commit to nonintervention in the affairs of private enterprises. Once a rule of law is in place to protect private enterprises, under this account, TVEs will disappear. A differing account suggests that, perhaps for cultural reasons, TVEs are an innovative organizational form which offers lasting advantages. Later Parts return to this question.

Despite the impressive achievements of TVEs in the 1980s and early 1990s, they were very far from perfect institutions, in part for reasons suggested by property rights theory. Neither government/party officials nor managers had clear rights either to residual returns or to residual control. Part III reports on a variety of experiments that were tried to improve on the situation. Several different types of contracts with enterprise managers were tried to improve their incentives. Ownership reforms also were instituted to loosen and regularize the control of government and party officials. Part III reports on evidence from other researchers which suggests that those reforms did improve productivity, as property rights theory would suggest.

Part IV turns to our second puzzle, namely the more recent problems facing TVEs. Why, given the reforms described in Part III, have TVEs not done better recently? One key part of the answer seems to be that competing organizational types, especially private enterprises and enterprises with foreign direct investment, have become more attractive. Indeed, many TVEs have been privatized. Part IV considers why that might be so, and also discusses the barriers that remain for private enterprises in China. It also suggests that TVE privatization need not necessarily represent an improvement in efficiency—rent seeking may also explain some of what is going on. The other key part of the answer to the puzzle of the decline of TVEs may be the serious limitations which they face. In particular, TVEs may lack the organizational incentive structure needed to work well as they grow due to their initial success. Cultural norms and personal ties which keep small-scale TVEs working may not be adequate to the task of supporting larger businesses. These points should not yet be pushed too far, though. TVEs currently face serious problems, but they are still an impor-
tant part of the Chinese economy, and their possible decline into minor status is far from a done deal.

Part V considers various paths which Chinese reform may follow in the future. One path stresses further liberalization and privatization, with the goal of reaching a Western-style market economy dominated by private enterprises. Movement along this path will require a variety of major reforms: banks and capital markets must be freed from state dominance, the property rights of private businesses must be secured, courts must become more independent, and labor markets must be reformed, to name some of the biggest and most obvious tasks. This path, in turn, splits into two branches: one branch leads to a U.S.-style system dominated by capital markets; the other branch leads to a Japanese- or German-style system dominated by banks.

The second path strives to create a more unique Chinese system, building on the strengths of TVEs. Chinese culture and society might allow TVEs to become strong community-based, cooperative businesses that integrate various stakeholders' interests well. This path requires reforms to enhance democracy and accountability within both local governments and TVEs themselves. This path leads to a destination more unknown, and hence riskier, than the first path, but it cannot be said with any certainty that the path is necessarily inferior to the first. It is probably less likely to be taken than the first path, however.

Looming as the major overarching obstacle on both paths is the tradition, and still reality, of Communist Party dominance over all areas of life in China. The great achievement of the reforms to date is giving Party members a stake in enhancing the efficiency of TVEs and private enterprises and to provide some degree of commitment against pervasive Party influence in the economy. However, the reforms have gone only so far in achieving those ends—much more needs to be done. The great question facing China is whether Party members will be willing to undertake additional reforms which further limit the Party's influence. The hope is that past reforms have set in motion a political and economic dynamic which give enough Party members a strong stake in further reform. The fear is that those with ultimate power will still feel too threatened if reform, at some point, calls into question the ultimate authority of
the Party. Thus, another possible path is that the reform process will break down while the Chinese economy still has a long way to go in catching up with Western nations. This is the least desirable of the paths and probably less likely to be taken than the first path (leading to Western-style capitalism), although it is more likely to be taken than the second path (leading to TVEs as a long-term, uniquely Chinese institution).

Finally, Part VI considers what events in China, and specifically TVEs, teach us about the relationship between property rights and economic development. I suggest four general lessons. The first concerns the relationship between property rights and other institutions. Defining property rights properly is important to development, but other institutions (e.g., norms, financial institutions, capital markets, labor markets, and political structure) are also quite important. Well-defined property rights (at least, property rights in collective business associations) are neither necessary nor sufficient conditions for successful development. The success of TVEs in the '80s (puzzle 1) shows that well-defined rights are not necessary for development. The growth of problems in the '90s despite improved property rights (puzzle 2) shows that improved rights alone are not adequate—other institutions need to be in place to encourage development. In China, and I will suggest in U.S. history as well, product market competition and political federalism have been at least as important as well-defined property rights in encouraging development.

The second lesson is that would-be reformers need to consider carefully the political constraints facing proposed changes in property rights. One of the main arguments in favor of gradualism in China is that it limited the harm done to losers within the economy; that is, those tied to failed enterprises. As new sectors grew, persons within those sectors created the political base which supported further reforms. Our fourth lesson will highlight possible problems with this approach, but alternatives which economists find attractive on paper but politically infeasible have little practical point.

The third lesson is that property rights reforms are at least as much the effect of economic development as they are its cause. Economic development is a long, dynamic process, and reforming
property rights, in many cases, may be best addressed only after other, easier-to-reform institutions have been addressed (the first lesson) and after political support for property rights reform is in place (the second lesson). This is not to trivialize property rights reform or downplay its importance. The Chinese themselves have come to see such reform as crucial to moving forward. At some point continued development probably becomes quite hard to maintain without property rights reform. That point, however, will not necessarily come right at the beginning of development.

The fourth and most speculative lesson is that the development path followed may affect the end-states which can be reached feasibly. Part V describes a variety of possible end-states for Chinese reform. Some reforms along the way, however, could make reaching one or more of those end-states extremely hard, if not impossible. For instance, reforms which create too strong a vested interest in SOEs and TVEs could make developing institutions supporting private enterprises harder. Alternatively, going too far in developing private enterprises could rule out reforms which might have developed the TVE into a truly unique, long-lasting alternative type of business organization. If banks are pushed in a Japanese direction then the expansion of stock markets may be limited, or the expansion of stock markets may stop China from adopting a Japanese-style main bank model. Further complicating matters, it may not be obvious how one reform today may preclude other reforms tomorrow. A reform which looks like the most attractive option today could wind up precluding the best long-run path.

I. BACKGROUND SKETCH

Townships and villages are the lowest rungs in the Chinese governmental hierarchy. Prior to the beginning of reforms in the

2. See infra note 10 for the type of property rights reforms considered in this paper.
3. The full hierarchy from top to bottom is central government, provinces, prefectures, counties, townships and villages. See Yingyi Qian & Joseph Stiglitz, Institutional Innovations and the Role of Local Government in Transition Economies: The Case of Guangdong Province of China, in REFORMING ASIAN SOCIALISM: THE GROWTH OF MARKET INSTITUTIONS 175, 178 (John McMillan & Barry Naughton eds., 1996) [hereinafter REFORMING ASIAN SOCIALISM]. Villages are thus units within townships. Municipalities can operate at several of these
late 1970s they were called communes and brigades.\textsuperscript{4} They are located in rural areas and on the outskirts of large cities. The typical township has a population of 15,000 to 30,000, while the typical village has a population of 1000 to 2000.\textsuperscript{5} Although much discussion of TVEs dates their growth only to the beginning of reform in 1978, Table 1 shows that the collective sector, of which TVEs are a major component although the numbers do not report TVEs separately, began to increase its share of national industrial output in the late 1960s. This growth was not especially encouraged by the central government, but seems to have emerged as a result of the decentralized nature of the Chinese political and economic system, with local cadres taking matters into their own hands.\textsuperscript{6}

TVE growth accelerated in the late '70s and '80s, becoming a central part of China's rapid growth during that period.\textsuperscript{7} As Table 1 shows, the collective sector rose to produce about one-third of China's industrial output, while the state sector's output shrank.\textsuperscript{8} Although the growth of TVEs does not seem to have been a key part of the vision of the early reforms, those reforms loosened restrictions on industrial activity in rural areas and allowed greater competition in many product markets.\textsuperscript{9} Rural areas also grew richer and had more labor available as a result of successful reforms in agriculture.\textsuperscript{10}

\begin{itemize}
\item \textsuperscript{5} See id. at 3.
\item \textsuperscript{7} See HONGYI CHEN, THE INSTITUTIONAL TRANSITION OF CHINA'S TOWNSHIP AND VILLAGE ENTERPRISES: MARKET LIBERALIZATION, CONTRACTUAL FORM INNOVATION AND PRIVATIZATION 2-6 (2000).
\item \textsuperscript{8} See infra Table 1 and notes 11-13 and accompanying text.
\item \textsuperscript{9} See Du Haiyan, Causes of Rapid Rural Industrial Development, in CHINA'S RURAL INDUSTRY: STRUCTURE, DEVELOPMENT, AND REFORM, supra note 4, at 47, 55-56.
\item \textsuperscript{10} See id. The importance and timing of de-collectivization of Chinese agriculture suggests that other types of property rights reform may need to come earlier in the process of development. "Property rights" are not some kind of monolithic entity; there are many sorts of property rights in many sorts of things, and a process of economic reform optimally
\end{itemize}
This relative growth has slowed more recently. Table 1 shows that the collective sector stabilized at about one-third of industrial output during the '90s. The state sector continued to dwindle in relative size during that decade, but the growth during the decade came in the private and "other" sector rather than in the collective sector, including TVEs. Many TVEs began to experience financial difficulties in the '90s with a number of bankruptcies occurring. According to official figures, 15.9% of companies in the collective sector faced losses in 2000. Figure 1 shows that the number of persons employed by TVEs peaked in 1996 and has declined slightly since then. Figure 2 shows that the number of TVEs peaked in 1994.

TVEs are typically small businesses, with an average of about six employees in 2000. However, they have been growing from an average of about two employees in 1990. They produce a wide variety of goods, generally simple ones. Most TVEs produce goods for local consumption or intermediate goods for larger local businesses.

China has experienced a rather bewildering proliferation of types of enterprises. Later sections go into somewhat more detail as to some of those types, but a brief description of the leading alternatives may help here. TVEs are controlled by township or village governments, and nominally owned by the entire township or
village. SOEs are controlled by one of the higher levels of government and nominally owned by all the people of China. Private and "other" enterprises include many different types: some may be completely owned by one or a few private Chinese citizens, some may be owned in part by private citizens and in part by various governmental units, and some may be fully or partly owned by foreign persons or entities. Both the legal and the statistical realities are murky, making statistics broken down by ownership quite hard to interpret.

II. PUZZLE 1: THE GROWTH OF TVEs IN THE 1980S

According to standard property rights theories of the firm, TVEs should be a colossal mess. A property rights theory of the firm focuses on the rules defining who has the right to claim residual income, who has residual control rights, and how those rights may be transferred. Following a Coasean approach, the critical prerequisites are that these rights be clearly defined and that they be transferable so that they can flow to those who most value them. In this Article I contrast a property rights approach to the firm with an institutionalist approach. Under the latter, property rights matter, but a variety of other institutions, including norms, capital markets, banks, laws, and so on, are also crucial to how firms develop and whether they flourish.

18. See CHEN, supra note 7, at 23.
19. See id. at 47.
23. See generally MASAHIKO AOKI, TOWARD A COMPARATIVE INSTITUTIONAL ANALYSIS 225-29 (2001) (noting the interdependence of institutions within a given domain).
TVEs fail to have clearly defined property rights, and in the early 1980s rights were even less clear than now.\textsuperscript{24} TVEs are notorious for the ambiguity in their definition of rights to residual income and control.\textsuperscript{25} Perhaps even worse, rights to residual benefits and control were not transferable, and still to a great extent are not.\textsuperscript{26} Yet, TVEs were a central part of China's rapid growth in the '80s and early '90s.\textsuperscript{27} That is our first puzzle, and our task in this and the next Part is to try to make sense of it. Let us start by taking a closer look at the structure of TVEs.

Figure 3 gives a stylized schematic view of the flow of benefits and control rights in TVEs.\textsuperscript{28} Nominally, the owners of a TVE are the residents of the township or village in which it is located. In fact, actual authority over the enterprise lies in the hands of the local government and party leadership.\textsuperscript{29} These local governmental and party leaders, in turn, are accountable to government and party officials at higher levels.\textsuperscript{30} The local political leaders generally will not make most day-to-day decisions for their local enterprises, but instead delegate those decisions to the managers of individual enterprises.\textsuperscript{31} Those managers in turn oversee and delegate some decisions to the enterprise's employees, most but not necessarily all of whom are residents of the township or village.\textsuperscript{32}

As for the flow of benefits, again in theory and by law, the enterprises are to be run for the benefit of community residents. The reality is more complex and shifting. Ultimately the residents do receive many of the benefits, either in the form of wages or in the form of public goods, such as schools and hospitals provided by the local government and paid for by funds received from the enter-

\textsuperscript{24} See CHEN, supra note 7, at 48-53.
\textsuperscript{25} See David D. Li, A Theory of Ambiguous Property Rights in Transition Economies: The Case of the Chinese Non-State Sector, 23 J. COMP. ECON. 1, 3 (1996); Weitzman & Xu, supra note 12, at 133.
\textsuperscript{26} See Jefferson & Rawski, supra note 21.
\textsuperscript{27} See supra note 7 and accompanying text.
\textsuperscript{28} Figure 3 is adapted from figure 2.1 in CHEN, supra note 7, at 22.
\textsuperscript{29} Id. Sometimes government and party leaders are the same person, but often they are not. See id. at 26.
\textsuperscript{30} See id. at 27. In some villages, government leaders are now chosen by direct election. See id. at 25-26.
\textsuperscript{31} Id. at 23.
\textsuperscript{32} See id. at 30-32.
prises. Managers are paid from funds from the enterprise's earnings; the extent to which their pay varies based on the economic success of the enterprise has varied widely over time and across enterprises. As we shall see in the next Part, there has been a definite trend for managerial pay to become more closely tied to enterprise performance over time. Local political leaders may receive money personally from the enterprises, and more importantly, TVEs are the main sources of funds they can use in providing goods and services to community residents. Higher level politicians also have a stake in the enterprises as some taxes flow to higher levels of government.

Even from this brief sketch we can see that the two key sets of actors on whose incentives we must focus are local political leaders and enterprise managers. These two sets of people make most of the key decisions affecting an enterprise. In the remainder of this Part we shall examine first how product markets and the federal system gave these actors relatively strong incentives to make TVEs more efficient; second, why incentives were better for TVEs than for either SOEs or private enterprises; and third, major problems that still remained for TVEs. This Part will end by exploring several different stories in the existing literature, stories that differ both in how they explain the success of TVEs and how long they predict that success will last.

Let us consider first the incentives of local political leaders. Two key elements of the situation they faced in the early '80s led to the growth of TVEs. First, reforms allowed rural industrial enterprises to enter into a large number of product markets. The second key element is the nature of the federal political structure. Local governments are expected to provide a wide range of goods and services to their residents. Revenues from TVEs are one of the

33. See id. at 23, 25.
34. Id. at 23.
35. See id. at 26, 34-35.
36. See id. at 32-35.
37. See id. at 21 (noting that these “[t]wo groups of actors participate in decisions that have led to the expansion of TVEs in rural China”).
38. See supra note 16 and accompanying text.
39. See CHEN, supra note 7, at 25-27.
main ways available to fund those requirements. Local leaders also are given objectives for economic growth in their communities. How well they meet these economic objectives and provide various goods and services affects their prospects for advancement with the State and the Party.

The combination of these two factors gave local political leaders a strong incentive to develop local TVEs. The opening of product markets allowed them to produce a variety of goods. The success of agricultural reform and increased labor-savings provided them with capital, and greater efficiency in farming left more people available to do other work. The fiscal responsibilities of local political leaders under the federalist system gave them incentives to have productive, revenue-making enterprises. Moreover, these two factors also helped discipline local political leaders and their enterprises. Product market competition meant that inefficient businesses would be under serious pressure. Federalism meant that if a locality was doing poorly, mobile resources (some capital and labor) would move to other, better-performing areas. Federalism also meant that jurisdictions could learn from the successes and failures of other jurisdictions.

We also must consider the incentives facing TVE managers. Initially they generally did not have much of a stake in the residual income of the enterprises which they ran. As we shall see in the next Part, however, reforms gave them a clear personal stake in the success of the business. From the inception of TVEs, the managers’

40. See id. at 34-35.
41. See id. at 32-42.
42. See Cao, supra note 16, at 30.
43. See CHEN, supra note 7, at 32-33.
44. See Brett H. McDonnell & Daniel A. Farber, Are Efficient Antitrust Rules Always Optimal?, 48 ANTITRUST BULL. (forthcoming 2003) (manuscript at 9-14, on file with author), for a brief overview of the literature on the important corporate governance benefits from product market competition.
46. See CHEN, supra note 7, at 31 ("Whenever leaders of a township or village observed that their neighboring townships or villages had increased income brought about by newly established enterprises, they simply launched enterprises of their own to catch up with such income increases.").
chances for career advancement clearly depended in part on how well their business performed. Furthermore, since townships and villages are relatively small units, local political leaders are somewhat better able to monitor the performance of managers, as leaders have fewer enterprises under their care than political leaders at higher levels.

Why did TVEs in the '80s fare better than their leading competitors? Let us first compare them with SOEs. SOEs have been notoriously poorly run,47 and Table 1 shows how their share of industrial output in China has dropped drastically over the last few decades. Some important differences between SOEs and TVEs include the fact that the career success of local political leaders at the township and village level is more closely tied to the success of TVEs than is the success of higher-level officials to the success of SOEs.48 Additionally, higher-level officials are evaluated more on political and ideological criteria and less on purely economic criteria.49

The smaller scale and scope of the lower-level political units is also an advantage for TVEs. This means that lower-level officials have fewer and smaller enterprises to oversee, and they are thus able to do a better job monitoring the behavior of enterprise managers.50 Relatedly, lower-level officials live in the relatively small communities in which they govern and are likely to feel pressure from residents if they are not delivering the goods. This acts as a check on township and village officials—a check which is weaker for higher-level officials.51 Also, the lower levels of government are organizationally simpler than higher levels, and TVEs are typically smaller than SOEs. This means that SOEs are often subject to orders and regulations from a variety of different ministries, each with its own views and interests and each with the ability to stop activity which it does not like. This overlapping

48. See OTSUKA ET AL., supra note 20, at 49.
49. See CHEN, supra note 7, at 50-51.
50. See id. at 51-52.
51. See id. at 52.
authority at the SOE level can make it harder for enterprises to act quickly and decisively.\textsuperscript{52}

A final way in which TVEs are superior to SOEs is they face a harder budget constraint. One of the classic problems of socialist enterprises is the soft budget constraint.\textsuperscript{53} The idea is that even when such enterprises do poorly, they too often are propped up by the government and not allowed to fail.\textsuperscript{54} However, the threat of failure is one of the main stimulants of efficient and innovative behavior in a successful market, and its absence leads to a proliferation of inefficient "white elephants."\textsuperscript{55} The soft budget constraint is a major problem for Chinese SOEs, as the central government controls the major Chinese banks, which all too frequently make loans based on political rather than economic criteria—and a leading political criteria is to sustain the SOEs.\textsuperscript{56} There is something of a soft budget constraint for TVEs too, as local financial institutions have been a major source of finance for them, with local political leaders guiding loans to the TVEs.\textsuperscript{57} However, this problem is less severe, if for no other reason than that the local financial institutions have many more limited resources and thus cannot sustain failing local enterprises for as long.\textsuperscript{58}

These factors help explain why TVEs outperformed SOEs in the '80s. Why, though, was that growth concentrated in TVEs rather than in private enterprises? As shown by Table 1, and as we shall explore more below in Part V, growth in the '90s centered on private enterprises. Why didn't that happen earlier? The leading


\textsuperscript{56} See Cao, supra note 16, at 39-40; Che & Qian, supra note 54, at 17-19.

\textsuperscript{57} See Chen, supra note 7, at 60.

\textsuperscript{58} See Che & Qian, supra note 54, at 17. TVEs also seek funding from the large banks controlled by the central government, but are lower in priority to SOEs at those banks. See id. at 19.
explanations seem to be legal and bureaucratic obstacles to private enterprises and difficulties in obtaining financing.

A variety of authors have noted that one major advantage of TVEs over private enterprises in the early reform period was that TVEs were better protected from state predation, and thus faced fewer legal and bureaucratic obstacles.59 State predation is an endemic problem in China's authoritarian, state-centered system. For many years private enterprises were not legally allowed at all. Even once they were tolerated, that tolerance at first was rather minimal. Private enterprises faced obstacles in obtaining permits and being allowed to carry on their business, they faced the corruption of officials, and they found it difficult to get courts to protect their interests and rights.60 TVEs faced some of the same problems, but they were sponsored by local government, and hence local political officials could help protect them and advance their interests in the bureaucracies and the courts.61 Indeed, a number of TVEs, in all but name, apparently were actually private enterprises which chose to legally organize as TVEs in order to gain governmental protection.62

Private enterprises also faced severe difficulties in raising money. Banks are controlled by the government, and strongly tend to prefer to lend to enterprises associated with the level of government which controls the bank.63 The stock market is still small and limited to SOEs.64 Although TVEs also have had trouble obtaining financing, local governments had access to some funds, and more ability to effectively lobby state banking institutions, than private individu-

59. See CHEN, supra note 7, at 54-57; Chun Chang & Yijiang Wang, The Nature of the Township-Village Enterprise, 19 J. COMP. ECON. 434, 443-44 (1994); Che & Qian, supra note 54, at 11-12; Li, supra note 25, at 7.

60. The difficulty of instituting the rule of law in China has been an ongoing theme in the literature. See, e.g., Eric W. Orts, The Rule of Law in China, 34 VAND. J. TRANSNAT'L L. 43 (2001); Harry Williams, Property Rights and Legal Reform in Township and Village Enterprises in China, 2 ASIAN-PAC. L. & POL'Y J. 227, 230 (2001).

61. See Chang & Wang, supra note 59, at 443.

62. See Williams, supra note 60, at 241.

63. See Chang & Wang, supra note 59, at 444.

Thus, the ties of TVEs to local government gave them an advantage over private enterprises in raising money.

Despite these relative advantages over SOEs and private enterprises, TVEs still faced a number of problems. Some concerned the incentives facing local political leaders and their selection. Although, as argued above, local leaders had good reason to care about the economic success of TVEs, that was not their only concern. Ideological conformity, public order, education, promotion of birth control, and other factors unrelated to TVEs entered into their formal evaluation, and their personal ties to higher-level officials were, of course, important as well. Moreover, local leaders were not selected solely on their ability to oversee enterprises, and their background was still in politics, not business. Thus, these were not the ideal people to be in control of Chinese businesses.

A particular incentive problem arising from the political structure is the incentive to misreport economic statistics. Since political leaders are judged, in important part, on the economic success of the businesses under their control, they have an incentive to inflate the performance of those businesses. Some Western economists think that Chinese economic statistics are very seriously misleading as a result of this incentive. Indeed, one could argue that the explanation for the apparent success of TVEs, and of China generally, is that it is all a statistical mirage. That would be going too far, though. These successes are, in part, a statistical mirage, but even those Western economists who are leading the charge against the accuracy of Chinese statistics grant that China has experienced much economic development over the last few

65. See Che & Qian, supra note 54, at 14-15.
66. See CHEN, supra note 7, at 38-39 (noting that, although “the development of TVEs was the single most direct and critical determinant of township leaders’ performance,” the leaders’ overall performance was evaluated on the basis of many factors).
67. See id. at 26-27.
68. See id. at 38-39.
69. See id. at 40-41. There is also an incentive to underreport as well, as a way to avoid sending taxes to the central government. See id. at 64-65.
decades—to those familiar with the society, the changes are just too
great to be denied.\textsuperscript{71}

Enterprise managers also faced imperfect incentives, particularly
in the early years of reform.\textsuperscript{72} They made most of the important
daily decisions about the businesses, and yet were far from being
the residual claimants.\textsuperscript{73} The next Part will consider reforms that
have reduced this problem. Even after these reforms, however,
managers probably do not have an adequate stake in the long-term
success of the enterprise. This reduces their incentive to have the
business invest in projects which pay off in the long run and,
additionally, to invest in firm-specific human capital.\textsuperscript{74} Managers
are also subject to imperfect monitoring by political leaders,\textsuperscript{75} and
hence have much scope for engaging in self-dealing.

A final problem worth noting is the difficulties in obtaining
financing. Although TVEs were better positioned to obtain financing
than private enterprises, they were disadvantaged relative to SOEs.
The extreme imperfections of the banking system combined with
the lack of working securities markets make raising capital hard.
Local governments have access to some resources, but that is
limited.\textsuperscript{76} Informal financing from family, friends, and employees
was probably important to TVEs as well as private enterprises, but
such sources of capital work well only for quite small businesses.
The term “small business” describes most TVEs pretty well, but
suggests that TVEs are limited in their ability to grow beyond a
small size.

\textsuperscript{71} See Jefferson & Rawski, supra note 6, at 47 & n.1.
\textsuperscript{72} See generally Dwight H. Perkins, Reforming China’s Economic System, 26 J.
ECON. LITERATURE 601, 615-18 (1988) (discussing the early economic reforms in China and
how these reforms contributed to problems with enterprise managers).
\textsuperscript{73} See Jefferson & Rawski, supra note 6, at 51. Of course, this is an issue for managers
of some Western businesses too. In the West, however, the managers of small businesses
(like most TVEs) are generally also owners, or closely supervised by owners. The problems
are more complicated for the managers of large public firms—a wide variety of mechanisms
try to align their interests with those of residual claimants.
\textsuperscript{74} See Chun Chang et al., Incentive Contracting Versus Ownership Reforms: Evidence
from China’s Township and Village Enterprises, 31 J. COMP. ECON. 414, 421 (2003).
\textsuperscript{75} See Enrico C. Perotti et al., State-Owned Versus Township and Village Enterprises
in China, COMP. ECON. STUDIES, Summer-Fall 1999, at 151, 167.
\textsuperscript{76} See id. at 152. But cf. Che & Qian, supra note 54, at 17-19 (discussing the hard budget
constraints faced by local governments, and noting the positive effects on TVEs).
I have thus examined the weaknesses in formal property rights of TVEs, the factors that nonetheless allowed them to grow rapidly in the '80s, some reasons why they were more successful than either SOEs or private enterprises, and serious problems which nonetheless remained (in part because of weak property rights). In Part III, I will consider some property rights and related reforms which the growth of TVEs helped spur, but first, let us consider two contrasting strands in the literature which attempt to explain the success of TVEs.

The first strand sees TVEs as largely transitional institutions. The advantages of TVEs over private enterprises described above are due largely to serious imperfections in Chinese politics. The statist system meant that enterprises needed protection from governmental predation and financing given the limits on private financial institutions. Once these state-imposed limits on private enterprises are reduced enough, one would then expect TVEs to become less advantageous than private enterprises, and thus TVEs would be likely to decline in importance.

A competing strand sees possible longer-run strengths in TVEs. Some suggest that they represent more cooperative forms of organization which are made possible by the alleged higher-trust environment of China. Franklin Allen, Jun Qian, and Meijan Qian point out that China is a major exception to the empirical literature which suggests a strong connection between legal protections of investors, capital markets, and economic growth.

77. See Chang & Wang, supra note 59, at 443.
79. See Weitzman & Xu, supra note 12, at 137-41.
suggests that TVEs could represent a new organizational form based on a commitment to community members with a long-term commitment to the enterprise.  

These two strands make both positive and normative claims that are interrelated but should be distinguished. The positive claims differ as to whether TVEs will tend to fade away over time. The normative claims differ as to whether TVEs represent efficient or otherwise normatively attractive organizational forms that compare favorably with private enterprises in an environment where the latter are less discriminated against than in the China of the '80s. If one believes that the more efficient type of organization will tend to dominate over time, then the two sets of claims tend to converge, but that evolutionary dynamic need not be true at all. TVEs could continue to prosper in China despite relative inefficiency if it is in the interest of dominant elites to keep them going. Conversely, TVEs could lose ground to private enterprises even if they are relatively efficient if elites find they can profit more personally from private enterprises than from TVEs. Neither possibility can be ruled out in China today. Part IV will return to the positive question in considering the growth of private enterprises and stagnation of TVEs in recent years. Part V will return to the normative question in considering various paths that Chinese reform could follow in the future.

III. CONTRACTUAL AND PROPERTY RIGHTS REFORM IN TVEs

Chinese reformers were not blind to the property rights problems posed by TVEs. Indeed, writing by Western economists such as Harold Demsetz influenced their thinking on the subject and helped inspire some of the reforms described in this Part. More impor-


82. I make a similar point on the importance of distinguishing between positive and normative claims in comparing U.S. market-centered corporate governance with Japanese and German bank-centered models in my article on the corporate governance convergence debate. See Brett H. McDonnell, Convergence in Corporate Governance—Possible, but Not Desirable, 47 VILL. L. REV. 341, 383-84 (2002).

tantly, the advantages to be gained from prospering TVEs gave local and central officials incentive to search for new reforms which improved their performance. Initial efforts focused on improving the contractual relationship between enterprise managers and enterprises. Later efforts moved to deeper changes in ownership structure. This Part first will describe briefly some of the reforms that have occurred. It will then review Hongyi Chen's work explaining the adoption of different contractual reforms, and recent work by three Carlson School of Management scholars on the economic effects of the contractual and property rights reforms. This Part concludes by arguing that these two pieces of research suggest both that property rights affect economic performance and that property rights reforms are, in turn, the result of economic and political development—two of the general lessons which I return to in Part VI.

Chen usefully divides the varied forms of contracts between managers and enterprises into three main types: fixed-wage, profit-sharing, and fixed-payment. Under the fixed-wage system, which prevailed early, the manager receives a fixed wage but has no claim to the firm's residual profits. This system gives the manager "weak incentives to improve the efficiency of the firm." Under profit-sharing, the manager receives some fraction of the residual. This strengthens the manager's incentive to improve efficiency, with the incentive growing stronger as the fraction which the manager receives grows larger. Under the fixed-payment system, the enterprise manager pays a fixed payment to the local government and then the manager is entitled to the entire residual. This gives the manager the strongest incentive of the three forms. Note, though, that the manager's incentives are not yet fully optimal

84. See supra notes 42-46 and accompanying text.
85. See Chen, supra note 7, at 107-12. Chen also has a somewhat more detailed scheme with six contractual forms: work-point, wage/salary, collective contractual responsibility, personal contractual responsibility, leasing, and auction. See id. at 83-102.
86. Id. at 108.
87. Id.
88. See id. In some ways this system parallels a model from Chinese history: the salt industry. See Jonathan D. Spence, Ts'ao Yin and the Kang-His Emperor: Bondservant and Master 179-84 (1966); Frederic Wakeman, Jr., The Fall of Imperial China 47-50 (1975).
89. See Chen, supra note 7, at 108.
under the fixed-payment system, as the manager does not have an adequate stake in future increases to profit which may result from current expenditures.\textsuperscript{90} Leasing contracts typically last three to five years.\textsuperscript{91}

The lack of fully optimized managerial incentives encouraged property rights reform, and, indeed, the changes in contractual form were followed by changes in property rights. In some cases, local governments have simply sold enterprises in their entirety to one or a few private persons.\textsuperscript{92} In other cases they have converted enterprises into stock companies or share cooperatives.\textsuperscript{93} The enterprise is set up as a company where ownership rights—control and residual claimant status—are defined by share ownership. Typically, the local government retains some shares (or rather, the local residents collectively retain shares, with the local government representing them), employees are given a collective share, and individual employees or other persons are given individual shares.\textsuperscript{94} The government may or may not retain a majority of the shares.\textsuperscript{95} The idea behind this conversion is to obtain the benefits of clearly defined property rights.

There are two interesting pieces of research on these developments, one on the causes of the contractual reforms, and one on the results of the contractual and property rights reforms. Chen analyzed, theoretically and empirically, how local governments might choose between the three basic types of contractual forms (fixed-wage, profit-sharing, and fixed-payment).\textsuperscript{96} She argued that both enterprise managers and local political officials may add value to the enterprise.\textsuperscript{97} Managers contribute expertise and effort in organizing production, monitoring the work force, and so on. Political officials help by providing external resources (capital, labor, protection from interference) which their political connections

\textsuperscript{90} Id. at 108-09.
\textsuperscript{91} See id. at 98.
\textsuperscript{92} See Chang et al., supra note 74, at 419.
\textsuperscript{93} See id.
\textsuperscript{94} See id. at 420.
\textsuperscript{95} See id.; see also CHEN, supra note 7, at 113-19.
\textsuperscript{96} See CHEN, supra note 7, at 103-05 (providing an example of a TVE which converted to joint stock ownership).
\textsuperscript{97} See id. at 151.
help them obtain within China’s imperfect market environment. Efficiency suggests giving more control and incentives to political officials where the latter issues are more critical to the enterprise (with the fixed-wage system as the extreme in this direction), while managers should get more control and incentives where the former issues are more important (with the fixed-payment system as the extreme in this direction). 98

Chen tested this hypothesis using field data she gathered from sixty-four TVEs. 99 She found that her model adequately explained the data as to type of contract used. 100 In the early years of reform and in regions that have not reformed very far, using political connections to obtain resources was of greater importance, and so the fixed-wage system was more common. 101 As reforms continued and China became a more open market economy, the importance of political connections diminished relative to the task of organizing internal production efficiently. 102 Hence there was a move first to profit-sharing and then to the fixed-payment system. 103 This is a very interesting example of how persons and institutions endogenously are induced to develop and change property relations in response to other changes that are occurring in the economy and society.

The other interesting piece of research is by Chang, McCall, and Wang at the Carlson School of Management. 104 They considered the effects of both the contractual reforms and the property rights reforms described above. Their data set was eighty firms in Wuxi City spanning the years 1984 to 1993. 105 Their dependent variables were return on equity and return on assets. 106 They found that both contractual reforms and ownership reforms improved firm performance, although the coefficient for the contracting variable was

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98. See id. at 139-41.
99. See id. at 193.
100. See id. at 205-07.
101. See id. at 199.
102. See id. at 204.
103. See id.
104. Chang et al., supra note 74, at 416-17.
105. See id. at 419.
106. See id. at 423.
These results provide some support for the standard argument that improved property rights improve economic performance.

Property rights reforms alone, of course, do not guarantee good corporate governance. After all, stock companies in Western economies still face serious corporate governance questions. There are two basic types of governance problems in Western corporations. First, in companies with many dispersed shareholders, there is the problem of controlling managers and limiting their ability to make decisions that benefit themselves at the expense of the business. Second, in companies with a controlling shareholder, the controlling shareholder may exploit minority shareholders.

What is rather unique about China is that these two problems can occur, in severe forms, simultaneously. Usually in developed economies if there is a controlling shareholder, then at least that shareholder generally has the will and the means to control managers. In China, however, if the controlling shareholder is a unit of the government, then that government may not do a good job of monitoring managers, and yet also may make decisions which benefit itself at the expense of minority shareholders. TVEs that have converted to stock ownership probably face both of these problems. Perhaps the problem of controlling managers is limited by the relatively small size of the enterprises, and the problem of exploiting minority shareholders is limited by the prospects of

107. See id. at 416. One possible objection to these results is that only firms with good prospects were chosen for reform, and thus reform itself may not explain the good performance. The authors were aware of this possibility and attempted to correct for it by adding variables that indicated whether an enterprise switched structure in the next year or two. See id. at 424. They found that this did not change their results. See id. at 424-25. It is possible, though, that their indicator variables did not adequately capture the information local officials may have had as to the prospects of different enterprises.


repeat business, or by the fact that local officials may have a variety of other relationships with other shareholders. Where the combination of these two problems together seems truly serious is in Chinese SOEs, which have also turned to stock ownership reform, but, so far, with fairly limited results.\textsuperscript{111} I will return to these issues in the next two Parts.

Despite these remaining problems, the reforms considered in this Part nicely illustrate two of the general lessons I will discuss in the final Part. The first is that well-defined property rights are helpful for economic development, although other things matter too.\textsuperscript{112} The work of Chang, McCall, and Wang illustrates the benefits from improved property rights.\textsuperscript{113} The struggles which reformed SOEs still face, however, illustrate that property rights reforms alone are not enough. Chen’s research and the timing of the property rights reforms illustrate that property rights change is often the result of economic development, not simply its cause.\textsuperscript{114} Local officials became interested in TVEs for the reasons discussed in Part II.\textsuperscript{115} Once committed to these enterprises, they had reason to want to make them perform better. Improved contracts and property rights help performance, and so local officials were led to the reforms we have discussed in this Part.

IV. PUZZLE 2: RELATIVE STAGNATION OF TVEs IN THE 1990S

Given the contractual and property rights reforms, one might have expected that TVEs would continue to flourish in the 1990s. Yet we have already seen that, at least in relative terms, TVEs stagnated during the decade. Table 1 shows that the collective sector did not continue to increase its share of industrial output. Figures 1 and 2 show that the number of employees and enterprises also stagnated.

\textsuperscript{111} See generally Cao, supra note 16, at 33-43 (discussing the problems encountered by Chinese SOEs during the initial reforms converting them from state-run to state-owned).
\textsuperscript{112} See infra Part VI.A.
\textsuperscript{113} See supra notes 104-07 and accompanying text.
\textsuperscript{114} See infra Part VI.C.
\textsuperscript{115} See supra notes 46-47 and accompanying text.
What happened? That is the question posed for this Part. Part of the answer starts to emerge from looking at Table 1. The proportion of industrial output contributed by private and "other" enterprises skyrocketed in the '90s. That sector became the leading edge of Chinese growth. This Part will give some answers as to why that occurred. Those answers are considerably more speculative than the points made in the last two Parts, as we are now considering a more recent time period, and, so far, less research is available (at least in English) to explain trends during that time. Still, we can start to look for answers in emerging strengths of competing organizational types and in weaknesses of TVEs.

Perhaps the biggest question is why entrepreneurs have suddenly found private enterprises more attractive. Here the current literature is perhaps most lacking in addressing this question, but there are at least some clues. Part of the answer is that many new private and "other" enterprises are former TVEs that have been turned into stock companies with some of their stock sold to private persons or organizations. One needs to be wary about the statistics: even an enterprise in which the local government retains a majority of the shares may turn up in the "other" category. To the extent this is true, the shift from TVEs still may be more apparent than real, because an enterprise in which the government retains a majority of the shares is still effectively controlled by the government. Indeed, even where the government has only a minority of shares, it (or the Party) may well still effectively control the voting of the workers' collective shares, giving it effective control. Still, an enterprise totally owned by the local community is presumably somewhat different than one with minority shareholders—the local government needs to worry about keeping those shareholders happy if it wants to encourage further investment.

A key question is how well the partially or totally privatized TVEs are functioning, and whether the change has led to efficiency improvement. The research by Chang, McCall, and Wang provides at least a partial answer that there have indeed been efficiency improvements. It is not obvious that this need be so. Some of the

116. See supra notes 92-95 and accompanying text.
117. See Chang et al., supra note 74, at 420.
118. See id. at 426.
privatizations involved sales to local officials or their family or friends, probably at low prices, and may represent rent seeking rather than moving resources into the hands of people who can use them more efficiently. Even if this is so, however, those resources now in private hands would be worth more to those persons if they were effectively able to sell control of the enterprise to those who could create more value from them. Thus, even rent-seeking privatizations create some political pressure for further improvements in property rights increasing the transferability of ownership rights.

Clearly the political and legal atmosphere facing private enterprises today has become better than in the '80s. Most accounts, however, still suggest that China is far from having established what Westerners would recognize as an effective rule of law. There have, however, been some moves in the direction of the rule of law, as "[c]ontracts are becoming more reliable, and corporations can be established on firmer ground than previously." Still, much of the development of private enterprises in China today probably represents a variant of crony capitalism, as those with ties to local leaders are able to set up or buy businesses through bypassing rules and procedures which would thwart those who are less well-connected.

Another important part of the growth of the private and "other" categories is foreign direct investment. There was a large growth in foreign investment in China during the '90s. One benefit of such investment is that it gives governments stronger incentives to protect private property rights, since foreign investors can quite credibly threaten to pull out of a jurisdiction, or at least invest no further, if they find that local institutions are not treating them fairly. Of course, such incentives will not always outweigh the private and short-term incentives politicians may have to treat

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119. See CHEN, supra note 7, at 101-02 for an example.
120. For the importance of such reforms for China today, see Jefferson & Rawski, supra note 21.
121. See Orts, supra note 60, at 106-10.
122. See id. at 106.
123. To be fair, the biographies of the President and Vice-President of the United States demonstrate that crony capitalism lives on even in the world's most advanced capitalist society.
businesses unfairly, but the mobility of foreign investment at least creates more pressure for protecting the interests of private enterprises.

During the '90s, some SOEs possibly became stronger competitors of TVEs, although the overall share of SOEs in industrial production continued to decline.\textsuperscript{124} Competition from TVEs put pressure on SOEs to reform. In the '90s many SOEs were corporatized, that is, turned into stock companies.\textsuperscript{125} To encourage better governance of the newly corporate companies, in 1993 China instituted a new Company Law, which resembles Western laws in many respects.\textsuperscript{126} It also instituted stock exchanges and a new securities law to help finance SOEs.\textsuperscript{127}

As noted above, however, big problems remain for SOEs.\textsuperscript{128} Passage of a decent corporation law alone is far from assuring good corporate governance. Good governance in Western companies depends on a host of supporting institutions, such as capital markets, managerial labor markets, markets for corporate control, product market competition, independent accountants and accounting standards, and even norms.\textsuperscript{129} Corporatized SOEs in China seem to face a grim two-fer that is rare in Western companies: the controlling shareholder (the State) takes advantage of minority shareholders, while managers take advantage of all shareholders because the supervising state agencies have neither the interest nor the ability to adequately supervise the managers. Thus, although

\begin{itemize}
\item \textsuperscript{124} See infra Table 1.
\item \textsuperscript{125} See Schipani & Liu, supra note 47, at 24-25; Simon, supra note 81, at 288.
\item \textsuperscript{126} See Company Law of the People's Republic of China, Adopted at the Fifth Meeting of the Standing Committee of the Eighth National People's Congress, 1993, available at http://www.cclaw.net/download/companylaw.asp (last visited Feb. 18, 2004) (unofficial English translation) [hereinafter Company Law]. The law, however, is not similar to Western corporate laws in all respects. One doubts that any U.S. state corporation law contains anything like the provisions of Article 14: "A company must, when engaging in business activities, abide by the law, observe professional ethics, strengthen the construction of socialist culture and ideology and accept supervision of the government and the public." Id. at ch. 1, art. 14.
\item \textsuperscript{128} See supra notes 47-48 and accompanying text.
\end{itemize}
some SOEs may have reformed enough to pose stronger competition to TVEs, SOEs generally do not appear to be the major problem TVEs face. Indeed, SOEs represent one area where reform in China has not yet succeeded.\textsuperscript{130}

The other main type of cause for the relative stagnation of TVEs would seem to be their own weaknesses. One major weakness they face is, perhaps, not really an internal weakness: TVEs have trouble obtaining financing.\textsuperscript{131} Much of the problem here lies with China's largely unreformed banking system, which is still heavily biased to SOEs. The stock markets are even more explicitly limited to SOEs.\textsuperscript{132} Private enterprises can at least draw upon personal savings and foreign investment. Part of the problem of obtaining financing, however, is probably due to internal weaknesses: if TVEs were a more attractive vehicle for individuals and foreigners, they could probably attract more investment.

The internal weakness of some TVEs may be a result of their past success. Part of what may keep many TVEs working adequately is their small size.\textsuperscript{133} Even if local political officials are not ideally suited to monitor the internal workings of businesses, their task is easier if the businesses are not very big. TVEs also may not attract the very best managers, nor give them the very best incentives, but again, if the businesses are small this drawback may not be too severe. A variety of articles have argued that cultural norms and personal ties help small-scale Chinese businesses succeed without the formal protections and structures of Western corporations.\textsuperscript{134}

The very success of TVEs, however, may have caused some of them to grow much larger, and made growth the more efficient path for others. If the internal controls of TVEs are liable to break down beyond a certain point, though, this growth could cause problems. Or, recognizing the likelihood of such problems, investors may be turning to other organizational forms as the optimal scale

\begin{footnotes}
\item[130] See Qian, supra note 78, at 43-49.
\item[131] Cf. Che & Qian, supra note 54, at 14-19 (explaining that, although TVEs have greater capital access than private enterprises, they have harder access than SOEs and were "hit badly during the retrenchment period" in their ability to obtain loans).\textsuperscript{132}
\item[132] See Friedman, supra note 64, at 488-89.
\item[133] TVEs have tended to be quite small. See supra note 14 and accompanying text.
\item[134] See Weitzman & Xu, supra note 12, at 137-41; Allen et al., supra note 80, at 33-34.
\end{footnotes}
of businesses increases. This point remains speculative, and the literature on TVEs has not yet produced clear evidence in its favor. However, it seems a plausible explanation worth exploring.\textsuperscript{135}

This Part has argued that stagnation and possibly even decline has set in for TVEs. That point, however, is itself speculative. After all, though the percentage contribution to output may have stopped growing, overall output continued to grow strongly in China during the '90s,\textsuperscript{136} and thus the absolute value of TVEs continued to grow. The trends do not yet show any clear decline in the relative share of TVEs in the Chinese economy. If such a decline does eventually occur, then this Part has suggested some reasons for it. Such a decline, however, is not inevitable. Even if it does occur, it may be the result of policy choices which one could question, rather than the result of any inherent inefficiency of TVEs. We now turn to consider possible future paths for TVEs, and policies which might lead to those paths.

V. FUTURE PATHS AND POLICY CHOICES

China's reforms are far from finished. China is still a relatively poor country,\textsuperscript{137} many of its economic institutions are still quite inefficient, and it is still some distance from achieving a full-fledged

\textsuperscript{135} A recent \textit{Wall Street Journal} article makes a similar point regarding private enterprises in China:

Many private ventures, which began as small family shops, now face big-company issues: managing expansion, forays into international markets, increasingly complicated finances, stock-market listings and the fight against rip-offs of their own brands. Whether these firms are ready to provide greater transparency, and whether they have the depth of management needed to handle their growth, will determine whether Wenzhou's trajectory remains upward.


\textsuperscript{136} \textit{See infra} Table 1. \textit{But see supra} notes 68-71 and accompanying text (noting the caveat as to statistics).

\textsuperscript{137} China's gross domestic product (GDP) per person, using a purchase power parity measure, was $3550 in 1999; the figure for the United States was $31,910. \textit{See THE ECONOMIST POCKET WORLD IN FIGURES} 234-37 (2002). For comparison's sake, here are the figures for a few other notable countries: Taiwan, $21,140; Greece, $15,800; South Africa, $8710; Mexico, $8070; Brazil, $6840; Thailand, $5950; Philippines, $3990; North Korea, $970. \textit{See id.}
market economy. The question is, what is next for China? This question has both a positive component (where will China go next?) and a normative component (where should China go next?). The answers to the two components could, of course, be quite different. In this Part, I will discuss three or four (depending on how you count) paths which China could follow. I then discuss the relative likelihood and attractiveness of the different paths, and whether all of the paths are necessarily mutually exclusive. The Part concludes by noting that the core question for China's future is whether Party officials will be willing to continue the process of limiting the Party and the State's ability to interfere in economic affairs. Whatever happens, interesting political battles appear likely for China's future.

A. The Path of Liberalization and Privatization

The first possible path for China stresses further liberalization and privatization. The goal of this path is a Western-style market economy dominated by private enterprises. If it is followed, TVEs and SOEs will eventually either be privatized or else wither away into unimportance. One part of this path of course involves transferring current state-owned enterprises over to private owners and revising various laws and rules which discourage private ownership.

To succeed, however, this path must involve much more than ownership transfers and legal revisions. A variety of supporting institutions must be developed and improved in order for private enterprises in China to flourish. As Enron and other recent scandals illustrate, even in the United States good governance of private enterprises is a fragile achievement, particularly for large businesses. Vital supporting institutions include banks, capital markets, property rights, independent courts and the rule of law.


139. See Cao, supra note 16, at 14; McDonnell, supra note 82, at 383-84; Paredes, supra note 129, at 1085-1100. These commentators stress the importance of a variety of supporting institutions in order to achieve good corporate governance in Western-style private enterprises.
and labor markets. Let us look at each of these in turn, and see where China stands today.

Banks are one economic institution that has not yet received enough successful attention from Chinese reformers. As noted above, the main banks of China are still owned by the State and loans are still granted for political reasons and heavily favor SOEs, creating a serious soft budget constraint problem. The banking system thus takes private savings and misdirects them to inefficient SOEs. This must change. One source of change would be to change the ownership structure of existing banks. If bank ownership could be diversified to a variety of state or even private organizations, bank performance might improve. There has been some movement in this direction with the Communication Bank of China. Perhaps more helpful would be to allow more entry and competition among banks. Foreign banks could provide better monitoring and choice of loans, and competition from them would force domestic banks to do a better job. Ultimately, one would like to see privately owned domestic Chinese banks.

Chinese capital markets are also underdeveloped. China does have several stock markets. However, it strictly controls what firms can offer shares, with entry basically limited to favored SOEs. Thus, today's stock markets, like today's banks, essentially act as a way to channel private investment into state enterprises. In the United States and countries with similar institutions, a well-functioning stock market is vital to good corporate governance for large businesses. The stock market creates a market for corporate control, which helps discipline managers, and provides the basis for equity compensation, which helps improve the incentives of

140. See QIAN & WU, supra note 78, at 14-15.
141. See supra note 53-58 and accompanying text.
143. See supra note 78, at 22.
144. See id.
145. See id.
147. See Friedman, supra note 64, at 479-89.
managers. A complex web of securities law, monitoring by large institutional shareholders, exchange regulation, state corporate law, managerial labor markets, and norms governing directors helps make the U.S. stock markets work. China has started to put some of the pieces in place, including a fairly modern securities law and company law. More of the puzzle, however, needs to be put together.

Property rights for private enterprises and their owners are indeed one part of the puzzle, though only one part. China now has a Law on Individually-Owned Enterprises which provides some legal protection for private enterprises. Legal obstacles, however, remain which could be removed. For instance, the initial capital requirement for limited liability companies ($60,000) is quite high. More generally, a web of regulations and permit and licensing requirements can make it quite hard, time-consuming, and expensive to start a business. Such rules need to be simplified.

Even if laws and rules are improved, they also need to be enforced in an impartial and predictable way—a requirement often referred to as the “rule of law.” Here too, much remains to be done. A major obstacle, which I shall discuss more below, remains the central role of the Party. Another issue is the tendency of local courts to favor local interests, especially the interests of local officials and their friends. Qian and Wu suggest a two-tier judiciary, with a lower tier of local courts and a federal or central tier with the power of appellate review above that, as a way to combat the latter problem. The former problem is a tougher nut to crack. Rules protecting sitting judges from being removed or having their pay reduced, along the lines of the Article III protection of judges in the U.S. Constitution, might help, but even that

149. See McDonnell, supra note 82, at 341.
150. See supra note 127.
151. See supra note 126.
152. See QIAN & WU, supra note 78, at 24.
153. See id. at 25.
154. See Orts, supra note 60, at 74-77 (describing the “western concept” of the “rule of law” as distinct from other possible interpretations of the term).
155. See QIAN & WU, supra note 78, at 21.
156. See id. at 28.
157. See id. at 28-29.
158. See U.S. CONST. art. III, § 1.
would not get at the problem of the Party's dominance in the selection of judges.

Labor markets are another part of the mix of Western-style corporate governance. In particular, managerial labor markets help give managers incentive to behave themselves—managers with good reputations are more likely to get better jobs elsewhere. Labor markets for lower level workers are also part of effective corporate governance in that enterprises which do well can afford to pay their employees more, and enterprises with reputations for treating their employees well are likely to attract better, more efficient employees. For these markets to work, managers and employees must be able to move about and choose where to work. Many old restrictions on movement and enterprise choice have been removed, although some remain.

As we shall discuss more soon, many of these reforms may threaten the interests of existing state and Party officials, making them difficult to implement. Moreover, investors will be less likely to invest in private enterprises if they think the prospects for further reforms along the lines suggested above are dim. Thus, one final type of reform required to make further liberalization and privatization work is reform of the political system itself. In the end, might this require allowing real political competition, including the entry of new parties? We shall discuss that below. That reform still seems far away. One, more limited reform with some real promise is now being tried, though. The Party of Chairman Mao now allows private business people to become Party members.

Hopefully, allowing entrepreneurs into the Party will create an internal constituency which will push for further reforms along the lines discussed above. This dramatic political change, though, carries the risk that it will lead to crony capitalism, with entrepreneurs using their position within the Party to favor their own

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businesses, rather than to create laws which favor private enterprises more generally.

This first path of liberalization and privatization may divide into two different sub-paths. So far, I have treated Western-style private enterprise systems as an undifferentiated whole. At least two quite differing types of systems, however, exist among advanced capitalist economies. The U.S. economy is dominated by sophisticated capital markets, while the Japanese and German economies are dominated by large banks. Insofar as these are competing alternatives, developing countries like China will at some point need to choose among them. There has already been some effort to experiment with main bank relationships in China.

B. The Path of Democratization

China's second path focuses on democratization rather than on liberalization and privatization. This path treats TVEs as a long-term institutional innovation rather than a transitional phenomenon. Some analysts of TVEs have seen in them the seeds of a new long-term development. There has been much debate over whether Western enterprises, especially those in the United States, adequately reflect the interests of stakeholders other than managers and shareholders. Some scholars believe that corporations should be run in the interests of shareholders only, while others


163. See Robert D. Cooter, Organization as Property: Economic Analysis of Property Law Applied to Privatization, J. LEGAL ECON., Dec. 1992, at 77, 93-94. See infra notes 177-80 and accompanying text for further discussion regarding whether these are competing alternatives and at what point a developing country might need to choose between them.


165. Or third, if you count the U.S. and the Japanese models of private enterprise as two different paths.

166. See Simon, supra note 81, at 268; see also supra notes 50-52 and accompanying text.

167. See, e.g., McDonnell, supra note 82, at 350.
think that managers should consider other stakeholders as well.\textsuperscript{168} Other stakeholders of concern include employees, bondholders, consumers, suppliers, the local community, and even the environment.\textsuperscript{169} Might TVEs better include some of these stakeholders and better promote stable, long-term relationships among these various interests?\textsuperscript{170}

In favor of such a possibility is the fact that TVEs are less structured to respond to the interests of shareholders than U.S. corporations. Insofar as TVEs respond to shareholders, if the leading shareholder is the local government, then there is at least a chance that local governments will represent broader interests than private shareholders. Certainly one would hope that the local government would represent the interests of the local community, and because most of the employees and many of the suppliers and consumers of a local TVE will also be local residents, those interests could be represented as well. There is also some rhetoric and even law\textsuperscript{171} favoring the involvement of employees in TVEs and SOEs. The local government also may have less pressure or ability to sell its interest than private shareholders of U.S. corporations, helping to commit to a longer-run interest.

On the other hand, just because local government officials are nominally supposed to represent the interests of local residents does not mean that they actually do. Although there is some formal and informal pressure on them to do so, much of their political career still depends on pleasing higher-level officials.\textsuperscript{172} Moreover, both directly and indirectly through family and friends, officials frequently have developed private pecuniary interests in enter-

\textsuperscript{168} See Stephen M. Bainbridge, Corporation Law and Economics ch. 9, (2002), for an overview of this debate. Note that even if one believes that other stakeholder interests should be considered, that does not necessarily imply that stakeholder constituency statutes are a good idea. See Brett H. McDonnell, Corporation Constituency Statutes and Employee Governance, 30 WM. Mitchell L. Rev. (forthcoming 2004).


\textsuperscript{170} Recall Article 14 of the Company Law, which requires companies to "strengthen the construction of socialist culture and ideology." Company Law, supra note 126.


\textsuperscript{172} See supra notes 29-32 and accompanying text.
prises which may conflict with the local public good. One index of the failure of TVEs to respond adequately to community interests is their appalling environmental record. Also, despite the official encouragement of employee involvement in TVEs, actual active involvement is infrequent.

TVEs might come closer to their potential with reforms that make them more responsive to the interests and concerns of local residents. The obvious reform is to make local government officials elected locally in free, open elections. Local officials’ behavior may change if their political survival turns on pleasing local residents rather than higher officials. Local residents also may have better information than higher officials as to the performance of local officials. There already has been some movement in this direction, with many local village officials now being elected, but elections are not yet held at the township level. I am not aware of any research which examines whether the behavior of TVEs has changed as a result of local elections—that will be an interesting topic to watch in the future. Of course, as I shall soon discuss further, this reform, like many others, is limited by the Communist Party's monopoly over political power. Local elections cannot involve contests between different parties. They could, however, involve contests between different individuals, if they can avoid the problem of Party endorsement determining who wins, and that could be enough to do much good.

Let us now compare and contrast these different available paths. A first question is whether they really represent distinct alterna-

173. See CHEN, supra note 7, at 52-53 (explaining local officials’ reputational interests as an example of their conflict with local public good).

174. See Williams, supra note 60, at 247. One could, however, argue that the dismal environmental surroundings fairly accurately represent the actual preferences of poor peasants at an early stage of development because a clean environment may be a luxury good.


tives. To some extent at least, I have overemphasized the distinctions. Many of the reforms discussed above under the rubric of liberalization and privatization also would be useful for reforms that try to extend and improve TVEs, and democratization of political power would also be useful for reforms which focus on creating a privatized market economy. As noted above, some think that the distinction between U.S.-style and Japanese- or German-style capitalist systems is overdone, and that banks and capital markets really complement each other.\(^{177}\)

Though overdone, the distinctions are real alternatives among which, at some point, China will have to choose. Alternatively, at some point the cumulative effect of reforms may point enough in one direction that it will become increasingly hard to switch paths,\(^{178}\) even if no conscious choice has been made. At that point, the active market for corporate control, which is characteristic of the U.S. system, would be very difficult to maintain while also maintaining the close bank-firm relationship, which is characteristic of the Japanese system.\(^{179}\) Maintaining a financial system which fully backs both TVEs and private enterprises will also be difficult—building a financial system which adequately supports either one will be hard enough. There are also political obstacles in maintaining dual systems—once one alternative becomes strong enough, the entrenched interests it creates will have little incentive to support opposing alternatives. There also may be complementarities between the different elements of corporate governance which make it hard to keep two different systems going simultaneously.\(^{180}\) Ultimately China will have to choose, deliberately or not, among the alternatives.

The next issue is the relative likelihood of the different paths. The stagnation of TVEs in the 1990s suggests that one of the privatization alternatives may be more likely. Moreover, increased democratization may represent a greater threat to the interests of the Party elite than liberalization and privatization, making democratization less likely. The privatization alternatives are also

\(^{177}\) See supra note 162.

\(^{178}\) On the concept of "lock-in," see McDonnell, supra note 82, at 356.

\(^{179}\) See Cooter, supra note 163, at 94.

\(^{180}\) See id.
advantageous because models of the end goal are readily available in advanced capitalist economies, making it easier to learn how to do things, whereas the TVE-focused alternative would involve charting untested waters. Consequently, reforms focused on making TVEs permanent seem less likely. On the other hand, the past success of TVEs has created some powerful interests likely to favor them, and TVEs provide a better ideological link to the Party's socialist past, in case that matters to anyone anymore. The long-term decline of TVEs, therefore, is not certain yet, though it is more probable than not.

Whether China's development is more likely to follow the U.S. or Japanese and German models of capitalism is hard to determine at this point. The problems faced by Japan, and to a lesser degree Germany, in recent years have made the United States the dominant model in international circles, though more recent problems in America have muted that effect somewhat. On the other hand, the Japanese system seems to have more cultural affinity with China than the U.S. system. In addition, the effect of foreign direct investment also may play a role because foreign businesses may tend to bring in the model of corporate governance with which they are familiar. It is not yet clear what country will have the greatest effect via this channel. Finally, it is not clear which of the two forms of capitalism has stronger entrenched interests supporting it politically. I would say that at this point China could still readily follow either of these two paths.

A separate question is which of the paths—the U.S.-based or Japanese- or German-based system—is more desirable. "Desirable," in turn, is ambiguous—one could desire efficiency, a fair distribution of wealth, or other goals, which may or may not favor the same path. The choice between the two variants of capitalism has been widely discussed. In an earlier paper, I argued that the two systems are roughly equal in productive efficiency, but the U.S. system is more flexible and adaptive, whereas the Japanese system is more egalitarian. It is, therefore, hard to compare the two, and which

181. See McDonnell, supra note 82, at 364-65, 381.
182. See id. at 381.
is better may well depend on how you weigh the relative values involved in evaluating the two.\footnote{183}

As for the TVE-dominated alternative, that comparison is made more difficult by the fact that we do not yet have a well-developed alternative to compare with the United States, Japan, and Germany. China today, while it has its attractions, is clearly not as attractive as the more advanced economies. For reasons discussed above,\footnote{184} however, democratic reforms might make the Chinese alternative significantly more attractive than it is today. Could democratic reforms go far enough to make the Chinese alternative competitive with the leading capitalist countries? Some think it is possible.\footnote{185} I am rather skeptical. Experimentation and exploration of the alternative would be interesting,\footnote{186} but I am not sure that the expected returns from such an experiment are worth it for the people of China who have come to expect continuing large improvements in economic development.

\textbf{C. The Path of Aborted Reform}

All of the discussion up to here has assumed that Chinese reforms will continue and that the choice is between different paths that all lead to relatively attractive end-states, though one can debate which end is better. Leaving the discussion there though, would be too optimistic. There is a real risk that the reform process could bog down and that China could remain seriously underdeveloped.\footnote{187}

There are at least two possible, interrelated sources of this risk. The first is the "partial reform trap."\footnote{188} The creation of transitional institutions, possibly including TVEs, may create vested interests

\begin{footnotes}
\item[183] See id. at 362.
\item[184] See supra notes 165-76 and accompanying text.
\item[185] See Simon, supra note 81, at 305-06.
\item[186] On the value of such experimentation and preserving alternative systematic approaches to corporate governance, see McDonnell, supra note 82, at 382-83.
\item[188] See Qian, supra note 78, at 38; see also Joel S. Hellman, Winners Take All: The Politics of Partial Reform in Postcommunist Transitions, 50 WORLD POL. 203, 204-05, 232-33 (1998).
\end{footnotes}
that seek to block further reform. There is some evidence of this problem occurring in Russia and Eastern Europe.\textsuperscript{189} On the other hand, it is also possible that interim reforms can create constituencies that back further reform. To at least some extent this has already occurred in China.\textsuperscript{190} The expansion of TVEs itself is an example of this. The question, though, is whether the process is likely to continue in China. Perhaps it will. After all, many local officials have found it in their interest to privatize TVEs. Even after this occurs, however, the problem of crony capitalism remains, and one must look hard to see what political constituency exists to get around that problem. One possible pressure for continued change is China's joining the World Trade Organization. This creates ongoing international pressure for China to open up its economy to competition and make its internal markets a more level playing field. The pressure to keep up with international competitors could then make many agents in China more focused on improving efficiency.\textsuperscript{191}

The other, related obstacle to continued reform is the Communist Party's continuing monopoly on power. The Party has a long, baleful history of interference in all areas of life in China. That Party's power was catastrophic for economic development, not to mention individual liberty. A big part of the genius of reforms to date is that they help partially commit the Party to less daily interference with the decision making of enterprises. Indeed, the reforms have managed to give local Party and government officials strong incentives to help local enterprises succeed.

Although success so far does not guarantee continued success, the reforms at this juncture seem to have created significant pressure for continued reform. The career success of officials is to a great extent tied to the economic success of the region or industry for which they are responsible. The political legitimacy of the Party and government today seem almost completely tied to delivering the goods—the old communist ideology seems increasingly irrelevant. Many local officials now also have private pecuniary stakes in

\textsuperscript{189} See \textit{Qian}, \textit{supra} note 78, at 38.
\textsuperscript{190} See \textit{id}.
\textsuperscript{191} See \textit{Qian \& Wu, supra} note 78, at 3, 17-18.
continued economic development. Entrepreneurs are growing in number and political influence.\textsuperscript{192}

Yet, obstacles remain. If you look at just about every reform suggested earlier in this Part, questions abound as to the interests of Party and government officials.\textsuperscript{193} Are they willing to reduce the power of state banks and the ability of SOEs to tap the stock markets? Are they willing to allow courts to become truly independent, thus risking decisions which could seriously hurt them and limit their power? Are they willing to expose themselves to free elections and ultimately to opposition parties? The answers to these questions are still quite unclear. The Party itself has conflicting interests, and individual officials now have quite complicated relationships with the Party. The hope is that individuals, and even the Party itself, are now committed enough to the path of reform that they will be unable to turn back, even if future reforms scare them. The fear is that at some point reforms may become too threatening to the Party's hold on power, and those at the top of the hierarchy may apply the brakes. After all, it has already happened once during the reform process, although the braking then turned out to be temporary.\textsuperscript{194}

Thus, we have to add a third or fourth\textsuperscript{195} possible path: reform may be blocked, leaving the system in its current mix of market and state. Aborted reform, in turn, might be thought of as having two possible sub-paths. In one of these, the economy stagnates, unrest grows, and the Party must resort to force, more or less successfully, to keep itself in power. In the other sub-path, even with blocked reform, the economy manages to grow enough to dampen serious dissent. The Party maintains largely unchallenged political control. Some recent analysts see China headed towards fascism (of the Italian style), with the Party retaining firm political control while supporting and supported by private business


\textsuperscript{193} See Rawski, supra note 187.

\textsuperscript{194} Following the massacre at Tiananmen Square, opponents of reform slowed the process for several years, but it soon resumed. See Wong, supra note 192, at 261.

\textsuperscript{195} See supra note 165.
interests (a form of crony capitalism). This scenario is basically the more successful sub-path of blocked reform.

Although it seems clear that the path of aborted reform is less desirable than any of the others, what about its likelihood? There is reason for guarded hope that this path is unlikely. Reforms seem to have created strong pressure for further reform. Slowdowns and temporary blockages are likely, but it would probably now be hard to shut down the reform process completely. A complete shutdown is far from impossible, however, and it may well be more likely than the TVE-focused path of democratization described above. Blocked reform, however, is probably less likely than either of the paths that lead to a modern capitalist system along American or Japanese lines.

VI. PROPERTY RIGHTS AND ECONOMIC DEVELOPMENT—FOUR LESSONS

The ultimate point of this Article is to examine developments in China, particularly TVEs, and see what those developments can teach us about the relationship between property rights and economic development. The story we have considered in the previous Parts of this Article suggests that a simplistic version of this relationship will not do at all. In a very simple version of the standard economist’s story, the key to achieving economic development is to define property rights clearly. Development will take off with properly developed property rights. This story places too much emphasis on clearly defining property rights. Property rights matter, but so do a number of other things. Focusing on rights first is not always the best approach for a developing country. I elaborate on this basic point in four lessons.

196. See Becker, supra note 161, at 16.
A. Lesson One: Property Rights Are Neither Necessary nor Sufficient for Development

Puzzle one, the success of TVEs in the 1980s, shows that clearly defined property rights to residual income and control are not necessary for successful enterprises. At the beginning, property rights in TVEs were quite fuzzy, and yet TVEs succeeded in becoming a dynamic, central part of China's rapid development. Puzzle two, the slowdown of TVEs in the 1990s, suggests that clearly defined property rights are not sufficient for successful enterprises. As shown in Part III, in the late '80s and early '90s, extensive property rights reforms occurred in many TVEs. Although the reforms seem to have increased efficiency, the relative growth of TVEs ended afterwards. In part this is because rights reform made private enterprises more attractive than previously. However, it is also in part because other obstacles to TVEs remained, in particular the extreme limitations of Chinese financial institutions. Moreover, legal property rights reforms are not enough for Chinese enterprises to achieve good corporate governance—we have seen in the United States that good corporate governance requires a host of supporting institutions.198

Thus, property rights matter, but other institutions matter too, including banks, capital markets, labor markets, product markets, political structure, and norms. These interact in complicated ways to foster, or hinder, good corporate governance and economic development. This interaction also suggests another complicating factor. If it is the interaction of many institutions that matters, then for each institution, including the legal definition of property rights, the best current version of that institution may depend, in part, upon the current state of a variety of other institutions.199 Full-fledged privatization, for instance, may well not have made

198. See supra notes 108-10, 142 and accompanying text.
199. A variety of economists have analyzed the possibility of such institutional complementarity. See Aoki, supra note 23, at 87-88, 207-08, 225-29; Susan Gates et al., Complementarities in the Transition from Socialism: A Firm-Level Analysis, in Reforming Asian Socialism, supra note 3, at 17-22; Paul Milgrom & John Roberts, The Economics of Modern Manufacturing: Technology, Strategy, and Organization, 80 Am. Econ. Rev. 511, 525 (1990); Paredes, supra note 129, at 1106-09.
sense for Chinese enterprises in the early '80s, when the institutions needed to support private enterprises were not in place.

This suggests a typology of theories along two lines of variation. Theories of development may place greater or lesser emphasis upon property rights as opposed to other institutions. They also may be more universalistic or more particularistic. The possibility of a more particularistic approach arises from the point about the interrelation between institutions. The more important one believes this point is, the less one is likely to prescribe a one-size-fits-all policy for any one type of institution regardless of the current state of other institutions in any particular society at a moment in time.

Figure 4 illustrates the possibilities. The x-axis handles property rights versus other institutions. The further to the right one moves on the axis, the greater the relative importance of property rights as opposed to other institutions. The y-axis handles the universality dimension. The higher up one moves on this axis, the more universalistic the theory. Thus, a simplistic version of the pure economic property rights story might be represented by point A—strong emphasis on property rights and highly universalistic. An extreme institutionalist theory might be represented by point C—much emphasis on institutions other than property rights and highly particularistic. The positions on the two axes tend to be positively correlated, but there are exceptions. For instance, Hernando de Soto, represented by point D, places prime importance on property rights, but thinks that how to best protect property rights depends heavily on a country's particular circumstances and customs. My own preferred approach would be something like point B—closer to the institutionalist theory, but recognizing that property rights are fairly important, and not too extremely particularistic.

One last point to make within the confines of this first lesson concerns the particular other institutions that are of special interest in the Chinese case. Product market competition and federalism are of great importance to the developments in China. Opened-up product markets created room for TVEs to grow, and

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200. Aoki's theory does not place a lot of emphasis on property rights. See AOKI, supra note 23, at 35-55. His particularism, while notable, is not extreme.

201. See DE SOTO, THE OTHER PATH, supra note 197, at 185-87.
product market competition creates strong pressure for good, or at least not disastrously bad, corporate governance. The federalism of the Chinese government and the Communist Party created incentives on the part of local officials to develop TVEs and competition among officials, which helped spur better performance.202

The importance of these institutions should not be a surprise to Americans, as they may well have been key to our own economic development. Consider the pivotal moment of 1787 and the creation of the U.S. Constitution. The creation of a common market was one of the leading goals and effects of the union, and surely it had a powerful influence on the growth that followed. Federalism was, of course, a central feature of that constitution. Although a Bill of Rights was soon appended, the early federalists argued that citizens would be protected from government intrusion less by enumerated rights than by the structural protections created by federalism and the separation of powers.203 Have Deng Xiaoping and Zhao Ziyang, in some small, halting way, followed in the path of James Madison?

B. Lesson Two: Political Constraints Matter

One major obstacle that property rights reforms face is that they may well hurt groups with enough political power to block the reforms. In the case of China, the most obvious and critical such group consists of the Party and the State officials, who will find their ability to intervene in economic affairs limited and who ultimately may risk losing political control altogether. Other groups are at risk too. For instance, the managers and employees of SOEs could find that their jobs are in jeopardy as other enterprises threaten theirs and as cost cutting becomes necessary in response. If a reform is too threatening to groups that are too powerful, that reform will not occur, no matter how much it might advance the public interest.

Thus, if those who propose property rights reforms actually care about seeing them implemented, they need to think carefully about political constraints on the passage and implementation of reforms.

202. See CHEN, supra note 7, at 32-42.
203. See THE FEDERALIST No. 20 (Alexander Hamilton & James Madison).
Political constraints matter. A very interesting element of reform in China is how it has managed to handle those constraints so far. China has reformed gradually, creating transitional institutions, rather than trying to leap immediately to institutions that closely resemble those in the West. One effect of this approach is that old institutions are not immediately destroyed, and those who rely on those institutions are not too badly harmed. For instance, SOEs have not been eliminated or shed workers too quickly. Instead, they have just not expanded much, allowing other enterprises, including TVEs, to surpass them. The existing SOE employees keep their jobs, but new entrants to the job market go to more dynamic enterprises. Thus, a potential strong voice against reform is, if not completely silenced, then at least seriously muted.

The gradualist nature of reform in China, however, has done more than simply neutralize potential opponents. It also has helped create powerful political supporters of further reform. We have seen how early reforms encouraged local officials to greatly expand TVEs. We also have seen how experimentation with TVEs and changing circumstances led local officials to further contractual and property rights reforms as a way of improving the performance of those TVEs that had become so important to their careers. The personal and general gains to be had from privatizing TVEs and allowing private enterprises and foreign investment then pushed local officials into yet more reforms. Hopefully, this process has not yet stopped. Thus, the process of gradual, step-by-step reform in China, so far, has managed both to mute potential opponents and to create political support for further reform in a self-sustaining dynamic process.

204. See QIAN, supra note 78, at 11-12.
205. See id. at 25, 43 (stating that economic reform in China has suited existing interests); see also Lawrence J. Lau et al., Reform Without Losers: An Interpretation of China's Dual-Track Approach to Transition, 108 J. POL. ECON. 120, 135-36, 140-42 (2000) (noting "continued enforcement of the rights and obligations under the plan" in the midst of economic liberalization).
206. See supra Part I.
207. See supra Part III.
208. See supra Part III.
209. There is no guarantee, however, that this process will continue. See supra Part V.
Other countries pursuing economic development will need to follow different specific paths, tied to the specific economic and political environment they face. Reformers anywhere, however, must take care that their ideas are politically achievable and sustainable. China provides an interesting case study in how that can be achieved. China's gradualist, step-by-step approach may have its problems, though, as we shall discuss when we come to lesson four.

C. Lesson Three: Property Rights Are both the Effect and Cause of Development

The traditional economists' story about property rights and development features clear, well-protected property rights as the leading cause of economic development. Yet, the historical sequence of TVEs in China does not fit this story. At the beginning of reforms TVEs had ill-defined property rights, while private enterprises had little protection at all. Other reforms, such as opened-up product market competition, strengthened federalism, and agrarian reform provided the initial impetus for new sorts of enterprises. It was only after TVEs started to become successful that their success started to create political momentum for property rights reform.\(^{210}\) In China, at least, property rights were at least as much the effect of economic development as its cause.

Of course, the causation is not unidirectional. Once property rights reform started to occur, it, in turn, spurred further development.\(^{211}\) Thus, property rights reform in China was both the effect and the cause of economic development. The two forces have managed to develop into a self-reinforcing virtuous circle. This third lesson is supported by the second lesson: property rights reform probably became politically feasible only once China reached a certain stage in economic and institutional development.

Moreover, protection of property rights itself should not be thought of as simply a political and legal matter. Much development

\(^{210}\) See supra Part III.

\(^{211}\) See supra Part III. Chen provides strong analysis of this process of "induced privatization." See CHEN, supra note 7, at 212-19.
For instance, the protection of minority shareholders is not simply a matter of having good laws on the books, or even of having independent courts which enforce those laws, although that would certainly help in China. Much protection of minority shareholders comes through market mechanisms and norms. Protection of shareholders thus develops gradually along with the development of markets, rather than preceding it. Frequently formal legal protections of shareholders will come along rather late in the process, as happened in the United States and the United Kingdom. When some legal reform does come before other mechanisms are well in place, as was the case for Chinese SOEs and the new Company Law of 1993, the law will remain something of a dead letter until other supporting institutions have developed adequately.

All of this is not to deny that property rights matter or to treat them as an epiphenomenon. At some point well-developed legal protection of various stakeholders within enterprises probably becomes crucial to continued development. That may be particularly true as the optimal size of enterprises increases, and informal mechanisms become inadequate to the task of protecting investors. China may well have reached that point, or at least be nearing it. The question of the optimal sequencing of various economic reforms is very hard, and will vary quite a bit from country to country. In some cases emphasizing the legal protection of property rights optimally will occur sooner than in others. The legal protection of property rights need not, and often will not, come right at the beginning of a process of development.

Another qualification to this lesson, one which applies to this entire Article, is that I am focusing on a particular kind of relatively

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212. See generally Andrzej Rapaczynski, *The Roles of the State and the Market in Establishing Property Rights*, 10 J. ECON. PERSP. 87 (1996) (arguing that property rights develop largely as "a product of market forces, rather than government fiat").
215. See id.
216. See CHEN, *supra* note 7, at 51-52 (noting that property rights in TVEs are protected because the small number of owners have oversight of the TVE management).
sophisticated property right, namely the rights of participants in business organizations. This is a more complicated type of right than the right of an individual over personal or real property. It very well may be true that protecting those simpler and more basic kinds of property rights does and should occur earlier in economic development than the protection of business association rights. Thus, a part of the difference between my account here and the analysis of people such as de Soto\textsuperscript{217} may simply be that we are concentrating on different sorts of rights.

\textbf{D. Lesson Four: The Path of Reform May Affect What Is Reachable in the End}

The development path followed may determine which end-states China can reach feasibly. This is the most speculative of the four lessons—one cannot conclude with certainty anything about this topic from China, because China today is still so far from any of its possible end-states. This lesson, however, is an important possibility for reformers to consider, as it creates a tough trade-off between short- and long-term goals of reform.

At some point, certain reforms could make it extremely hard, if not impossible, to reach one of the possible future paths described in Part V. Economists in recent years have recognized a variety of mechanisms by which economic development may be path-dependent. That is, past developments will open up some possible future developments while foreclosing others.\textsuperscript{218} One reason this may occur is that past developments may create political groups which block future changes which threaten them.\textsuperscript{219} Another reason is that various institutions within an economy may complement one another. Once a certain set of complementary institutions has

\begin{flushleft}
\textsuperscript{217} See supra note 197.
\textsuperscript{219} See supra Part VI.B.
\end{flushleft}
become dominant, it will be very hard to change any one of those institutions in a way inconsistent with the rest.\footnote{220}{See supra notes 198-99 and accompanying text.}

For instance, if reforms in China were to create a very strong vested interest in SOEs and TVEs, that interest might be able to block new reforms which would help support private enterprises. Conversely, if private enterprises become well-entrenched economically and politically then there may not be political support for other reforms which might help TVEs develop into a truly unique, long-lasting business organization alternative. Similar possibilities exist for the two Western-style sub-paths.\footnote{221}{See supra notes 162-64 and accompanying text.} If China were to develop a Japanese-style banking system, that might limit its ability to expand stock markets along a U.S.-style model. Conversely, if it develops U.S.-style capital markets it may not be able to simultaneously develop a Japanese-style banking system.\footnote{222}{See supra notes 178-80 for some reasons for possible incompatibilities.}

If this fourth lesson is true, then the strategy of reform becomes much more complicated. Lessons two and three have stressed the gradualist, step-by-step nature of Chinese reform. Rather than identifying a clear long-run end-state and aiming directly for that, Chinese reformers have focused on what can be done in the near term to help move the economy forward. This process even has a name: "grasping for stones to cross the river."\footnote{223}{chen, supra note 7, at 210.} Lesson two showed how this process has helped China advance within its political constraints. Lesson three showed how saving property rights reform for later in the process has helped generate a self-propelling dynamic.

Lesson four, however, draws our attention to a problem of this process which focuses on what looks best in the relatively short term. The short-term reforms may change what one can achieve in the long run. A reform which looks attractive in the short run may wind up foreclosing the most attractive long-run path. The natural response would seem to be to ask that reformers consider these long-run effects as well. There are at least two problems with the response, however. First, the incentives of those in power may be unduly focused on short-run success rather than long-run success,
as their personal stake may not extend as long as the national interest. This may well be a greater problem for democracies than for authoritarian governments such as China, but the problem still remains. Second, it may be very hard to predict the long-term effects of current reforms.

It is not a necessary truth that there must be a conflict between what reforms are best in the short and the long run; the two may coincide. I do not see any good reason to believe that China has yet forestalled any of the possible future paths described in Part V. The day may yet come, however, when China faces decisions which will block one or more of those paths, even if it is hard to tell when that day has arrived. But, hey, no one ever said economic development was easy.
### TABLE 1

Percentage of Total Industrial Output by Type of Enterprise

<table>
<thead>
<tr>
<th>Year</th>
<th>State-owned</th>
<th>Collective</th>
<th>Private</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1952</td>
<td>41.54</td>
<td>3.26</td>
<td>20.57</td>
<td>34.63</td>
</tr>
<tr>
<td>1957</td>
<td>53.77</td>
<td>19.03</td>
<td>0.83</td>
<td>26.37</td>
</tr>
<tr>
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Figure 1

Number of TVE Employees
Figure 2

Number of TVEs

![Bar chart showing the number of TVEs from 1990 to 2000. The number of TVEs ranges from 1,000 to 3,000,000 in thousands. The chart indicates a general increase in the number of TVEs over the years.]
Figure 3
Flow of Benefits and Control Rights

Source: Derived from CHEN, supra note 7, at 22.
Figure 4

Property Rights and Institutions

Universality

Importance of Property Rights

A
Property Rights Theory

B
This Article

C
Institutionalist Theory

D
De Soto