China's Lucky Corporate Governance – for 北大商业评论 Peking University Business Forum

Randall Morck[1], Bernard Yeung[2] and Minyuan Zhao[3]

Three Governance Problems

Corporate governance is an ongoing challenge in all countries – developed and developing. The challenge is to make sure that the people who decide how to use a market economy's resources are competent, honest, and not too lucky, and that their decisions serve the people as a whole. The need to make sure top managers not too lucky may actually be China's main corporate governance problem in the next few years; and we tentatively propose directions that Chinese policy makers might consider for addressing this problem. But before we explain, we need to remind the reader about more traditional corporate governance problems – preventing incompetent or dishonest people from running firms.

In European, Latin American, and Asian countries, whose corporate sectors are mainly controlled by a few wealthy families, the key challenge is often finding competent sons. In state-owned enterprises, a similar problem of finding a politically loyal top manager who is also talented arises. Russia and much of Eastern Europe seem to be rapidly evolving towards oligarchies of the Latin American sort, where 'idiot sons' are a key corporate governance problem. The 'idiot son' problem, more generally, occurs

[1] Jarislowsky Professor of Finance, University of Alberta; William Lyon Mackenzie King Visiting Professor, Harvard University

[2] Krasnoff Professor of Global Business, Economics and Management, Stern School of Business, New York University and Deputy Director of the Global Business Institute, Stern, New York University.

[3] Assistant Professor of Strategic Management, Carlson School of Management, University of Minnesota.

whenever corporate power is assigned based on blood or loyalty, rather than merit. It is too soon to tell whether China too will follow this path.

Different countries developed solutions to the ‘idiot son’ problem. The powerful families that led Meiji Japan’s development, like the Mitusi and Sumitomo, rejoiced over daughters because an inept son could ruin the family, but a daughter, married to the family’s best hired manger, insured prosperity for another generation. In the United States, small investors collectively own most of the stock in most large corporations, and most are run by professional managers. The brightest American students compete for admission to elite MBA programs, and firms’ boards of directors then hire and fire them in search of the best talent. Successful top managers earn tens and even hundreds of millions of dollars per year.

This is controversial, but is perhaps a bargain if they really do manage America’s resources well. Even multimillion dollar salaries are insignificant compared to the costs of wasted national wealth in many unsuccessful developing countries.

But the American solution to the ‘competence’ problem is incomplete and can exacerbate the second corporate governance problem - dishonesty. The vast money at stake in this contest attracts rascals – highly competent crooks. This seems to us to characterize the scandals at Enron, Worldcom, and other high profile American corporate governance scandals, though the top executives charged with wrongdoings now defend themselves in court by arguing that they were merely incompetent, which is apparently better than being dishonest. Of course, heirs to powerful families, whose incompetence erodes their patrimonies, can resort to theft to maintain their lifestyles, as is alleged in many corporate governance scandals in Europe.

The American proverb ‘sunlight is the best disinfectant’ seems apt here, for transparency, public criticism of dishonesty, and legal actions against exposed thieves all ease this ‘honesty’ problem. Transparency makes irregularities in companies’ use of the nation’s resources apparent to all, especially if energetic financial newspapers compete to bring economic news to the public. Public criticism of dishonesty is important too, for corruption is so rampant in some countries that it becomes a part of life, and no longer attracts condemnation. Legal action against corporate thieves is also necessary, and transparency makes it harder for corrupt officials to protect corporate thieves.

China surely also needs competent and honest people deciding how to allocate its resources. Without denigrating either of these two problems, we suggest that the third governance problem – too lucky top corporate managers – may be more urgent in China right now. Too much good luck is a known corporate governance problem elsewhere. In America, firms routinely sue each other for billions of dollars. This occasionally showers billions of dollars on a lucky firm, and this windfall is almost always wasted. Oil companies, inflated with profits by record oil prices in the 1970s, made catastrophically wasteful investment decisions. Japanese *keiretsu* firms and Korean chaebols, well connected to their countries’ banks and governments, got much needed investment capital to take an early and profitable ride of their countries’ respective cycle of growth. They got rich but overbuilt so extensively that both countries still suffer from the burden of excess capacity in many industries.

All of these problems were created by reasonably competent and honest people who were ‘too lucky’. These top corporate managers were in the ‘right place’ at the ‘right time’ to be showered with money, and understandably misperceived this good luck as a sign of their corporate governance genius. Perceiving themselves to be uniquely talented, oversaw bold new ventures, takeovers, and overseas corporate expansions that turned out to be disasters. In retrospect, these firms should have paid higher dividends, returning their excess cash to shareholders, who could have used it to buy shares in promising new firms.

The Danger of Too Much Luck

China’s economy is currently booming, and many Chinese companies are certainly managed by highly talented individuals. However, such widespread prosperity can bestow success upon the lucky as well. Economic history shows that early on in an economic development boom, established firms reap high profits – but only temporarily. As the economy grows, competition rises and firms with lucky top managers are squeezed by those with talented top managers. The danger in China, as we see it, is that vast amounts of capital will be allocated before the talented can be distinguished from the lucky, and much of China’s national wealth might be wasted. To prevent this, China has two critical needs:

1. Capital must be allocated to those with genuinely good plans for using it.
2. Potentially talented people need the skills necessary to prepare such plans.

Of course, China has many other needs, such as improved institutions that provide people with incentives to work hard to produce what the economy needs. But these two needs underscore the importance of corporate governance: it's really about the quality of the decentralized plans that direct economic activity in any sort of market economy, including one with Chinese characteristics.

Table 1. Different Countries' Shares of the World's Resources, Early 2000s

Country	*Physical capital*	*High skill labor* [a]	*Medium skill labor* [b]	*Low skill labor* [c]	*Arable land*	*Forest land*
United States	26.2%	30.5%	8.2%	0.7%	17.0%	8.9%
Canada	2.2	1.4	1.1	0.1	4.4	9.6
Japan	22.0	7.3	4.3	1.1	0.4	1.0
Germany	6.8	3.2	3.0	0.6	1.1	0.4
France	4.2	1.7	1.8	0.8	1.8	0.6
United Kingdom	3.7	2.4	1.8	0.7	0.6	0.1
Other industrialized countries	16.5	10.2	8.2	2.8	8.7	10.5
China	4.5	11.7	30.6	24.5	13.7	6.4
India	1.4	8.7	13.3	27.4	15.6	2.5
Brazil	2.3	2.6	2.0	5.2	5.7	21.5
Mexico	1.7	1.7	2.3	1.5	2.4	2.2
Other developing countries	8.5	18.6	23.4	34.6	28.6	36.3

Note: All values are approximations. The "world" refers to 93 countries (23 industrialized countries and 70 developing countries) for which reasonable data are available. Physical capital and the arable land are for 2002, the labor categories and forestland are for 2000.

a. Adults who have completed college (post-secondary education).

b. Adults who have completed primary (first-level) education but have not completed college (post-secondary education).

c. Adults who have not completed primary (first-level) education.

Sources: Physical capital estimated from information on gross fixed capital formation from World Bank, World Development Indicators, 2005. Data on labor from Barro and Lee (2001; dataset available at http://www.cid.harvard.edu/ciddata/ciddata.html). Data on land from World Bank, World Development Indicators, 2005. We are grateful to Prof. Tom Pugel for this information.

Table 1 lists the economic resources of different economies. The importance of capital allocation decisions can be inferred from 'capital intensity' – the ratio of physical capital over unskilled labor. This is already higher in China than in most developing countries, though it is still lower than in the developed countries. China's 'skill intensity', its ratio of skilled labor over unskilled labor, is lower than in the developed countries AND lower than in most developing economies, especially the more advanced ones like Mexico. This mixture – lots of capital and a shortage of skill – invites 'lucky manager' corporate governance problems, for China has too few people qualified for top management positions, especially in firms that need someone with both finance and technological expertise. In the current boom, many unqualified managers are likely to misconstrue their luck as skill.

Obviously, the traditional corporate governance concerns of inept or dishonest top managers cannot be overlooked, but focusing excessively on them would be a diversion and possible even a drag on China's growth. Table 1 shows that China desperately needs many more skilled people, who can put its large and rapidly growing stock of capital to good use, and quick and accurate ways to distinguish the lucky from the talented. China needs its established companies to invest wisely. But China also needs its capital to flow to talented people who are currently outside its established corporate sector. The circulation of cash within established companies is dangerous, for it invites the problems of American lawsuit winners, 1970s oil companies, Japanese *keiretsu*, and Korean *chaebol*. Rather, capital must flow away from companies and people with few good ideas about how to use it and towards people with bright ideas but little cash.

A skeptical observer of China today might ask "What problem? China is developing so fast and so well that its resources surely must be controlled by highly talented people." While this is certainly true in some firms, others are picking the lowest-hanging fruit, which requires little real talent. They can continue doing this for some years more, but eventually we need world class firms with genuinely clever top managers who can find ways to reach the higher fruit. Some may say why question our corporate governance – our top firms are able to acquire top blends around the world. This, however, could at least partly reflect the circulation of cash within rich established corporations. To avoid some of the problems now afflicting Korea and Japan, China should recall the old saying, “居安思危.” (when living in safety, think about future danger).

Other countries’ economic histories prove the wisdom of this saying. Economic growth is easier while a country is in the earlier stages of “catching up.” Countries that are starting from a low level can grow by accumulating capital, replacing obsolete management styles (like the Soviet system China adopted), imparting basic skills to workers, and importing foreign technology. But as countries grow richer, further growth starts to require much more: totally new management styles, highly educated workers, and technologies better than those used elsewhere. Switching to this harder, but more sustainable growth pattern requires that corporate governance be not merely good, but exceptional. Indeed, Japan ignored the “lucky” CEO corporate governance problems and thus largely recycled cash within a few elite corporations under the same management. The consequence is her infamous lost decade. China should be wiser. She needs to prepare for the future by encouraging potentially talented people to develop such expertise before its lack becomes economically dangerous. Letting ‘lucky’ CEOs recycling profits would risk derailing China’s growth.

Corporate governance problems due to 'too lucky' managers can cause at least as many economic problems as those due to 'incompetent' or 'dishonest' top managers. Yet it is less likely to evoke censure, and therefore is harder to correct. Overseers and underlings naturally do not criticize managers who seem to be doing well. If luck and talent are hard to distinguish, it is natural to give the manager the 'benefit of the doubt'. Western financial analysts now joke about 'lucky' Japanese CEOs; quipping, for example, that 'A Japanese CEO is someone who, in the 1980s, buys anything at any price and then, in the 1990s, sells anything at any price.' Japanese firms did well in the 1980s as oil prices fell, trade barriers declined, and technological innovation by a few world class Japanese firms created short-term opportunities for other Japanese firms. But too many Japanese CEOs wasted the resulting profits in a buying spree that bid up the prices of assets and corporations throughout the world, and then desperately sold assets to pay their bills when their luck changed in the 1990s. Japanese firms run by truly talented top executives, like Honda, (which the MITI strongly dislike) did not overextend in the 1980s and remained on course through the 1990s.

Corporate Governance

China's corporate sector is in danger of making worse mistakes than Japan's made. In many other countries, lucky CEOs must answer challenges from skeptical bankers, suspicious institutional investors, and even small shareholders who demand information at annual shareholders meetings. Top managers who cannot convince such skeptics risk losing their positions to upstart rivals backed by outside investors, or even by other firms threatening corporate takeovers. Although such challenges to their authority can make

American CEOs' lives difficult, they help distinguish the competent from the inept, the honest from the dishonest, and the talented from the lucky. When the system fails, as it did with Enron, Worldcom, and Adelphia, the nation's resources are wasted. America's prosperity depends on the rarity of those failures. The prosperity of other market economies depends on the success of their varied systems for making the same distinctions. Japanese and Korean bankers, given special duties to oversee corporate decisions in those countries, failed to offer sufficient skepticism, and permitted serious misallocations of their nations' resources.

China has yet to develop a system for continually examining and reexamining its corporate leaders. Evaluating corporate leaders calls for unbiased and disinterested judgments by well-informed people who are not afraid to question established business leaders. In the absence of such questions, poor decisions by an invisible and unaccountable elite can squander surprisingly vast resources.

In a sense, this is a problem of excessive freedom. Top corporate executives in cash-rich corporations have too much freedom of action. No informed, wise, and powerful overseers watch over them to prevent mistakes. Western financial analysts call this sort of situation a 'free cash flow problem', this term stressing the need for 'checks and balances' to constrain corporate leaders.

Corporate governance is a potential problem whenever leaders are entrusted to make important decisions for others. In a listed corporation, public shareholders entrust their savings to a CEO, who must make decisions for the general good of all shareholders. In a state-owned-enterprise, the people as a whole entrust a CEO to make decisions for the general good of the voters. Since most of China's listed firms have State agencies as dominant shareholders, the two are intertwined.[4] Shareholders and people that the state represents may disagree sometimes as to what decisions are best, but neither desires unmitigated waste of resources of the sort that rampant free cash flow problems permit.

The Invisible Boss

Listed SOEs have one or more State organs as their dominant shareholder. Such organs usually control more than 50% of the stock in China's listed firms, and the figure often exceeds 75%. The significant SOEs typically have a board – the director is often the party secretary who represents a "party committee." The party committee also has control over the board of directors and thus the actual corporate governance power. We emphasize here that the issue is not whether there is a board of directors – it is about who has real corporate governance power. The party committee hires and fires the CEO, and can overrule his decisions. Note that while a party secretary may merely respond to instructions from above. Chinese CEOs are thus diligent servants of the party committee, or a group of "high-up" people, and especially of the more powerful party representatives. Often, public shareholders and the Chinese public in general know little or nothing about these invisible bosses, to whom they have entrusted their savings and national wealth.

Party representatives are appointed by the Communist Party committee running the jurisdiction which holds a control block of shares in the company. Many listed firms

[4] In mid-2004, 目前在上证所上市的民营企业有 100 家左右，其中三分之一是通过直接改制上市，三分之二是通过借壳买壳上市，特别 是 2003 年在借壳买壳的重组案例中，有 50%是民营企业。但是，民营企业在资本市场所占的比例，与其 在国民经济增长中所起的作用相比还有很大差距，我国 GDP 增量的 8%是来自于民营企业，但在整个资本市场的结构中民营上市公司只占 2%。Source: 上海证券报, see http://finance.tom.com 2004, Jun, 21, 13:35.

are controlled by holding companies, which in turn are controlled by municipal or provincial governments. One holding company often controls many listed firms, though these may have other large shareholders – friends or relatives of powerful party representatives. Each firm's party representatives are appointed by the party executive that controls the government that controls the holding company.

This arrangement may serve well if the party representatives are competent, honest, and genuinely talented managers. But, like any other corporate governance arrangement in any other country, it requires checks and balances to correct the problems that inevitably arise whenever corporate governance is mistakenly entrusted to the inept, dishonest, or lucky. In the Chinese situation, governance problem can arise in all the usual ways.

One common governance problem, called an 'other people's money problem', occurs when corporate governance is entrusted to people who own little stock. The party representatives often have little or none of their own money invested in the stock in the firms they govern. Like the managers of American widely held companies, like Enron, their interests align poorly with those of their small shareholders, who invest their savings hoping for a steady appreciation in value to provide wealth in their old age. This problem can be exacerbated by holding companies, which additionally insulate the party representatives from the consequences of poor decisions that adversely affect the firms they govern.

Another common corporate governance problem is called an 'entrenchment problem', named for the wet and cold 'trenches' that soldiers of World War I dug to defend the devastated battlegrounds of Flanders. This problem occurs when those entrusted with corporate governance power 'dig in' so they cannot be removed even when their poor decisions devastate the corporation. This problem is especially important in countries where wealthy families' corporate empires pass to 'idiot sons' (but some patriarchs retain control though not holding official positions). China could confront entrenchment problems too unless there are clear and transparent mechanisms for identifying and replacing party representatives who poorly govern their firms.

A third common corporate governance problem, called 'tunneling', occurs when one person exercises corporate governance power over a group firms. That person might sometimes decide to transfer wealth from one of those firms to another. While the other shareholders of the firm receiving this wealth might applaud, those of the firm losing the wealth understandably view such a decision as a corporate governance problem. If the party representatives systematically favor some firms (such as those in which friends or relatives own stock) over others in a group of firms, the group is said to have a 'tunneling problem'. Since one State organ often controls many Chinese firms via holding companies, this is a potential concern in China too.

Actually, 'tunneling problems' might be especially severe in China because corporations' party representatives often also serve the people as government officials, or are closely associated with such officials. Such officials might, knowingly or unknowingly, divert party money, government money, or money from State banks to enrich favored corporations. This seems to be what happened in both Korea and Japan, where favored firms received showers of cash from governments or banks influenced by government officials. These favored companies had executives skilled at extracting funds from government officials and bankers, but inept at investing the funds wisely. The result was much waste of national wealth and prolonged weakness of their economies relative to the rest of the world.

Free Cash Flow Problems and the Invisible Boss

Law makers and regulators can best minimize corporate governance problems by imagining themselves as inept, dishonest, or too lucky corporate insiders. Imagine yourself the CEO of a firm with huge cash inflows due either to the general prosperity of China or to connections with government officials or State banks. You know of no good uses for your company's money, so what should you do? If you do what Western firms with excess free cash flow are supposed to do, and pay bigger dividends to your shareholders, what happens? Your party committee shouts at you that you have no good ideas and might replace you. If you build up a hoard of cash within your company, they shout at you to enter disadvantageous dealings with other group firms, and your cash hoard is 'tunneled' away to other group companies to benefit whoever controls those firms.

Both sorts of shouting encourage you to invest in something, anything at all. Indeed, you would be inclined to invest in any thing that fits the current economic fad most pleasing to the shouting bosses, no matter what the real economic effect is. Investment is good for the country if it commits resources to sensible uses that generate the products the people and society need. But pressure to invest in anything, just for the sake of investing, squanders the nations resources. Even worse, it may keep those resources out of the hands of genuinely talented people with good ideas about how to use those resources.

This not only wastes the resources themselves, but deprives society of the increased national wealth they might have created.

Driven to misallocate the company's resources, you fear exposure and disgrace when the waste starts to become apparent. If you are of only average bravery, you may be tempted to loot the company and hide in Los Angeles.

Once a company starts down this path, changing direction is difficult. Transparency must be avoided to hide past errors, and this lack of transparency permits both further errors and the looting of the company by desperate insiders.

One Possible Plan

In this section, we advance a direction we think Chinese policy makers and academics might consider as a way of dealing with these problems. Our purpose is to illicit bright ideas – we "throw out bricks for jade," (抛砖引玉) as a Chinese would advise. We feel that improving corporate governance in China requires turning down the volume of the shouting and trusting the Chinese people. We suggest that party committees might accept that some firms have managers who are good at what they do, but lack ideas for further expansion. These managers could be rewarded, not punished, for raising dividends. The Chinese people who receive these dividends could then decide which other companies do have good ideas and buy the shares those companies issue to raise capital.

Since State organs are major shareholders in many firms, higher dividends generate more money for the State. One possible use for this income is further investment in other companies. But the State is not needed for this: the Chinese people could reinvest their dividends in other companies. However, the State has investment opportunities that ordinary Chinese people do not. Remember that Table 1 shows China having too few skilled people relative to its large capital assets.

Education especially is a sound public investment for China at present, and increased spending on general education at all levels seems a uniquely wise use any additional dividend income for all levels of government throughout China. China especially needs more investment in education for the young and the rural areas. Slower economic reforms deprive many regions of universal high-quality education, letting their human resources there go to waste. To reverse the flow of brighter and more productive people into the coastal cities, China might invest in education everywhere by paying teachers in rural and inland areas much higher salaries. As well, many of the bright students in poor areas lack resources to attend good schools. Scholarship money funded by corporate dividends would be a direct approach to alleviate the low skill intensity problem identified in Table 1.

Many other countries' governments establish independent 'institutional investment funds' to provide long term stable financing for specific social programs, such as unemployment insurance or pensions for the elderly. For example, the government of California established the California Public Employees Retirement System (CalPERS) to invest in stocks and bonds in order to provide old age pensions to retired bureaucrats in that state. Poland privatized its large state-owned enterprises by distributing their shares to such funds. China could endow similar institutional investment funds with shares currently controlled by various State organs and delegate the payment of unemployment insurance, old age pensions, and other social services to them.[5] As China's population ages, and the costs of the State providing for the elderly rise, decisions made now to fund such institutional investment funds will look increasingly wise. We tentatively suggest this as a direction for thought in China now.

Other countries have gone further. Denmark has independent institutional investment funds that hold stocks and bonds and invest the income these generate in a variety of public works – from scientific research laboratories to pollution clean-up programs. Institutional investment funds can be used to provide financing for almost any public project. For example, institutional investment funds called university endowment funds provide much of the revenue for America's great universities, like Harvard and Yale. China's universities might be financed similarly. Institutional investment funds called workers compensation funds provide medical care and pensions for injured workers in Canada. Similar funds might finance Chinese universities and protect Chinese miners, factory workers, and farmers by providing minimal pensions for those injured at work. China's health care system, road and bridge construction, and numerous other social goods could be likewise financed on a long-term basis with income from institutional investment funds.

In many countries, institutional investment funds are both politically popular and strong forces for good corporate governance. A politician who establishes a fund to provide for the education of the people, their health, and their old age is virtually guaranteed popular respect. And institutional investment funds, or their financial advisors, compete to hire

[5] That is, these funds could demand corporate dividends and use the dividends to pay unemployment insurance, pensions, and other social services.

the best university graduates to monitor the firms whose stocks and bonds they own, for poor governance means lower dividends and less money for the fund's beneficiaries – schools, universities, hospitals, scientists, injured workers, or old people.

China's corporations might ultimately be owned by legions of institutional investment funds, whose dividend income pays for old age pensions, education, health care, basic science research, and numerous other social needs.

A stock market dominated by such institutional investment funds exposes dishonest corporate insiders to especially vigorous public condemnation. In China's current stock market, corporate insiders who steal money from shareholders, who are mainly speculators or rich wheeler-dealers, may seem like thieves stealing from other thieves. But dishonest corporate insiders who deprive institutional investment funds of income are stealing from students, the sick, cancer researchers, and the elderly. Theft, or losses from incompetence or 'too lucky' managers, is much less socially acceptable. And investment fund managers, anxious to avoid blame for low returns, should watch for and energetically expose governance problems. Given the social importance of their mandates and the magnitudes of their economic resources, the institutional investment funds, or firms they hire to provide advice, should compete to hire the brightest graduates of China's universities to do this monitoring.

Of course, investment funds, like any other business, can develop governance problems as well. The key advantage of a multitude of investment funds as shareholders in China's increasingly numerous listed corporations is that a system of 'checks and balances' can develop. The investment funds' beneficiaries – school children, medical patients, etc. –

and their economic champions – teachers unions, physicians unions, etc. – have a direct economic interest in monitoring the governance of the investment funds. They too should also hire the brightest graduates of China's universities to do this monitoring.

However, this layer of monitoring could have market failure, especially if the monitoring agents feel powerless and if monitoring costs are high. The government can make monitoring easier for everyone by mandating thorough public disclosure of these funds management and operations, and by legally empowering fund beneficiaries, and encouraging competition among funds.

Chinese corporations should meet international standards of disclosure so that institutional investment funds can expose governance problems. This should include the publicizing of transactions between group member companies. Institutional investors, with public aids and legislative backing, should be able to correct governance problems they detect. Corporations' party committees should have a higher public profile, and institutional investment funds should be able to force the replacement of party representatives responsible for poor corporate governance. This might be done, for example, by letting shareholders elect the party committee.

Institutional investment funds should regularly disclose their holdings and trading so that their beneficiaries (or their economic champions) can expose governance problems. These should elect the boards of directors of the institutional investment funds, and be able to vote out incumbents who govern poorly.

Competition also aids monitoring, for it creates benchmarks. There should be many moderately large institutional investment funds, rather than a few very large ones. This lets monitors compare one institutional investment fund to another, making governance problems more obvious.

It would be useful to recap the underlying thoughts in our proposal. First, the proposal builds on China's needs – direct corporate profits away from internal recycling and waste to much needed investments, including education, health, and social securities. The investment funds are the means to achieve the purpose. Second, China needs to improve corporate governance. Through the investment funds, constituents with vested interested to monitoring and enforce corporate governance are designed the job. Third, we recognize the need to create transparency and monitoring of the investment funds too. Public policies to create and enforce transparency in the corporate sector and institutional investment funds are fundamentally important.

China's leaders have undertaken a bold venture – building a genuine social market economy. We humbly propose this system of institutional investment funds as fully consistent with their visionary undertaking. What could better define 'a market economy with Chinese characteristics' than using the stock market, the central core of a market economy, financing traditional Chinese concerns like education and care for the sick and elderly – and improving general standards of corporate governance to boot?