

Alternative Visions of Incomplete Property Rights

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Abstract

Property rights are incomplete when all the attributes of a property cannot be perfectly specified ex-ante. Ex-ante delineation of every attribute is infeasible in the presence of high transaction cost. While the importance of transaction cost is well recognized in the mainstream view of property rights, the role of uncertainty is however, inadequately explained. In this paper we analyze the nature of incomplete property rights under the condition of uncertainty stemming from legal and political predicaments. Taking this view, we explain the logic of vaguely defined property rights in the Chinese Township and Village Enterprises (TVEs). While TVEs are growing amazingly and are considered a growth engine for China, rights on them are not clearly defined. In this sense, we argue that vaguely defined property rights in the TVEs work as a 'slack' to safeguard against uncertainty faced by private ownership. Unless a level playing field is ensured through eliminating legal and political uncertainty, it is natural that privately owned firms would unlikely triumph over vaguely defined TVEs.

Keywords: Incomplete property rights, Transaction cost, Uncertainty, China, Township and Village Enterprises

JEL Classification: D23, P48

(First Draft: comments and suggestions are welcome. Please do not cite or quote)

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1. Introduction

Property rights are the basic building blocks of an economy that dictate the allocation of scarce resources in the society and thereby greatly affects economic outcome. Countries that provide greater security to private property can grow faster than countries where protection of private property is absent or loosely protected. North and Thomas (1973:91) have sketched an historical account about *The Rise of The Western World* and attribute the rise to an efficient economic organization that requires an individual's "... exclusive rights to use as he sees fit his land, labor capital and other possessions... the right to transfer his resources to another, and that property rights are so defined that no one else is either benefited or harmed by his use of his property." The system is efficient because secure property rights provide individuals with the incentive to innovate and produce, and conversely inhibit those activities that are unproductive so that the system brings private rate of return close to the social rate of return.

Private and social benefits coincide if rights on property are completely specified leading to internalizing all externalities. Internalizing all externalities is not feasible if the cost of policing and enforcing or namely transaction cost is high. Transaction cost can be reduced if the person that affects mostly the value of an asset becomes the residual owner (Milgrom and Roberts 1992, Barzel 1997). Residuality is an arrangement of right by which residual control right and residual return right are tied together to facilitate the evolution of more appropriate form of property rights. Thus, the notion of well-defined property rights can be rephrased as 'well-defined rights over residual control'. Once such an arrangement of ownership is established, the problem of transaction cost is resolved by not completely eliminating it but reducing it to such an extent that Pareto Optimality is attained. If this postulation is held, we can conclude that property rights arrangement in which residual control and return rights are held by the owner is economically more beneficial than when they are held by different entities.

China's township and village enterprises (TVEs) are performing spectacularly. But property rights on them are vaguely defined in the sense that they are collectively owned by local residents but right of ownership is exercised by the town and village governments. Jefferson and Singh (1999:6) thus, raise a paradox

China's economy has been dominated by publicly owned firms, both state- and collective-owned. Although these factories display many of the negative characteristics that economists ascribe to public ownership, they accounted for most of the extraordinary growth of Chinese industry during the critical early years of transition.

Not only they are growing amazingly but sometime they are outperforming private enterprises. Some studies have found that private firms did not achieve as large productivity gains as collectives did (Svejnar, 1990). For instance, Dong and Putterman (1997) argue that the success of TVEs poses a serious challenge to the conventional prescriptions favoring privatization. They find that firms owned by township and village enterprises were at least as productive as those owned by private entity. This conclusion is supported by Svejnar (1990: 247) who reports that “productive efficiency is not related to ownership.”

This situation has lead many scholars to argue that the case of TVEs is indeed a paradox to the traditional property rights paradigm. For instance, Weitzman and Xu (1994) describe the TVE as "vaguely defined cooperatives" because property rights on them are poorly defined. As such, their outstanding performance would appear to represent “... a paradox or challenge for traditional property rights theory.” While this conclusion deserves attention, we should interpret it cautiously because private ownership (privately owned firms) in China is constrained to enjoy its full potential by the growing uncertainty embedded to country’s legal and political system. In contrast, TVE has been able to cope with these uncertainties due mainly to the involvement of state at various levels – local, provincial, and central levels. This paper aims at contributing to this hypothesis analyzing legal institutional structure under which private and TVEs are operating. We argue that vaguely defined property rights in the TVEs works as a ‘slack’ to safeguard against uncertainty faced by private ownership.

The paper is structured as follows: section two elaborates the concept of incomplete property rights. Section three describes the general features of property rights in the TVEs whereas section four describes the legal and political institutions under which they operate. Section five argues that current institutional settings to protect property rights function as ‘slack’ or buffer for TVEs for responding to uncertainty but at the same time impede the proper functioning of privately owned firms. Section six finally concludes.

2. Nature and causes of incomplete property rights

Property rights bestow owners certain attributes in relation to an asset. Essential attributes comprise of right to consume or benefit from the use of an asset, exclude others from uncompensated use of property, right to sale, dispose, or transfer of the asset, and also the right to derive income from the asset. When all these attributes related to an asset are perfectly specified, property rights are complete. Or in other

words, if property rights are defined as a complete bundle of rights; the term ‘complete bundle’ means that the bundle encompasses all the possible uses of the resource over which property is defined and that each use embedded in the bundle is completely specified. Complete specification requires *ex ante* collection of information regarding all harmful and beneficial effects caused by a particular assignment of rights over property. It however, relates to a lot of future contingencies. According to Shavell (2004) “... a completely specified act includes in its description the place, time, and the contingency under which it is committed – for example digging at a designated location, on Thursday at 4:00 p.m. if it is not raining (the contingency).”

In reality, the contingencies are many. For example, how a particular use in the future relating to a specific property affects other parties is unknown. As a result, *ex ante* delineation of all attributes of a property is infeasible which leads to a conclusion that property rights are inevitably incomplete. The reasons for incomplete property rights are attributed to two fundamental reasons: transaction costs, and human bounded rationality.

Ex-ante delineation of all attributes regarding to a property requires information *a priori*. However, for most use of the property only some beneficial and harmful effects are easily known, and the reminder can be known incurring great cost (Demsetz, 1966). This is because uncertainty increases about whose rights will be affected and by how much. So a point will be reached beyond which cost of *a priori* determining of effects exceeds the expected benefits. The greater the uncertainty of the effect, the less likely that prior compensation be paid to those harmed or prior fees be charged to those benefited. However, the great uncertainty imposes so much cost of sorting out and measuring legitimate claims that undermine efficient resource use. In this regard, the cost of acquiring information will be lowered after property rights have been put to a particular use, so that assessment of effects may become sufficiently easier in some instances to make the payment of compensation economic. In this sense, perfect delineation of property is possible given zero transaction cost.

Secondly, acquiring substantial information regarding all harmful and beneficial effects does not necessarily ensure that rights will be perfectly delineated. This is due to the fact that even if zero transaction cost facilitates accumulation of all relevant information *ex ante*, there is still possibility to inaccurately model property rights because human brain possesses limited capacity to process and analyze information perfectly. However, with the assumption of costless transaction, the problem of bounded rationality can be resolved through *ex-post* negotiations and shifting to an alternative more appropriate form of right when contingencies are exposed. Williamson (1985:20)

argues “rather than contemplate all conceivable bridge crossing in advance, which is a very ambitious undertaking, only actual bridge crossing choices are addressed as event unfolds.” Thus, an alternative arrangement of right *ex-post* as event unfolds would be no less efficient than delineating all attributes *ex ante* because zero transaction cost facilitates to draw a comprehensive general clause. If so, the existence of incomplete property rights can be attributed utterly to the presence of high transaction cost.

Even though transaction cost is important for incomplete property rights, we cannot neglect the role of uncertainty in this regard. Even though Demsetz (1966) takes the matter of uncertainty into account, he indicates that it is only the problem of transaction cost. Thus, the issue of uncertainty remains almost neglected in explaining the imperfect delineation of property rights.

Uncertainty makes our decision processes complex and volatile. Since the consequences of actions extend into the future, accurate forecasting is essential for making objectively rational choices. But in the real world, most choices take place under conditions of uncertainty. The fundamental implication of Keynes’s (1937) uncertainty is that all economically meaningful behavior derives from agents’ efforts to protect themselves from uncertainty. Keynes defines what he means by “uncertain” knowledge -

By uncertain knowledge....I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty; nor is the prospect of a Victory bond being drawn. Or again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth owners in the social system in 1970 (quoted from Minsky 1975:66).

From the above discussion we can sum up the definition of uncertainty which means that no probability distribution of outcomes exists. This is different from the risk in the sense that risk has a known probability distribution of outcome. So, if one is confronted with risk, presumably one could insure against it. However, in the case of uncertainty, one cannot insure against. This implies that, under uncertainty, one does not have a probability distribution of outcomes and even does not know what the possible outcomes are.

North (1999) describes three dimensions of uncertainty. The first is simply not having enough knowledge. This sort of uncertainty can be turned into risk by acquiring more

knowledge. The second dimension of uncertainty relates to ‘non-ergodic’ aspects of the systems residing in a world of continuous change. The change includes the social structure and behavior of human beings. Under this condition of uncertainty we have to grope around and have much less assurance that we are going to solve the problems. This problem solving ability becomes further complex due to third dimension of the uncertainty which is the lack of dynamic theory of change in a *dynamic* world, one of continuous change (North, 1999). It implies that some dimensions of uncertainty can be overcome by acquiring knowledge. However, others remain in the economic spheres which cause the real problem. We should take this matter into account while explaining the incomplete property rights.

In the functionalist model of property rights uncertainty is simply viewed as an element to increase transaction cost. In so doing, contribution of the determinant to incomplete property rights is not properly emphasized. As a result, we stress that the presence of uncertainty appears to be of more serious concern than it is figured out in the simplistic view. It is true that transaction cost increases where uncertainty is high. In this sense, uncertainty and transaction costs are not mutually exclusive. However, uncertainty cannot be eliminated by merely transaction cost even if the other way around is sometimes feasible. For instance, uncertainty can be originated from several sources in an economy including legal and political institutions. If these institutions are standardized conducive to general contract, transactions costs are reduced because general terms and conditions affecting transactions are already defined. Thus, only contract-specific terms and conditions are necessary to be defined further. This means that uncertainty can increase transaction costs but transactions costs cannot eliminate uncertainty.

Table 1 draws a matrix showing the effects of transaction costs and uncertainty. Assume that there is no fundamental uncertainty. What is relevant for defining property rights is sheer transaction cost. In this situation, if transaction cost is insignificant we can reach to a situation of perfect delineation of property rights (quadrant I). Absence of uncertainty helps forestall externalities that may arise in the use of resources and a state of zero transaction costs facilitates defining these externalities as well as ensures proper enforcement of rights once they are defined. However, this is a world of utopia where we cannot reach. Thus, we have to drop some assumptions to assimilate with the real world situations.

Table 1: Matrix showing nature of incomplete of property rights

		Uncertainty	
		Absent	Admitted
Transaction cost	Low	Property rights are perfectly delineated	A comprehensive set of contract to define property rights is expected
	High	Since all future contingencies can be predicted in advance, a precise and specific contract is the likely outcome	Property rights are inevitably incomplete

Assume that there is no uncertainty but transaction costs are high (quadrant IV). Since all future contingencies can be predicted in advance, a precise and specific contract is the likely outcome. Thus, transaction costs are reduced and well-defined property rights is possible since no uncertainty involves which requires extensive and elaborate definition of factors that affect and be affected by the uses of property. Conversely, let us assume that transaction costs are low but there is uncertainty (quadrant II). Uncertainty inhibits us to draw a precise definition of property rights. However, zero transaction costs facilitate to write a comprehensive set of contract *ex-ante* regarding a property. We can reach to a near optimal level of property rights because incompleteness in rights delineation can be overcome *ex-post* drawing upon the general clause defined *ax-ante*. This means to say that when any new use of the underlying property is figured out *ex-post* that generates externality, parties can define rights on it since they enjoy the advantage of zero transaction costs.

However, admitting both transaction costs and uncertainty, we enter into the zone of serious difficulty on the question of defining property rights. This is indeed, the situation of real world. From this vantage point it can be said that mere existence of transaction cost is not relevant for property rights to be incomplete, rather we cannot ignore the fundamental uncertainty prevalent in the process of defining it which can prevent the emergence of more efficient form of property rights. Thus, we argue that emphasizing both on transaction cost and on fundamental uncertainty we accord with

the true nature of incomplete property rights. Now, what is the response to this uncertainty? Keynes argues -

About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know. Nevertheless, the necessity for action and for decision compels us as practical men to do our best to overlook this awkward fact and to behave exactly as we should if we had behind us a good Benthamite calculation of a series of prospective advantages and disadvantages, each multiplied by its appropriate probability waiting to be summed (quoted from Minsky, 1975: 66).

Uncertainty often encourages agents to adopt rules of thumb because standardization and coordination may be more effective than individual prediction. Herbert Simon developed a more realistic description of human bounded rationality, and considered to what extent the limited capability for analysis that is provided by bounded rationality can meet the needs for reason in human affairs. In practice, economic actors are *intendedly* rational but *limitedly* so, because of information problems and the complexity of computing best strategies. In the real world, instead of trying to work out Nash equilibrium or solve optimization problems, individuals follow *rules of thumb*. This postulation has a lot of implications for explaining why property rights in the TVEs are socially optimal or near optimal from the view that their performance is not inferior to that of privately owned enterprises.

3. Ownership Characteristics of TVEs

The predecessors of the Chinese Township and Village Enterprises (TVEs) were the Chinese Commune and Brigade Enterprises (CBEs) that consisted of rural sideline production and agriculture cooperatives. In 1958, by the directives of the Political Bureau of the Central Committee of China's People's Congress (CPC), 740,000 agricultural cooperatives all over the country were merged into 26,000 people's commune (Hantang, 2000). However, CBE's were a big failure; they suffered from insufficient capital, poor management and lack of any market skills which pushed many CBE's to shut down (Bouckaert, 2007). Moreover, the social norms and practices to view CBEs were also adverse for their survival. For instance, they were regarded as the 'tail of capitalism' and were strictly constrained in their operation during the first period of the Cultural Revolution (1966–1975). This attitude changed a bit in the later period. When the political leadership emphasized the need for modernization over ideological class struggle, CBE's were given a major task in the campaign for the mechanization of

agriculture. In 1984, communes and brigades were abolished and the CBE's were renamed as TVEs through widening their scope. In addition to the enterprises formerly run by the township and village, the concept of TVEs now included cooperative enterprises jointly run by some commune members, other forms of cooperative industries, and individually owned enterprises (Hantang, 2000). At the broader level there are two types of TVEs in respect of ownership structures: collective TVEs, which were owned by the community or administrated by the town-village government, and non-collective TVEs, such as individual, partnership, cooperative stock-sharing, stock-sharing, and joint venture enterprises.

What is the property rights arrangement in the TVEs? Who owns use rights, control rights, and residual rights? One of the major features of TVEs is the ambiguity of their property rights. They are neither state owned enterprise (SOEs) nor privately owned. Apparently it seems that TVEs are similar to SOEs but the former differs significantly from the latter by a number of important characteristics. For example, the sources of capital in TVEs are the private savings, loans from rural co-operatives, and the Agriculture Banks of China and surpluses in township and village government revenue (Pollard, 2003). These sources are almost exclusively local in nature. TVEs possess greater degree of autonomy than SOEs and face greater budget constraint than do SOEs.

For the typical TVEs there is no owner in the spirit of standard property rights theory. In general collectively owned TVEs are owned by the local residents. All the community members are nominal owners. They become the owner by dint of residing in the community. Thus, leaving the community by any member means the revocation of ownership. In the similar fashion, an outside individual will automatically gain ownership by marriage to a community member. Even though use rights or ownership of TVEs are rested on local residents, they are controlled, managed and supported by the local governments or by hired managers. As noted by Weitzman and Xu (1994: 132)

Many Chinese economists report that TVEs are usually controlled by local governments and typically there is no separation between the communal government and the TVEs. These reports describe a situation where many TVEs do not have genuine autonomy in business transactions; the communal government has major influence in the determination of managerial personnel and employment.

In the early stage of the TVEs, they were directly controlled and managed by local government in the sense that approval of new projects, raising funds, managing human resources, are under the discretion of local government. Once this stage has been passed, the local government can decide to delegate some authority to professional managers

and not remain in direct control of the daily operations of the TVE. Even if local government delegates full operational responsibility to management, this does not mean that the management has the control right in the TVE, independent of the control of the local government because local government retains the power to appoint managers (Chang and Wang, 1994). This gives managers a sense of belonging to the local government and they feel responsibility to consult with local government officials prior to make major decisions.

Workers sometimes have voting power to select or appoint managers. However, this power is nominal (Chang and Wang, 1994). This is due to the fact that the local government is the ultimate initiator of voting. If local government is satisfied with a manager, the necessity for voting is eliminated. Moreover, workers employment in the TEVs is also controlled by the local government. Because of this conflict of interest, workers rarely raise their voice against administrative bodies. This implies that workers almost have no power to select or say about the appointment of managers. Song (1990) reports that almost 83.3 percent of TVEs managers believe that they are appointed by local government.

Another important aspect is the residual return right. The typical community member waits passively to receive or to enjoy the benefits, of which the major part is not in monetary form but in the form of communal social investment, which is shared by every one in the community. It seems that both parties (local government and citizens) share the residual returns of TVEs. They are required to retain a major portion (60 percent or more) after-tax profit earned by TVEs and distribute the remaining among the workers as bonuses and pay to local government as fees (Weitzman and Xu, 1994).

Despite the fact that residual return and control rights are held by separate entities which is not the best arrangement according to the standard property rights theory, TVEs have played a significant role in the growth of the Chinese economy since the economic reforms of 1978. They accounted for 47 per cent of total industrial output in the year 2001 and their annual average real growth rate over the period of 1988–99 was 19 per cent (Fu and Balasubramanyam, 2003). In 1978, TVEs accounted for 9.1 percent of China's total industrial output, rising to 36.8 percent in 1992. Moreover, their economic efficiency is very close to that of privately owned enterprises in China (Svejnar, 1990). Does this suggest that secure private property right is not a prerequisite for economic growth?

Our answer is not affirmative for this question. The first point of argument is that there are lots of uncertainties stemming from current legal and political system of China.

Vaguely defined property rights in the TVEs are successful in coping with these uncertainties whereas private firms find it excessively costly to exercise their rights. Thus, without leveling the playing field for private and TVEs, we cannot simply conclude that Chinese scenario poses a threat for standard property rights theory observing the fact that TVEs are sometimes outperforming privately owned firms.

4. Uncertainty in the Chinese political and legal systems

Brunetti and Weder (1997) group uncertainty into four broad categories: government instability, political violence, policy uncertainty, enforcement uncertainty. We restrict our analysis to the enforcement uncertainty. Enforcement uncertainty focuses on the relation between private sector and the state. Or in other words it is the degree of confidence private firms can have that their property and contracts will be enforced properly and will not be subject to arbitrary behavior. These measures concentrate on the discretionary behavior of the judiciary as well as the bureaucracy.

Private property requires impartial and legal system based on which contracts are drawn and enforced. Once rights are assigned, they should be enforced by third party which is usually the government. In this sense, legal system provides the basic building blocks for private property in the sense that it governs the contractual relationship between parties or enforces contractual rights and provides security for ones property. In this aspect, they determine the degree to which private property rights are secure. Moreover, they are the basic determinants of the level of transaction cost. This implies that legal and political uncertainties increase the cost of transaction in exercising private property rights.

The Chinese Communist Party (CCP) founded a new China as a socialist state in 1949 by successfully unifying the mainland China. The Kuomintang (KMT) legal system was abolished which left the formal legal system in a complete vacuum. This required establishing a new judicial system; but the urgency to fill this legal vacuum was not felt by the authorities in the first three to four years of the PRC. This is partly because of the heavy reliance on pre-1949 communist experience of law which was basically an extension of military force (Chen, 1999). At the end of 1952, the Central Committee of the CPC focused on economic reform for socialist industrialization and socialist transformation of agriculture and other commercial activities. The implementation of this plan was the 1954 constitution by which the necessary condition for planned economy and the socialist transformation was set.

The new communist government tried to safeguard and build the country to follow

Marxist-Leninist-Maoists instruction both economically and politically until 1978. The socialist ideology of Maoism directly and explicitly renounced the notion of private property rights and cemented the party as the guardian of public welfare. For instance, China enacted land reform in 1949-51 which deprived the landowners of their land and distributed it among the landless peasants or smallholders. Landowners were politically ruined and lost all their rights. Obsessed with Marxists doctrine that private ownership of the means of production was the root of all social evils, the government under Mao did away with land reform by forcing Chinese peasants to organize themselves into millions of production units and to pool their land and other significant means of production. Every members of a collective became a part owner of the pool and as such was entitled to a share of the collective's harvests. Under the new system, individual peasants no longer possessed any means of production, and no collective member could do anything about his or her share of the pool, which was indivisible. Thus, the interests of the individual were subordinated to those of the collectives.

Collectives were communally owned. Thus, member got more or less the same share of the harvests, regardless of differences in individual contributions. This helped to generate a tendency to shirk. Consequently, agricultural productivity was low and the resultant food shortages bothered the government to a good extent (Wu, 2000). In order to reduce the possibility of a threat that might come from the starving peasants, government agreed that a small piece of the collective land could be used by each farming household to plant crops of its own choice and that the harvest from that land could be retained by the household. However, this might threaten the basic tenet of socialism. To offset such an ideology to emerge, the government emphasized that the private land could not be more than a small fraction of the collective land and that peasants should not be allowed to farm their private land until they had finished their daily work for the collective. Such a system of abrogating rights over the means of factors of production caused China to suffer a lot from the chaos ensued by endless class struggle (Bin, 2007).

Mao's death in 1976 presented China with a chance to break with its past. The Chinese elite led by Deng seized that chance, terminated the Cultural Revolution immediately, and after about a year launched economic reform. The 1978 reform brought a change in the Chinese legal tradition as well. Indeed, 1978 was an epoch in the Chinese history and a turning point in legal development. A legal system was declared as necessity for social modernization and party leaders were also repeatedly emphasized on law providing social order conducive to economic development (Chen, 1999). While Mao China was virtually without law, Deng's China witnessed massive

and rapid enactment of laws and regulations specially laws and administrative rules related to economic and commercial relations. For instance, legal relationships such as contract, property and foreign business relations have been brought gradually within the ambit of a range of formal and increasingly detailed legislative and regulatory enactment. The General Principles of Civil Law (GPCL) enacted in 1986 which codified a broad principles of property rights, albeit subject to the provisions that these not conflict with state policies and public and social interests. The GPCL reflected CPC policies that at once had begun to limit the intrusion of the state into social and economic relationships while still asserting the basic provisions of state control. Despite these improvements, enforcement remains a serious problem, and as a result the PRC law regime tends to be ineffectual in lending predictability to economic activity (Potter, 1997).

However, in the post-Mao period of economic reform, the state remained a key player in property relations- state property rights remained dominant, albeit purportedly in the service of social interest. The 1982 constitution extended the protection to property, but only to the extent that it is “lawful property” the definition of which remains the exclusive province of the state. Article ten of the constitution stated that land in rural and suburban areas, except those which already have been defined as state ownership, belong to the collectives, while the state owns the land in cities which implies that the law prohibits private land ownership. Moreover, the constitutional requirements that the exercise of citizens rights, including the right to own property, not conflict with the state or social interest effectively grant the state a monopoly power on interpreting that interest and on determining the extent to which private property rights that might possibly conflict with it will be recognized and enforced. Article 11 of the 1982 constitution acknowledges only the property rights of individual enterprises, defined as self-employed business. This conspicuous silence on the property rights of private-operated firms stems from an ideological consideration – the specter of exploitation raised by such firms. Contrary to the Western legal tradition, the communist constitution was believed to be a tool for party rule and intended more as a statement of policy goals (James, 2007).

The first round of the constitutional review took place in 1988. The amendments stipulated that the state permits the private economy to exist and grow within the limits prescribed by law as a "complement" to the public economy. In 1988, article 11 was amended to include a clause that permits private firms and promises to protect their “lawful rights and interests”. The new paragraph stated that

The state permits the private economy to exist and develop within the limits

prescribed by law. The private economy is a supplement to the socialist public ownership economy. The state protects the lawful rights and interests of the private economy and exercises guidance, supervision and control over it.

However, the amended article reserves the right of the state to exercise guidance, supervision, and control over the private sector of the economy. The amendment also carefully subordinates the private sector to “a supplement to the socialist public economy” (Huang, 2003). This means that private firms are allowed to grow but only to the point of not attenuating the socialist character of the economy and only to the extent of complementing the SOEs.

So far there was no formal legislation to govern private enterprises. Shortly after the amendment of the constitution, national legislation governing private enterprises were enacted in June 1988. The State Council promulgated three sets of regulations: the Provisional Regulations of the PRC Concerning Private Enterprises, and two other shorter statutes relating to taxation of private enterprises and their investors. Shortly thereafter some other supplementary regulations were enacted and by the early 1989, private enterprises were subject to the most extensive legislation to govern them since the founding of PRC in 1949 (Conner, 1991). The Regulations themselves placed few limitations on the scope of business activities for private enterprises, but they were subject to restrictions contained in other legislation. Private enterprises could not engage in military or financial industries, or do business in commodities prohibited by the state, which included cultural object and antiques, jewelry, rare minerals, stamps, firearms and ammunition, military industrial products, cars and civilian explosives. Private enterprises were deprived for long. The Regulations therefore enumerated the rights of private enterprises and their investors, particularly their property and management rights.

In 1993, The PRC constitution was amended for the second time to facilitate the transformation to socialistic market economy to replace planned economy. The genesis of the 1993 constitutional amendments emphasized that China is still only in the initial stage of building “socialism with Chinese characteristics”. Nevertheless, through the third amendment of the constitution in 1999, the role of the private sector was upgraded to make it an "essential part" of the socialist market economy. Even though the amendment introduced the "primary stage of capitalism", it did not include a provision on the sanctity of private property rights. Instead the language provided that self-employed, private, and other non-public sectors constituted an important component of the socialist market economy whose lawful rights and interest would be protected by the state. While this was touted as a major step forward in China’s reform

process, the reference to state protection of lawful rights and interest signals that the private sector will remain subject to significant state control.

A further amendment to the constitution of China was made in 2004 to enshrine private-property rights. Prior to this amendment, the constitution stated that the state may in the greater public interest, requisition land for its use in accordance with the law. Through the fourth amendment, the constitution included a provision for compensation for the land expropriated or requisitioned. As part of the 2004 amendment, the government strengthened provision for protecting private property. For instance, before the current amendment took place, the constitution protected the rights of citizen to own and inherit lawfully earned income, savings, houses and other lawful property. However, the new amendment promulgated that Chinese citizens can now have an inviolable rights to private property. But the constitution is less a prescriptive document than a constantly changing description. It will unlikely bring the full property-rights revolution China's development demands due to the fact that the constitution's ability to limit the government is very limited which implies that uncertainty regarding the protection of private property remains.

The great systemic hazard relates to the land use rights. The Land Administrative Law in the PRC was introduced in 1998 which was further revised in 2004. It is stated that urban land is owned by the state, and that the rural and suburban lands are collectively owned by peasants. So in a nutshell, all land in China is owned either by collectives or by the state which means that private rights on them are precarious. Since individual cannot own land, the law allows individual to take lease from the collectives for a term of thirty years. However, the use of the land is limited to those purposes expressly allowed by the lease. In the case if leaseholders desire to alter the land use rights, they have to receive approval from a variety of governmental bodies including two thirds of the villagers' congress or representatives (James, 2007). This implies that land use right for private purpose is insecure and precarious.

This insecurity is further exacerbated by the state expropriation risk. The only limit of the state's expropriation is that such takings must be "in the public interest" which is further defined by the state. Chinese courts must rely on the legislature to codify a definition of the public interest. This yields state an enormous discretion in defining public interest. Moreover, Chinese law does not provide any provision for individual wishing to check the due process of the takings. Where an individual to file a suit against local government's officials questioning whether an expropriation is truly in the public interest, the judges hearing the case would be hired and paid by local officials sitting as defendants who further have the right to demote, promote, or even fire the

judges. This implies that judicial independence to protect and enforce private property is not duly instituted even though the Chinese government enacted a new Property Law in 2007.

The obvious drawback is that there is no third party to enforce the rights. It is natural that if the contracting parties are free to violate the agreement they have entered into without any concern of reprisal, very few would enter into contracts. Third party is an integral part either to ensure the terms of the contract or to ensure justice when contract is violated. This role is played by the state thorough an independent judicial system. In the case of China, state and collective entities appear to be contracting party against individuals which construes that a contracting party itself is the enforcer of rights which means that if state violates the contract, the defending party should first recourse to the violating party. Despite the fact that constitution provides provision for compensation in the case of takings, lack of third party enforcement or independent judicial system is highly likely to compromise with the spirit of private property. Zhang (2006) quotes Han (2004) saying that on average the compensation farmers received accounted for only about five to ten percent of the total market value. Clearly, a large fraction of the land rent is appropriated by local governments and developers.

Apart from the compensation issue there are other ambiguities that also are threats for private property. For instance, the law does not stipulate the relationship between collectives and individual particularly the farmers for rural land. Therefore in reality, in the process of land requisition, the local governments need only deal with the village committee. Sometimes, they collude to extract as much rent as possible from farmers' land. To a large extent, farmers do not have much voice in the land requisition process. They are rarely informed of the purpose of land procurement or the terms of compensation until the arrangements are finalized and officially announced. Moreover, individuals usually must vacate their house or other property on the land under a short notice. Otherwise, the state can use force to demolish the property by exercising the power of law (Zhang, 2006). Furthermore, local governments and developers often provoke additional outrage by using the land for commercial purposes in violation of the original public purpose intent.

Furthermore, the socialist spirit is prevalent in other laws as well meant to be protecting private property. In March 1999, the Chinese government adopted Contract Law expecting to play a crucial role in regulating China's burgeoning market economy. Three guiding principles of Contract Law are freedom of contract, good faith, and the fostering of transactions (Liming and Chuanxi, 1999). As Unified Contract Law of the PRC confirms contracts to notions of "lawful rights and interests of the parties. But the

contract law is also imperative to protect “state and social interest”. The reference to preserving the social interest indicates that the rights and interests of contract parties are qualified by pursue of this somewhat ambiguous and elusive goal in the sense that there are some provisions in the law that requires contracting parties to refrain from disrupting social and economic order as well as undermining the public interest. These limits of the constitutional provision reflect the fundamental position that China’s socialist system privileges socialist public property, and while it might tolerate or even encourage private property, this was still dependent on the policy directions and dispensation of the Party/state (Potter, 2001). Thus, in the case of China, while the policy of the socialist market economy would permit individual enterprises and private firms to play an important role, ultimate property rights remained subject to the policy priorities of the Party/state and were not to receive absolute constitutional sanction.

5. Coping with the uncertainties

Uncertainty transforms the possibility of taking all valuable attributes of property into account *ex ante* impractical. However, legal and political uncertainties prevalent in China cannot be avoided simply by incurring high transaction costs because they are embedded with the basic institutions of the country. Needless to say, the institutional nature of this sort imposes huge transaction cost to enterprises especially private enterprises due to the fact that enforcement of private rights is clearly stated neither in the constitutions nor even other law meant to protect private property. This means that privately owned firms are operating in a world of great uncertainty coming from the state or local and provincial governments. In order to exercise their full ownership on property, private ownership has to incur a lot of transaction costs or sometimes may not be possible at all to exercise rights. If this is the case, it is natural that private ownership might not be the first choice for entrepreneurs. This is manifested by the fact that many private entrepreneurs want to develop under the disguise of TVEs (Lo and Tian, 2002).

The preference is not whimsical rather a rational choice due to the fact that discriminatory legal environment is unlikely to contribute to the successful performance of the collective sector. As a result, the Chinese experience cannot pose a challenge to the property rights theory but rather demonstrates the importance of legal protection for private property rights. Under the existing Chinese system of highly concentrated political powers, private citizens may find it difficult to obtain key resources that are crucial for the success of the TVEs (Chang and Wang, 1994). From this perspective, vaguely defined ownership in the TVEs may provide some institutional advantages over

private firms in solving the agency problem. Moreover, the assignment of property rights to the local government may be an efficient response to Chinese institutional constraints which we call slack in response to uncertainty.

Hirschman (1970) introduces 'slack' as a cushion to which firms can resort during its unpleasant day. Similarly, existence of some sort of slack in an economy is rather necessary for responding to uncertainty. At organizational level, slack consists of payments to members of any entity in excess of what is required to maintain it (Cyert and March, 1992). It absorbs a significant portion of the variability of the firms' environment especially threats emanating from external environment propelled by various institutional changes. For example a precipitating change in demand of the product of a firm might throw it at the brink of extinction, which may cause it to go burst when operating at equilibrium. Slack that can be called in when it is in need to firm, plays a crucial role to provide firms with supportive means. In recognizing the importance and pervasiveness of slack, Hirschman argues

It assumes not only that slack has somehow come into the world and exists in given moments, but that it is *continuously being generated* as a result of some sort of entropy characteristic of human, surplus-producing societies.... Firms and other organizations are conceived to be permanently and randomly subject to decline and decay, that is, to a gradual loss of rationality, efficiency, and surplus producing energy, no matter how well the institutional framework within which they function is designed (1970: pp. 14-15).

The notion of general equilibrium or Pareto optimality implies that there should be no slack in organization. Thus, entrepreneurs should not earn abnormal profit in the long run. However, slacks at both organization and economic levels exist for responding to uncertain economic conditions. For example, organizations do have employees more than optimal level, firms maintain cash more than immediate necessity. In accordance with this presumption, the degree to which a really attainable level of property rights deviates from a perfectly delineated or Pareto optimal structure of rights arrangement can be marked as slack that acts as buffer against uncertainty.

The TVEs in the Chinese countryside are part of the large government institution with broad power given by the fundamentals of political system. For this reason, the full support of the local government provide the citizens and other stakeholders in the TVE a sense of security needed for long term development. In this sense, ambiguous property rights are a response to high transactions costs and high uncertainties in the market place. Moreover, a government bureaucrat or a government agency can properly work around the obstacles and make the transaction possible. Facing such uncertainties in the

marketplace, entrepreneurs may want to include the government as an ambiguous owner.

The advantage that ambiguous property rights can achieve is that involving government as a contractual partner facilitates firms to get help from bureaucrats easily. TVEs do not have the same fear of confiscation of the fruits of their investment that private enterprises have because TVEs are the creatures of local government, precisely the same body that farmers fear will confiscate or redistribute their land. While private entity may face uncertainty as to the results of long-term investments, TVEs, whatever their other problems, face no real uncertainty in this area at all. As a consequence, an emerging non-state firm finds it highly beneficial to include the local government as part of the firm. This gives rise to vaguely defined property rights which is sometimes outperforming the private enterprise. If the market is full of uncertainty or when firm has trouble with market transactions, the local government can step in and intervene on behalf of TVEs. For a purely private firm, asking for help from the local government may not be as easy, because the firm and the government do not share inside information of the firm (Li, 1996).

This provides our basic point of analysis that when formal institutions are precarious or uncertain; societies may attempt to evolve along the alternative existing institutions to protect their economic activities. That's the reason why private firms tend to disguise themselves as TVEs. Under the current institutional settings, they find it is prohibitively costly to write a complete contract. In this context, ambiguous property rights arrangement, which often involves local officials as shareholders of TVEs, may be a better option because it can help secure protections from the local government and reduce impediments to reform at the local level. In other words, high transaction costs provide an environment where ambiguous property rights can be more efficient under certain conditions than well defined property rights. From this vintage point it can be concluded that the case of TVEs with vaguely defined property rights does not provide any threat to the traditional property rights hypothesis. Once the level playing is ensured, it is highly likely that private firms would outperform TVEs.

Now the question is how long this 'slack' can work for Chinese economy? This is the issue that Chinese policy makers should consider seriously. There are plenty of opportunities for rent-seeking in the current arrangement of property rights. There are lots of externalities involved with the TVEs. It is understood that any profit from TVEs benefit both the local government and residents. However, beneficiaries are not being rewarded according to the input they put to the TVEs. This usually generates a tradition of shirking which needs to be monitored (Alchian and Demsetz, 1972).

Monitoring by local government again is costly. Thus, it is a matter of serious concern which system of monitoring – private with residual arrangement or collectives with government monitoring – is cheaper. On the other hand, currently a lion share of the profit is paid to the local government in the mode of fees and other charges which is usually spent for building infrastructure and other such development activities. This indeed, creates a possible hotbed for corruption. As Bouckaert (2007:1) argues “These enterprises (TVEs) are seen as the result of ‘bureau-preneurship’ because local bureaucrats were integrated in their management in order to pre-empt predatory behaviour and to facilitate the relationships with the central institutions”.

Moreover, we cannot take it for granted that the current level of growth in the industrial output is the saturation level for China. May be because of ambiguous institutions of property rights, growth prospects in China is slightly impeded. This issue has already raised by some scholars. For instance, Prosterman et al (1996:90) argue regarding the productivity of agriculture “... farmers could obtain crops two to three times larger than what they currently harvest. The farmers... acknowledged that the land could afford much larger yields. Yet few of them had made any major alterations to their plots, even though they all knew that such changes would boost their output.” If this is the case, there is no reason to be fascinated by current growth of TVEs. Rather government should concentrate more on eliminating current legal and political uncertainties to provide a better playing field for private enterprises if China wants to continue the pace of amazing growth in the days to come.

6. Conclusion

Bringing transaction costs to the discussion of property rights has undoubtedly opened new avenues to look for efficient allocation of scarce resources. This theory suggests that incomplete property rights are the result of high transaction costs. However, the more we emphasize on transaction cost for explaining incomplete property rights the more we are prone to neglect numerous aspects of the problem. Uncertainty is one of such aspects which is also responsible for incomplete property rights. We have shown that even though the mainstream view has recognized the problem of uncertainty, the theory explains the problem of uncertainty as merely a problem of transaction costs. Contrasting to that, we have argued that uncertainties are rather a serious problem for incomplete property rights because they lead to high transaction cost. However, by incurring higher transaction cost, uncertainties cannot be eliminated because the origin of uncertainties is rooted with the fundamental institutions of a country. Thus, it is also a

crucial reason for property rights to remain incomplete.

Standard property rights theory argues that property rights in which control rights and residual return rights are placed to a single owner is the most efficient structure of rights arrangement. If so, noteworthy performance of Chinese TVEs of which control rights and residual return rights are held by different entities appears to be a paradox to the property rights theory. This paper has explained this paradox arguing that uncertainties embedded with the country's legal and political structures hamper the natural operations of privately owned firms. In contrast, TVEs have successfully adjusted with this environment due to the fact that rights on them are vaguely defined. Vaguely defined property rights work as a 'slack' responding to uncertainty. Since the basic institutions conducive to private property have not yet been laid down, there is no scope to argue, considering the fact that TVEs are as good as privately held firms, that property rights does not matter for economic performance. Unless we ensure a level playing field for both entities, such a conclusion is unfounded by evidence or logic.

Moreover, it is likely that TVEs can perform better if certain institutional restrictions are abolished. There are plenty of rooms under current institutional settings for rent seeking which will have a negative economic effect in the long run. From macro perspective, it seems to appear that overall high economic growth of China can absorb a high level of slack ensuing from ambiguous institutions. But in the near future, the level of slack should be reduced to minimum before a bigger crack appears in China.

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