State-Owned Enterprise Reform in China

Charles Wang
Dr. Lianfa Li
Economic System Reform in China
7/28/2010

Overview

The rapid economic growth of China since the beginning of economic reforms in 1978 has captured the interest of Chinese and Western economists. China, as described by Hovey and Naughton, has moved towards an evolving “socialist market economy”. It has experienced significant transition recently and state-owned enterprises (SOEs) still remains an important contributor to Chinese economy. As China has greater market freedom, notable issues remain to be resolved in order for SOEs to become effective free market corporations. Under such circumstances, how SOEs being transformed from state run socialist institutions to competitive market economy corporations and what actions should the Chinese government take in order to make SOEs remain competitive in global economy are naturally becoming one of the most debated issues in applied international macroeconomics, and the role of China in their development is addressed by a growing number of literature.

Chinese Economy

✓ Macro/micro

During Mao’s era, China was quite isolated from the outside world except some economic activities with USSR. The economic development during that time was driven by one single engine- the government’s public sector. It was not until the Deng’s era (1978-1989) that China’s economic development was driven simultaneously by the four engines as a synergy- the government, the business enterprises, the household and the foreign trade. The discharged synergy has
powerfully driven the China economy for a continuous two-digit growth in the 80s.

Hence, during Deng’s era China witnessed the changing of economic system from the central-planned economy to the market economy. Briefly speaking, market economy consists of two main parts, the macro economy (the public sector) and the micro economy (the private sector). Government plays the role of developing the macro economy of public sector, while the business enterprises and the households play the role of developing the micro economy of private sector. In addition to these three main units of carrying out the economic activities, the foreign trade and the import/export act as the regulator of economic resources. This is the concept of economic development of a country.

- Government: the unchallenged government decision-making

  State-Owned Enterprises (SOE) is one of the focuses in macroeconomics. SOEs can be divided into two categories: the SOEs under the ownership of central government and the SOEs under the ownership of local government. From 1992 onward, the SOEs ownership and management were separated. By 1995, according to the statistical data, the number of central-government-owned SOEs is 7275, and 110725 is the number of local-government-owned enterprises. Since China is a Communist Party-led state, it is understandable that all power of decision-making is held in the hands of Communist leaders. Its unchallenged and unchangeable position and authority has even been stipulated in the constitution of People’s Republic of China. Moreover, China is a big country with the largest population in the world. Therefore, it would be difficult to understand issues surrounding SOEs without realizing government’s role in decision making.

- Interest: Market economy has taken the place of central-planned economy.

  For the first three decades right after Communist China was established in 1949, interest-minded behavior had been suppressed and condemned. However, it has
changed ever since the 80s when market economy has taken the place of central-planned economy. From a practical perspective, things are profit-oriented in our world. Doing business is for profit; so is the intention behind the human relationship. In China, “profit” makes the mare go.

At the onset of 80s, China was set to move toward socialism with Chinese characteristics, and the effective way to materialize the “Four Modernizations” was to adopt the “Capitalist Market Economy”. However, political system and economic system are like two sides of a coin. They are related and complementary. The capitalist market economy means free competition on the market, but not free on the political arena which is under the strict control of the Communist Party. This built-in dilemma was given a way out by the late leader Deng Xiao-ping, who said that, “Whether it's black or white, a cat can catch a mouse is a good cat.” and “Let a portion of people become rich first.”

✓ Reform Motive: What was the motivation for China’s Reform and Open-door policy in the end of 1970’s?

Justin Yifu Lin, the founder and director of the China Center for Economic Research, former professor of economics at Peking University, and a leading Chinese economist, expressed his view on the motivation for China’s Reform and Open-door policy in the end of 1970’s. He points out statistical data: “From 1979 to 2002, the average annual growth rate of China’s real GDP reached 9.4%, and that of the real GDP per capita 8.1%, rivaling the record achieved by the four small East-Asian Dragons in their fastest development period.” He discovers China’s vivid and rapidly growing economy contrasts with those of the former Soviet Union and Eastern European countries, most of which are still in financial trouble. He states that the great achievements of China’s economic reform are the result of the mutual interaction between many internal and external factors.
Back to what was the motivation for China’s Reform and Open-door policy, Professor Lin suggests that the launch of economic reform and improvement of living standards of the people would provide the new leaders with legitimacy for their leadership after the economic disaster of the Cultural Revolution (1966-1976). However, he emphasized the fact that the new leaders of China also participated in the design and implementation of the planning system, and with socialism still being the dominant ideology, it was natural for the leaders to adopt a gradual, tinkering approach of economic reform.

**Market Economy**

✓ Benefit of opening

Under the open policy, the first goal to pursue was FDI-Foreign Direct Investment into China. It was called, “yin-gin-lai” (to draw in) policy. In order to do this, China opened certain areas, including the five Economic Special Zones, to encourage foreign investments. The opening was unprecedented; FDI is the main form of foreign capital flow to China, accounting for 95.9% of total inflow in 2002.

**Ownership Structures**

✓ Overview

Behind the successful open policy, the ownership structure does significantly influence the performance and value of Chinese firms. Hovey and Naughten in their paper *A survey of enterprise reforms in China: The way forward* carefully examines five different kinds of ownership: state ownership, legal person holdings, tradable A-shares, offshore ownership and foreign institutional ownership. This paper will focus on state ownership, legal person holdings and foreign institutional ownership. Below is the summary of their research paper.

✓ State ownership

Most scholars relate state ownership with negative performance. A year-by-year
analysis from Hovey (2005b), as well as Sun and Tong’s (2003) 634 listed SOEs study both found that the state had a negative impact on listed firm performance.

In addition, private sector investors have little choice as the vast majority of firms have substantial state holdings and look favorably on reductions in state involvement. In 2005, Hovey applies his event study methodology and concluded that the market reacts favorably to changes in block ownership involving a decrease in state ownership.

Moreover, Hovey mentions China requires at least 8% growth per annum to accommodate the 20 million workers entering the labor market each year (Leggett, 2000). The poor performance of SOEs obviously has negative impacts upon meeting this target. For instance, in October 1999, only a small portion of the SOEs were profitable, whereas more than 35% of the SOEs have encountered explicit losses, and another one third has implicit ones. Finally, Hovey proposes state divest its direct holdings in order to meet the objective of such growth.

Legal Person holdings

Hovey’s definition of Legal Person: “In China, Legal Person’s (LP) are technically autonomously managed investment organization, which are also primarily state-owned government agencies. Thus, LP holdings are autonomous domestic institutional holdings by the state through various holding companies. LP ownership is equity held by these domestic institutions or holding firms.”

Hovey’s study shows that LP ownership averaging between 3.8 and 32.1% of share capital provides the clearest positive relationship, which is “non-linear”. He further suggests that LP’s are the most respected shareholders by the market in China. Although only constituting 18.4% of the whole ownership structure in 2004, LP holdings have been analyzed and found to have positive influence on firm performance or value. The basis of the argument rests on large institutional
shareholders’ ability to monitor the firm and its management, and to be able to make the necessary changes whenever performance is unsatisfactory. To make final analysis, Hovey pinpoints two drawbacks and two advantages associated with LP.

The first drawback is LPs still have political pressures placed upon them and other agendas to consider. Though LPs have a performance motive, they may not essentially be focuses on maximizing either wealth of investors. The other drawback is that LP representatives and SOE management are both effectively state employees. Therefore, LP institutions may lack the same level as truly independent institutions.

On the other hand, the two advantages are: 1. LPs are less politically motivated and have objectives and incentives with a greater focus on the performance of the firm. 2. Since LPs have representatives elected to the board of directors and the supervisory committee, they also have greater power, proficiency and incentive to monitor and control the performance of management. Furthermore, LP appointed directors are selected more carefully, in addition to having better focused business and performance objectives (Xu and Wang, 1999; Gul and Zhao, 2001).

Finally, the paper concludes that evidences above provide strongly demonstrate LP ownership has the propensity to enhance the performance of publicly listed firms in China. The authors argue that the decline in LP ownership should be halted and held at its current rate, whereas direct state ownership should be substantially reduced.

Foreign institutional ownership

Most economists are optimistic about foreign institutional ownership as they argue that foreign institutional holders tend to monitor firms more closely, leading to improved firm performance. The findings in Hovey and Naughten’s paper support the notion that foreign institutional ownership on average leads to superior performance of publicly listed firms in China.

The way forward
It is concluded that LP holdings, the positive impact of foreign institutions, as well as less direct government ownership toward SOE have potential to strengthen the market.

The article finally suggests that when a firm is listed, “it should be listed under the sponsorship of LPs solely; the findings strongly suggest that the ideal firm ownership structure involves medium levels of LP holdings, a percentage of foreign institutional and individual shareholdings and minimal direct state holdings.”

**SOE Overview**

The strategic importance of the state-owned enterprise (SOE) sector to the Chinese economy cannot be underestimated. Before the economic reform of the 80s, the SOEs made up more than 80% of the national industrial output. However, it has dropped to 30% or less after the opening of the market. By now, most of the SOEs remain in the northeastern and the southern part of China. SOEs have decreased sharply due to the booming of other types of corporation, and about 40% of SOEs are suffering loss and getting worse without a sign of improvement. The financial burden of SOEs is the most killing headache of Chinese government.

Before 1979 when China was still isolated from the outside world, the state-owned enterprises contributed up to 80.8% of China’s GDP. SOEs played a very important role in the economy development of China, and of course the social stability as well by means of full employment. After 1979 when China adopted open economy policy, the SOEs thus became the burden of Chinese government due to lower productivity and less competitiveness. Working attitude and government-dependant mentality are two serious problems. Consequently, unconditional bank loans granted to the SOEs in order to maintain their business operations. In this way, the employment became an unavoidable responsibility of Chinese government.
Compared with Private-Owned Corporation (POE), which is much more efficient and productive, SOE has a long way to go. Hence, the success of SOE reform is a significant factor in China’s future economic prosperity. Hovey states that “The dilemma facing state authorities is to develop market-oriented corporations while at the same time coping with potentially high unemployment and a range of equity and social justice issues.”

**SOE History**

Hovey and Naughten present an analysis of the current issues in SOE reform in China. The Chinese government has made much effort on SOE reform. Before the recently announced program of privatization of listed SOEs, Hovey points out that “authorities in China have had an objective of gradually decreasing state holdings in the corporate sector.” Below is a chronological series of action taken by the Chinese government to reform SOEs.

- **Reduce state holdings**

  According to Hovey, China’s first major endeavor to sell-off state holdings in China was made in 2001, aiming to raise capital to finance pension and social security funds. Statistically speaking, the total sold amount in shares was about US$260 (Tong, 2005). Despite the market response and critics’ comments and objections to the 2001 sell-off attempt, the authorities in China have once again announced that they intend to reduce the holdings of the state.

  In April 2005, The Chinese Securities Regulatory Commission (CSRC) once again announced a strategy to reduce state holdings. Hovey writes, “Initially this is to be achieved by changing the status of state holdings from non-tradable to tradable. Listed firms were encouraged to prepare plans to implement this policy. These would be subject to regulatory and shareholder authorization (Economist, 2005a,b). Previously, non-tradable shares must be held for at least 1 year and thereafter may...
only be sold at a rate of 5% per annum.”

Following the maxim spoken by former chairman Deng Xiao-ping: “Cross the river by touching the stone,” the Chinese government took a cautious approach and started diluting the government’s control only of small SOEs. Initially four firms were given permission to convert state holdings to tradable shares. They were: Tsinghua Tongfanf, Hebei Jinniu Energy Resources, Shanghai Zijiang Enterprise Group and Sany Heavy Industry. (Economist, 2005a,b)

42 firms (28 from Shanghai and 14 from Shenzhen Stock Exchanges) were given permission later in the year. The second group comprises of large firms and contributes around 10% of market capitalization It includes Baostell, China’s biggest steel manufacturer, and Yangtze Power, a financier of the Three Gorges Hydropower (Economist, 2005a,b). In the light of Hovey, authorities appeared to be satisfy with progress by late 2005 and the reform program was to be extended to all remaining listed firms.

**Productivity and efficiency**

It is practical to evaluate the variations in SOE efficiency and productivity from the perspectives of macroeconomic fluctuations. Fu, Vijverberg and Chen use the traditional linear programming DEA model to estimate SOE efficiency. DEA constructs a production frontier according to all the data in the sample. The three scholars collected data from a whole province to make samples instead of from individual firms because firm-unit data are difficult to obtain. For Panel-Data (PD) efficiency, all the relevant data of SOEs in all 18 years (1986–2003) and from all the 30 provinces were pooled together to derive a common efficiency frontier. The general formula is below: (Eij denote the thus derived efficiency indicator for the ith year and the jth province; and rij be the ratio of each province’s SOEs number to the total SOE number in that specific year. Using rij as a weight, a nationwide SOE
weighted average efficiency indicator $E_i$ can be calculated.

$$E_i = \frac{1}{30} \sum_{j=1}^{30} r_{ij}, \quad i = 1986, 1987, \ldots, 2003.$$  

PD efficiency was 0.6143 in 1986 and 0.7450 in 2003. The empirical results show that SOE efficiency and productivity exhibited obvious improvements during periods of strong systematic reform and a prosperous economy.

**SOE Problem**

Statistically speaking, from *A Statistical Survey of China* made by State Statistic Bureau, we witness the progress of the SOEs reform: percentage of State-owned enterprises had dropped from 77.6%-28.5% from 1978 to 1998. Nevertheless, despite the efforts of authorities, especially the considerable endeavor of the China Securities Regulatory Commission, the Ministry of Finance, and the State-owned Assets Supervision and Administration Commission (SASAC), many decision making and problem solving still trouble government authorities.

Hovey in his paper states that “Concerns still revolve around poor corporate governance practices, market manipulation, backroom deals between brokers and other players in the market, brokers misappropriating investors’ funds, falsified accounts and members of the accounting profession and auditors that abet falsifying the accounts. Hence improving the quality of institutions and audits is a further key aspect of the reform process.”

**SOE Solution**

This paper concludes that there are mainly six approaches to solving SOEs problems effectively. To simplify the final solutions, this paper organizes the six methods and aligns them with their first letter, that is, two “L’s”, two “M’s” and two “I’s”. They are leverage, law, management, market, international aid and international consultation.

✓ **Leverage**
Most research papers indicate that state ownership is generally negatively correlated to performance. Consequently, the divesture of state ownership is recommended. The reduction of the supermajority state holdings will enhance minority rights and private investors will be more likely to invest in the stock market. In addition, Hovey points out that divesture of government shares also has propensity to affect China’s international credit rating.

Law

The government should strengthen of the legal system in order to protect the rights of shareholders. Moreover, Areas such as timely reporting and open disclosure should be addressed. On top of that, market transparency and openly tradable state ownership are appreciated.

Management

Hovey concludes that significant change in management is important in the reversal of poor performance, and a managerial labor market needs to develop quickly. Therefore, a more efficient management system should be implemented and the importance of appointment and training of senior personnel should be addressed.

In addition, I believe that China should depend on borrowed technologies to minimize the technological gap between China and other developed countries. By doing so, China can keep up its rapid economic growth for at least two decades. If China can maintain at least 8-10% growth for the next 20 year, according to Justin Lin’s conversation at a talk show named “chou-quan-pau-ka-fei” (周荃泡咖啡) in Taiwan 2008, China will be the largest economy in the world in 2030.

Market

China should gradually move away from a “price-distorted macro-policy environment” (Lin, Justin 1999), including policies of low interest rates. This should be done because many SOEs were unable to repay their loans from national banks.
Hence, Chinese firms are advised to be more aligned with market focus when it comes to the production and marketing of goods and services. A fair competition in the product market both domestically and internationally should not be ignored in the reforms of China’s SOEs.

✓ International Aid

Proposed by Justin Yifu Lin, international aid projects introduce advanced production technologies, increase management service and propose new approaches of economy development and poverty reduction. After opening her door in 1978, China began to accept aid from the international organizations and the OECD countries.

✓ International Consultation

The international consultations since the launch of China’s Reform and Open-door policy have played an important role in improving the policy makers’ abilities to understand the nature of existing issues, design reasonable economic reform scheme and facilitate the spread of modern economics in China.

Perhaps a move forward is financial globalization. Prasad, Rogoff, Wei and Kose in their paper provide a comprehensive assessment of financial globalization on growth in developing countries. Their research suggests that financial globalization can be beneficial under the right circumstances. One of its potential benefits is providing better opportunities for reducing volatility by diversifying risks.

Future

In conclusion, China, though economically opened in 1979, is still an authoritarian state under a political system called “Socialism with Chinese characteristics”. Hence, the market economy adopted in China now is not a real market economy, but at most the semi-market economy only. The market mechanism is not fully functioning to determine the optimal level of demand and supply. Many
economic factors are still under strict control by Chinese government or the officialdom.

However, Chinese government has invested a lot of resource and energy in resolving the problems in the state sectors, and we have seen significant improvement of SOEs. For instance, Medium and large SOEs, with more than 5 million RMB in sales revenue, have been privatized at the rate of about 8% per year in recent times, and it was reported that number of state-owned and state-holding industrial enterprises in 2008 is 21212, one third the number of SOEs in 1998 (64700). Nevertheless, we cannot stop the process of SOE reform.

Works Cited
4. Feng-Cheng Fu, Chu-Ping C. Vijverberg, Yong-Sheng Chen (2007). Productivity and efficiency of state-owned enterprises in China
5. Prasad, Rogoff, Wei & Kose (2004). Financial Globalization, Growth and Volatility in Developing Countries