# China's Ownership Transformation

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## Process, Outcomes, Prospects

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# Contents

# Foreword

China's emergence as a global economic player has been accompanied by a major internal transformation. Over the past decade or so, the economy has made the transition from complete reliance on state-owned and collective enterprises to a mixed economy where private enterprise plays a leading role. This remarkable transformation has been accomplished through the dynamic growth of the *de novo* private sector and more recently through privatization.

IFC has been an active participant in this transformation process through investments and technical assistance for private companies and pioneering research on private sector development and enterprise reforms. In 2000, IFC published one of the first studies on the emerging domestic private sector in China. The study analyzed the structure of private enterprise, the enabling environment for its development, and access to financing. It outlined an agenda for entrepreneurs, the government, and the financial sector for addressing constraints to private sector development. In 2002, IFC jointly with the World Bank published a study on the status and evolution of corporate governance and enterprise reforms in China. The study explored the main corporate governance issues that China has encountered during the course of corporatization and ownership transformation of its enterprise sector.

While China has been implementing reforms in its state enterprise sector over the past two decades or so, reforms have accelerated and have acquired new features since the start of the present century. First, the scale of change has expanded to affect almost every kind of state-owned enterprise—small, medium, large, and very large—under both central and local control. Second, ownership diversification has been so extensive that the role of the wholly state-owned nonfinancial company has declined substantially in many areas. Third, the range of restructuring mechanisms being used has expanded dramatically to include bankruptcies, liquidations, listings and de-listings, debt-for-equity swaps, sales to private parties (domestic and foreign), and auctioning of state firms, their assets, or liabilities. Finally, large layoffs, something unheard of just five or six years ago, have become a regular phenomenon in corporate restructurings and privatizations.

There has been no systematic study of the magnitude, forms, and consequences of this stage of enterprise restructuring. This book aims to fill this gap by looking at the process, the main players involved, and the outcomes. The empirical analysis is based on a survey of close to 700 enterprises in 11 Chinese cities. The study is a joint venture among the Australian National University, Beijing University, and the International Finance Corporation of the World Bank Group. The former State Economic and Trade Commission of the Chinese government facilitated the study for its successful implementation. Funding was provided by AusAid and IFC.

The study sheds new light on the progress that China has made in enterprise restructuring and privatization and on the challenges that enterprises, investors, and governments are facing in the process. An important finding of the study is that among the various forms of enterprise restructuring, privatizations involving outside investors have had the strongest positive impact on firm performance. Furthermore, the analysis finds that outside investors deliver improvements in performance more quickly than other forms of restructuring. The study shows that the private sector is emerging as an important player in the restructuring of SOEs but argues that its role could be enhanced further.

The International Finance Corporation has been playing an active role in supporting the growth of the private sector in China. Our cumulative investments in China since 1985 are approaching $2 billion in over 80 companies. The size and the breadth of IFC's program in China are in many ways a function of the level of development of the private sector in the economy. When the private sector was mostly small and informal, and the industrial and financial sectors were dominated by SOEs and joint ventures with foreign private investors, IFC's China program consisted largely of industrial projects sponsored by foreign investors. A number of these projects were in effect restructurings of state-owned enterprises through the injection of funds and modern technologies from foreign investors. IFC had an important role to play as a provider of long-term project financing that was not otherwise available for private projects.

The emergence of the domestic private sector has given us new opportunities to broaden our program to include support for local financial institutions, indigenous industrial and infrastructure enterprises, and small and medium businesses. The dynamic growth of the domestic private sector is creating the jobs needed to absorb laid-off workers from restructuring state enterprises. It is therefore a major positive force in the restructuring process.

Today we see the biggest investment opportunities in China with domestic private companies. These businesses are driving the rapid growth of the economy as they strive to expand and become more sophisticated. Increasingly, domestic private companies in China are looking at acquisitions of SOEs as their main growth strategy. A number of our projects demonstrate how a privately managed company can transform an ailing state enterprise into a profitable business that contributes to the local economy.

The study has benefited from the knowledge accumulated through our investment and technical assistance experience in China. Its findings also provide us with new ideas on how to continue to support the process of enterprise restructuring. I hope that investors, policy makers, opinion leaders, journalists, and all those interested in the status of China's enterprise reform can also learn from the study. And I hope that this study contributes to the further progress of enterprise restructuring in China.

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# Preface

*Gaizhi*, a Chinese term meaning "transforming the system," has become a major phenomenon in most parts of China. The restructuring of state enterprises has accelerated in recent years to include bankruptcies, liquidations, listings and delistings, debt-for-equity swaps, sales to private parties (domestic and foreign), and auctioning of state firms and their assets or liabilities. In many cases *gaizhi* has involved full privatization. *Gaizhi* programs in China have been gradual and low profile, but in many ways as far reaching as, and generally economically more productive than, privatization measures in Eastern Europe and the former Soviet Union.

Reforms have been most dramatic in the industrial sector where the number of state-owned enterprises has declined from 114,000 in 1996 to 34,000 in 2003. According to our estimates, about half of the decline is due to privatizations. Privatization in China has not been limited to small enterprises only: the average size of privatized SOEs is about 600 employees. The process has been socially painful: around 30 million SOE workers have been laid off since 1998. A dynamic *de novo* private sector has been able to absorb most of the laid off workers, thus alleviating the social cost of restructuring.

*Gaizhi* and the growth of the *de novo* private sector have transformed the structure of the Chinese economy. Over the past decade or so, the economy has made the transition from complete reliance on state-owned and collective enterprises to a mixed economy where private enterprise plays a leading role. We estimate that the private sector, narrowly defined, has become the largest sector of the Chinese economy, accounting for about 37 percent of gross domestic product in 2003. Overall, the nonstate sector accounted for two-thirds of China's GDP in 2003.

*Gaizhi* is not a one-off event but a continual process of reforms and restructuring. As of October 2004, about 40 percent of SOEs were making losses, compared with 18 percent for the nonstate sector. Enterprise reforms in China still have a long way to go.

There has been no systematic study of the magnitude, forms, and consequences of *gaizhi*. This book aims to fill this gap by looking at the process, the main players involved, and the outcomes of *gaizhi*. The empirical analysis is based on a survey of close to 700 enterprises in 11 Chinese cities.

Because *gaizhi* involves a comprehensive transformation of the state sector, which had been the foundation of the Chinese economy, a number of players have stakes in the process. Our analysis shows that local governments and enterprise managers have been the most active proponents of reforms with managers assuming a leading role in later rounds of restructuring. The government considers preserving social stability and protecting the welfare of state employees a top priority in SOE restructuring. Therefore, concerns about the social and fiscal implications of redundancies tend to constrain the pace of privatization. Consistent with this finding, firms with greater net assets are easier to privatize because they can compensate workers. Similarly, cities with stronger financial capacity tend to privatize more aggressively because they can absorb a greater portion of the social costs of restructuring. As a result, better-performing SOEs are likely to be privatized first, and there are significant regional variations in the pace and scope of enterprise reforms. A dynamic *de novo* private sector makes it easier to absorb redundant workers and therefore reduces the cost of restructuring. We find that the level of development of the *de novo* private sector has been the most important macroeconomic factor leading local governments to release SOEs into private hands.

While *gaizhi* can be held back by fear of labor redundancies, it is often the only way to check job losses in the state enterprise sector. An important result of our analysis is that *gaizhi* and privatized firms have maintained a lower rate of employment reduction and a higher rate of wage growth than non-*gaizhi* and fully state-owned firms. Consistent with the conventional belief, *gaizhi* firms discharged more workers in the year when *gaizhi* was implemented, but in subsequent years and overall they were able to retain more workers than non-*gaizhi* firms.

*Gaizhi* firms were able to limit job losses because restructuring has brought efficiency gains. We find that *gaizhi* has a positive impact on firm profitability, although a weak or insignificant impact on unit cost and labor productivity. Privatizations involving outside investors have the strongest positive impact on firm performance. Furthermore, outside investors deliver improvements in performance more quickly than other forms of *gaizhi*: their positive impact tends to appear early in the reform process.

Interestingly, we find that SOEs as outside investors also tend to have a strong positive impact on firm performance. China's experience shows that SOEs with a relatively high degree of autonomy in the market process may have difficulty in putting reforms into effect in their own enterprises but can be effective agents of change in other state enterprises.

*Gazhi* has brought efficiency gains by aligning incentives and reallocating decision-making powers within the firm. We find that *gaizhi* firms are more likely than non-*gaizhi* firms to provide managers with shares and bonuses. Shareholder representation on the board of directors of *gaizhi* firms has improved, and power sharing among the shareholders' conference, the board of directors, and the management has begun to occur. The influence of the Communist Party over the firm tends to decline after *gaizhi*, but the role of the labor union in collective wage bargaining is more clearly defined and enhanced. We find that the government is retreating from the privatizing firms by reducing its ownership share, while the share of insiders has been increasing rapidly.

The dominance of managers appears to be the main corporate governance issue of *gaizhi* firms. Managers tend to be overrepresented at the boards of directors and maintain decisive influence on key issues. What players and institutions are emerging to control the agency costs of managerial autonomy? Survey results indicate that outside investors are more likely to use and rely on the new mechanisms of corporate control, to provide effective checks and balances on managerial discretion, and to offer high-powered incentives to senior managers. In general, the presence of outside investors is associated with a reduced role for traditional stakeholders such as the government, the Party, and the labor union. These traditional stakeholders have less significant roles in outsider-controlled firms than in insider-controlled firms.

Thus one important result of our analysis is that privatizations involving outside investors are generally more productive than other forms of privatization and *gaizhi*. Yet, privatization in China does not exhibit a clear trend in the direction of a greater role for outside investors. While on average the ownership share of insiders has grown rapidly in recent years, outsiders' share has remained largely stagnant. In our sample of firms, insiders held 5 percent of privatizing firms' shares in 1995. In 2002, their share had risen to 32 percent. Over the same period, the combined share held by domestic and foreign private companies has remained at about 20 percent.

Insider privatization could be subject to greater conflicts of interests than other forms of *gaizhi*, especially given the major role that enterprise managers play in initiating and implementing restructuring programs. Media reports on irregularities in insider privatizations and particularly management buyouts (MBOs) have raised public concerns about lack of fairness and transparency of the privatization process in China. In response, the government has promulgated a host of regulations aimed at establishing an orderly process of ownership transformation, and at expanding the role of outside investors. A policy priority is to enhance the involvement of the private sector, both domestic and foreign, in the restructuring and privatization of SOEs.

We already observe a change in the role that the domestic private sector is playing in China's state enterprise reform. Historically, the private sector has been supporting restructuring largely indirectly by creating the jobs needed to absorb laid-off workers. While this indirect role will continue to be important, domestic private enterprises are emerging as significant players in the privatization process. A growing number of *de novo* private firms have begun to look at acquisitions of SOEs as their main growth strategy. These private companies have been injecting capital and dynamism in moribund state enterprises thus helping to preserve jobs. While private enterprises are becoming more active in acquiring and restructuring state-owned enterprises, they still account for a small share in all *gaizhi* cases.

China's approach to state enterprise reform has been extremely pragmatic. Ownership change is not seen as an end in itself nor is it seen as the automatic solution to inefficiency problems in the state enterprise sector. Local governments are primarily interested in aspects such as tax revenues, growth and employment. Looking for ways to obtain these results, they have been experimenting with institutional reforms. In the process, local governments have found that the way to deliver tax revenues, growth and employment to their constituencies is by opening more room for private enterprise. Enhancing the role of private companies in SOE reform will require, however, sustained efforts from both the government and the private sector to improve the business environment for entrepreneurship and move private enterprises toward global best practice.

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# Abbreviations and Acronyms

| | |
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| ABC | Agricultural Bank of China |
| AMC | assets management companies |
| BOC | Bank of China |
| CCB | China Construction Bank |
| CCP | Chinese Communist Party |
| CEO | chief executive officer |
| CSRC | China Securities Regulatory Commission |
| DCD | discounted dividends |
| DCF | discounted cash flow |
| DRC | Development Research Center |
| ETC | economic and trade commissions |
| FDI | foreign direct investment |
| FIE | foreign-invested enterprise |
| GDP | gross domestic product |
| ICBC | Industrial and Commercial Bank of China |
| IPO | initial public offering |
| M&A | mergers and acquisitions |
| MBO | management buy-out |
| MOF | Ministry of Finance |
| NPC | National People's Congress |
| NPL | nonperforming loan |
| PAYE | Pay As You Earn |
| PER | price-earnings |
| R&D | research and development |
| ROA | return on assets |
| SARS | Severe Acute Respiratory Syndrome |
| SASAC | State-owned Assets Supervision and Administration Commission |
| SASMC | State Asset Supervision and Management Commission |
| SETC | State Economic and Trade Commission |
| SME | small and medium enterprises |
| SOE | state-owned enterprise |
| SPC | Supreme People's Court |
| TVE | township and village enterprise |