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## Introduction

Corporate governance has moved to the center stage of enterprise reform in China. The Fourth Plenum of the Chinese Communist Party's 15th Central Committee held in September 1999 adopted a "decision" that calls for "strategic adjustment" of the state sector by "withdrawing what should be withdrawn." The decision identifies corporate governance as "the core" of the "modern enterprise system," the new system expected to prevail in the reformed enterprise sector. The current emphasis on corporate governance reflects the significant progress that China has made in building market institutions, but also the limited success of past reform efforts in changing corporate behavior.

Market-oriented reforms, including corporatization and ownership diversification, have brought corporate governance issues to the forefront. More than two decades of reforms have created economic entities with a relatively high degree of autonomy that are subject to significant market pressure and whose capacity to decide and structure the parameters of their mutual interactions are growing. Most large and medium state-owned enterprises (SOEs) have corporatized themselves, although the process has not been completed. Ownership diversification has taken two main forms: listing on domestic and international stock exchanges in the case of larger SOEs, and sales to insiders, namely, management and employees, in the case of small and medium SOEs.

In the process, new institutions for the exercise of corporate control have emerged, such as boards of directors and supervisors. As a result, issues such as how to make these institutions more effective; what their composition and *modus operandi* should be; and what the appropriate division of labor should be between them and traditional representative bodies, such as trade unions, employee conferences, and party committees, have become important. Corporatization and ownership diversification have also led to the emergence of new owners



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and stakeholders, such as individual minority shareholders (about 60 million at present), institutional investors, and employee shareholders. Their emergence has created the need to specify the rights of such stakeholders, clarify their role in corporate governance, and establish mechanisms to protect their interests.

However, to date ownership diversification and corporatization have had only a limited impact on corporate behavior. The current policy focus on corporate governance reflects growing concern about the negative consequences of poor corporate governance practices. According to a recent People's Bank of China (PBOC) report, of the 62,656 enterprises that had completed transfers of ownership by the end of 2000, 51.2 percent had failed to repay their bank debts. The poor financial performance of a large number of SOEs, including state-controlled listed companies, continues to impose a severe burden on the banking system, Treasury, and stock market and is a potential threat to social stability. The nonperforming loan ratios in the financial system are estimated at between 25 and 40 percent. Large excess capacity exists in manufacturing, but because of the structure of the labor market, many firms still carry excess labor on their books (Bhattachali and Kawai 2001). Unemployment concerns are slowing the pace of restructuring of loss-making SOEs.

Commitments under the World Trade Organization add to the urgent need to tackle corporate governance issues in a comprehensive and systematic manner. As part of its accession negotiations, China has committed to a broad range of market access measures. Some will revolutionize the organization of business activity, thereby creating pressures for moving toward a rules-based, as opposed to relationship-based, investment environment and greater transparency in business and government activities consistent with international investment-related rules. Further trade liberalization in the context of WTO entry is expected to create significant pressure to reallocate productive resources in accordance with China's comparative advantages. These changes would be in addition to the resource reallocation trends that are already taking place as part of the transition from a planned economy to a market economy and from an agricultural to a manufacturing and service-oriented economy. Corporate governance arrangements will determine to a large extent the way firms and other economic agents respond to these internal and external pressures.

The current policy focus on corporate governance thus plays an important role in the internal dynamics of market-oriented reforms in



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China. While establishing and strengthening the new mechanisms of corporate governance are necessary to realize and solidify the benefits of past reform efforts, they are also likely to prepare the ground for further progress in institutional transformation. A good corporate governance framework is likely to facilitate the state's withdrawal from direct ownership.

The topic of this study is the short- to medium-term corporate governance issues that are arising during the course of transformation of ownership in the Chinese state enterprise sector. The study looks at companies participating in the two main forms of ownership diversification: listed companies and small and medium enterprises whose ownership structure is dominated by insiders. The focus is on the new mechanisms and stakeholders emerging during the process of ownership diversification and their role in corporate governance: boards of directors and supervisors, minority shareholders, shareholding employees, creditors, information disclosure, and the capital market. While these issues are important for corporate governance in general, their relative importance differs in listed and nonlisted companies. Thus the study discusses the respective roles of boards of directors, minority shareholders, information disclosure, and capital markets in the context of listed companies. It discusses the role of employees, creditors, and outside private equity investors in the context of small and medium enterprises with insider-dominated ownership structures. However, many of the issues, observations, and recommendations extend to both types of companies.

In the case of listed companies, the analysis, particularly of board structure and practices, is based on a survey of corporate governance practices among companies listed on the Shanghai Stock Exchange conducted in early 2000 by Integrity Management Consulting and the Research Center of the Shanghai Stock Exchange. A total of 10,560 questionnaires were sent to the directors, supervisors, and senior managers of all companies listed on the Shanghai Stock Exchange at that time, of which 9,600 were individual questionnaires, 480 were enterprise questionnaires, and 480 were financial data questionnaires. The response rate was 41 percent for the individual questionnaires, 54 percent for the enterprise questionnaires, and 50 percent for the financial data questionnaires. Extensive information about corporate governance practices was thus obtained for 257 listed companies.

Regarding transformed small and medium enterprises, the information came from three sources in the following order of importance:

in-depth interviews with government officials, workers, and managers and detailed case studies of 14 enterprises in the towns of Jinhua in Zhejiang province and Zhucheng in Shandong province; interviews with enterprise and government officials in Beijing, Chongqing, Chengdu in Sichuan province, Shunde in Guangdong province, and other localities; and findings from surveys and research conducted by Chinese academic and government institutions. Localities were chosen based on considerations about political and economic importance, coverage of both interior provinces and coastal areas, and leadership in economic reforms. In particular, the cities of Jinhua and Zhucheng were selected because they were among the first in China to launch comprehensive reform of their state enterprise systems and other provinces have emulated their approach. These cities' relatively long experience with enterprise reform presents a valuable opportunity to observe the dynamics of ownership diversification at the local level in China and to draw conclusions that may be applicable to other localities that are at less advanced stages of reform.

The study is set out as follows. Chapter 2 traces the main historical developments in China's state enterprise reform from a governance perspective. It examines the evolution of the main governance problems, from controlling the agency costs of increased enterprise autonomy to the emergence of a modern corporate governance framework. Chapter 3 discusses emerging ownership patterns in transformed small and medium SOEs and the roles of creditors, employees, and outside investors. This chapter also recommends how to strengthen the role of employees, creditors, and private equity investors in corporate governance. Chapter 4 looks at the ownership and control structures of listed companies, focusing on boards of directors. The role of capital markets and information disclosure is examined in chapter 5. Finally, chapter 6 provides recommendations on corporate governance issues pertinent to listed companies.