



The Chinese State as Corporate Shareholder

Despite China's commitment to reforming state-owned enterprises, many are still not operating like commercial businesses. Although some of the enterprise reforms have worked, others have led to unanticipated problems. This article outlines some measures that could improve the process.

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AT THE Ninth Annual Trade Fair last fall in Harbin, the capital of northeastern China's Heilongjiang province, 1,078 small and medium-sized state-owned enterprises with 320,000 employees were offered for sale. In fact, the provincial government attempted to give away some of the troubled firms.

Although events like this seem to indicate that China is well on the way to privatizing its corporate sector, the state still maintains ownership of key businesses. In having the state carry out functions typically performed by private shareholders, China's implementation of its state enterprise reform strategy—to separate business from government—has produced problems unanticipated by the reform's framers: asset stripping, decapitalization, wage manipulation, and tax evasion. These problems not only threaten the objectives of China's enterprise reforms but, by spilling over to the financial sector, also jeopardize critical elements of the overall economic reform program.

The state enterprise problem

China's shareholding experiments have included management contracting, greater autonomy for managers, corporatization, and ownership diversification. A centerpiece of these experiments has been decentralization of governmental authority, with supervision of all but 2,000–3,000 of the 114,000 industrial state-owned enterprises shifted from the central authorities in Beijing to local governments. Recently, a multitiered organizational network of state asset management bureaus, state asset operating companies, and state asset supervisory committees has begun to emerge. Large national enterprise groups and holding companies are also being established. Several years ago, the Chinese leadership decided that the central authorities would select 1,000 large, high-priority state-

owned enterprises, with the intention of reinvigorating them, and divest most of those remaining. But, to date, relatively few state-owned enterprises—perhaps 10–15 percent—have been divested to the nonstate sector, and almost all of these have been small. (In some provinces, nearly 50 percent of small state-owned enterprises have been divested.)

Some of China's enterprise reforms, although ad hoc, have been genuinely creative and have increased productivity. Moreover, despite an expansion of the nonstate sector—urban collectives, township and village enterprises, individually owned firms, and foreign-funded ventures—propelled by reforms that have liberalized market entry, removed price controls, eased investment restrictions, increased tax neutrality across different types of enterprises, and exposed the market to international competition, state-owned enterprises remain the key drivers of China's industrial sector. Today, China's state-owned industrial enterprises account for one-third of national production, more than one-half of total assets, two-thirds of urban employment, and almost three-fourths of investment. They provide essential raw materials and dominate such capital-intensive sectors as power, steel, chemicals, and machinery.

The reforms have failed to address the fundamental problems of large enterprises, however. Despite China's record economic growth, the industrial state-owned enterprises' profits have declined from 6 percent of GDP to less than 1 percent in recent years. Many state-owned enterprises are technologically inefficient. Most remain obligated to provide cradle-to-grave social services to workers and their families. They also carry a rising proportion of redundant employees and retirees on their payrolls. A growing number are losing money: about one-half incur net losses—compared with one-third just a few years ago—that add up to about 1 percent

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of GDP. Factory-capacity-utilization rates for major industrial products of state-owned enterprises have fallen below 60 percent. Yet these enterprises absorb more than three-fourths of domestic bank credit, undermining the weak, state-dominated banking system; according to official estimates, nonperforming loans, largely to state-owned enterprises, represent 20 percent of bank portfolios. Perhaps more important, state-owned enterprises' demand for credit crowds out investment by nonstate firms, which have been the engines of China's growth.

Property rights

One of the main goals of China's enterprise reforms is to clarify property rights and delineate the roles of the state and of the enterprises. In 1992, a new regulation gave managers of state-owned enterprises “Fourteen Autonomous Management Rights,” including the right to set prices, the right to hire and fire workers, and so on. Implementation is uneven, however, with few industrial companies enjoying all 14 rights.

The transformation of state-owned enterprises into commercially oriented companies is proceeding slowly. Under China's company law, an enterprise's “investor” must be identified in the corporate articles of association, a daunting task. It is not a question simply of tracing funds but, rather, of assigning property rights. The competing claimants—various government departments and agencies—often cannot reach consensus on who the investor is to be. This dilemma is compounded inasmuch as most state-owned enterprises have large liabilities. Everybody wants the assets, but nobody wants the liabilities. With the unclear assignment of property rights, there is an asymmetry in the allocation of rights and obligations for good and bad assets. In effect, while assets are “privatized,” liabilities are socialized.

Property rights are fuzzy because government departments and agencies exercise the roles of both shareholder and administrator. Indeed, multiple government departments exercise the shareholder role. Across agencies—both horizontally and vertically—there is fragmentation and partial exercise of the ownership function, with no single entity responsible for the enterprise's bottom line. Consequently, managers enjoy more autonomy than is officially sanctioned, and, without proper checks and balances, are able to engage in opportunistic behavior.

Organizational reforms

Organizational changes have been the most visible aspects of China's enterprise reform process, with the establishment of a network of state asset management institutions and group companies. At the national level, the State Council—China's cabinet—acts as the ultimate owner of state-owned

enterprises on behalf of the Chinese people, with the National Administrative Bureau of State-Owned Property acting as the agent. Similar upper-tier bodies exist in provinces and cities. An intermediate tier is composed of provincial- and municipal-level holding enterprises—state asset operating companies. The state-owned enterprises are the third tier.

In the new organizational structure, the lines of authority are unclear, and the boards of directors and the senior executives are often the same people. In addition, board members are nominated not by commercially oriented owners or their representatives, but by government or party bodies. With few exceptions, sector bureaus and ministries, as well as large enterprises, have been transformed into new entities, but the corporate structure has not been modernized. Many managers see little difference between the old line bureaus and the new entities other than a name change. Not surprisingly, the multitiered network is burdened with conflicts of interest that prevent the separation of business from government.

Corporate governance incentives

Providing incentives for sound corporate governance is a challenge facing large enterprises the world over. In China, the lack of clear identification of the owners of state-owned enterprises undermines corporate governance because it leaves open the issue of who should be monitoring the managers. The commingling of the enterprises' commercial and social functions and the fact that the state is both the ultimate owner and the regulator of state-owned enterprises make for unclear governance objectives. Moreover, effective corporate governance is difficult to exercise because few of the institutions responsible for managing state assets regularly receive timely, accurate, and useful information about the financial performance of the firms they control.

Although the introduction of individual shareholders through public listings has not resulted in a clear separation of ownership and management interests, where ownership has been diversified to include institutional investors, new governance structures have emerged. Still, relatively few outside monitors, especially banks, exercise strong discipline on China's state-owned enterprises. The four specialized banks are mainly agents of the state. Although they are attempting to transform themselves into commercial entities, they have a long way to go to establish their independence. Mergers (or threats of takeovers) can be effective disciplining devices against poor management. But most mergers of large state-owned enterprises are engineered by the state and are not market driven.

Without reorienting governance incentives toward a market system of checks and balances, many of China's state-owned enterprises will continue to operate in a corporate

governance vacuum, with managers and other insiders exercising de facto control over the enterprises.

A policy agenda

Tackling these problems presents a huge policy challenge because they are both complex and interrelated; no single component can be dealt with in isolation. Although China has made progress, it could strengthen reforms in several areas.

Harden budget constraints. Subsidies provided to state-owned enterprises through the fiscal system have decreased steadily in recent years. In 1993, state-owned enterprises in all sectors received direct fiscal subsidies equivalent to almost 2 percent of GDP; in 1995, such subsidies fell to about 1 percent of GDP, and by 1997 they had fallen even lower. Dealing with subsidies provided through the financial system has been more problematic, because they are less transparent and less easy to monitor and reduce. Although some reduction has taken place, the four main state-owned banks still often roll over unpaid credits to state-owned enterprises. Interest rates have not been liberalized enough for the banks to differentiate terms among enterprises according to credit risks, which gives rise to cross-subsidies. The banks need to step up their governance involvement with these enterprises, especially in calling in debt-service obligations. But even where fiscal and financial system subsidy constraints have hardened, state-owned enterprises in China—as in other transition countries—have been able to avoid financial restructuring by resorting to interenterprise arrears. Alternatively, they arrange for soft financing on nonmarket terms from public utilities or other enterprises.

It is clear that reducing subsidies to state-owned enterprises over the past few years is having an effect: hundreds of thousands of workers are being laid off from money-losing firms. Yet liquidation of nonviable large companies through bankruptcy to rechannel their assets to more productive uses is not common. If state-owned enterprises are to be restructured, creating a policy framework for creditors to exercise their bankruptcy rights is important, as international experience has shown.

Foster competition. More intense competition, whether from domestic sources or from abroad—which would be fostered by China's accession to the World Trade Organization—would pressure state-owned enterprises to restructure. Their national market share has already been significantly eroded by nonstate firms, but, because of the legacy of the planned economy, those in some market niches (notably heavy industry) are protected by artificial regional autarky. A survey revealed that the average provincial market share for state enterprises was 53 percent. The survey also suggested that these firms are interlocked with one another: the average share of inputs each



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purchased from its largest supplier was 60 percent, with 78 percent of the state-owned enterprises indicating their largest supplier was another state-owned enterprise. By the same token, the average share of sales made to each of the surveyed enterprises' largest customers was 41 percent, and 60 percent of the enterprises surveyed indicated their largest customer was another state-owned enterprise.

Implicit and explicit policy-based barriers to entry—especially among would-be rivals based in different regions of China—are being reduced but are still substantial. Complex and nontransparent business-licensing procedures keep new entrants out of “foreign” provinces. In key sectors, such as electronics, petrochemicals, and machinery, interprovincial market share patterns have not altered appreciably in the past several years, particularly at the wholesale level. In “downstream” commercial

sectors, however, cross-market penetration is becoming more pronounced. Measures that foster interregional trade and investment will boost enterprise restructuring and the realization of economies of scale and help to unify the expansive Chinese economy.

Strengthen corporate governance. Greater diversification of the ownership of state-owned enterprises could provide an important opportunity for improving governance. Increasingly, enterprises are being partially divested to nonstate interests through minority shareholding, mainly through Sino-foreign joint ventures and shares sold on stock exchanges in China and elsewhere. Diversifying ownership, however, is not enough, and, without the proper institutional framework of checks and balances, may compound insider control problems. The keys to success are to ensure that ownership diversification is carried out through transparent and competitive procedures; that it is cross-regional and cross-sectoral; that the process provides for transferability of shares; and, most important, that it provides for investments on behalf of the state to be managed by independent professionals—custodians or trustees—whose remuneration is linked to performance. Reorienting China's state-owned enterprises toward the market will entail reducing the state's involvement to passive minority ownership.

Simplify organizational structures. The new organizational layers need to be eliminated wherever feasible. This is particularly true for the large enterprise groups being formed; the problems of Korea's *chaebol* provide a powerful lesson in this regard. To complement this streamlining, a robust market for managers within a firm, across firms, across sectors, and across regions would be helpful. Increasing outsider participation by appointing nonstate representatives to the enterprises' boards of directors is equally important. Board members should be selected from different regions and have diverse backgrounds. Cross-

sectoral and cross-regional diversification of management and of shareholders is also key.

Create a market for corporate control. The pace of restructuring through mergers and acquisitions of state enterprises is quickening. Mergers and acquisitions are important because they help solve problems—such as duplication of facilities and suboptimal plant scale—that resulted from decentralization. But, as noted above, many of these mergers have been arranged by government. A market for corporate control could be fostered that would provide for mergers and acquisitions to be transacted through competitive forces. Such a mechanism, which would make the threat of potential takeovers of inefficiently managed firms credible, would strengthen governance and ensure that state-owned assets are being put to more productive uses. Such a market could be based on the emerging network of regional property rights transactions centers.

Modernize financial accounting and auditing practices. Without accurate, transparent, and commercially meaningful financial information on enterprise performance, all other aspects of reform of state-owned enterprises would be for naught. Most of the accounting mechanisms used by these enterprises are still aimed at counting rather than financial management. China's accounting rules deviate from international accounting standards in several respects: on the policy basis of the framework, the intended audience, and the definition of terms. International practice identifies investors and creditors as the primary users of accounting information. Recently issued Chinese accounting standards are more precise and comprehensive than the earlier general principles. If they are fully implemented, accounts prepared under Chinese and international standards will become more similar. But even with the issuance of improved accounting standards, many of the managers will need to be trained to prepare such accounts. Cash-flow forecasts, especially of the largest firms, need to be issued semiannually or quarterly. Perhaps most important, financial accounts of state enterprises need to be independently audited and made public.

Conclusion

China's initiatives reflect a serious commitment to reforming state-owned enterprises. Over the past decade and a half, the authorities have implemented innovative, if ad hoc, experiments, with modest results. Despite this progress, attempts to reform the large state-owned enterprises have not met the policy aspirations of the Chinese leadership. Today, there is renewed attention to dealing with the problem so as to improve enterprise profitability and strengthen the banking sector. In the near term, reforms should follow a two-track approach: strengthening the overall institutional framework, especially with respect to property rights, corporate governance incentives, and competition and other market-based forms of checks and balances; and further reducing the state's ownership in the enterprises to minority, passive stakes managed by independent professionals. In the medium term, the state should completely withdraw from involvement in the enterprises in inherently competitive sectors. **F&D**

Suggestions for further reading:

Harry G. Broadman, ed., 1996, *Policy Options for Reform of Chinese State Owned Enterprises* (Washington: World Bank).

Nicholas Lardy, 1998, *China's Unfinished Economic Revolution* (Washington: Brookings Institution).

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