Chapter 1 Privatization in China

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Overview

Commencing its shift to a market economy in the late 1970s, China made a unique approach which is distinct from other transitional economies in Eastern Europe and the former USSR. China proceeded with the introduction of the market economy system progressively while upholding the socialist principle of public ownership of means of production. Consequently, China achieved high economic growth of 9% a year over the 20 years of its reform and open-door polices, with the "success" of the Chinese-style gradualistic reform drawing keen global attention.

In reality, however, the public ownership of capital, the officially-claimed essential tenet of China's economic reform, has been hollowed out, if anything, by the very "success" of the graduaristic reform. A growing number of state-owned enterprises lost out in market competition with emerging village and township enterprises, private businesses and foreign-affiliated companies which emerged under economic liberalization and open-door policy, with the weight of the state-owned sector in the industrial sector declining steadily. A small bunch of state-owned enterprises were relatively successful in adapting to the market economy, while, more often than not, flaws in corporate governance structure of those enterprises has caused serious instability in their management.[1]

Against this background, moves toward the privatization of state-owned and collective enterprises began to get into full swing in China in the latter half of the 1990s. Privatization, which at the earliest stage financially pressed local governments started on their own initiative, gradually expanded its reach. From 1999 to 2001, the Central Committee of the Communist Party of China (CPC) effectively gave the go-ahead to privatization moves, and privatization of large-scale state-owned and collective enterprises also got under way by making use of stock markets. Although the term "privatization" has yet to be used officially, but China's policy, in reality, is now moving into the direction of concentrating state capital on a handful of enterprises of strategic importance, while privatizing a vast majority of other state-owned and collective enterprises.

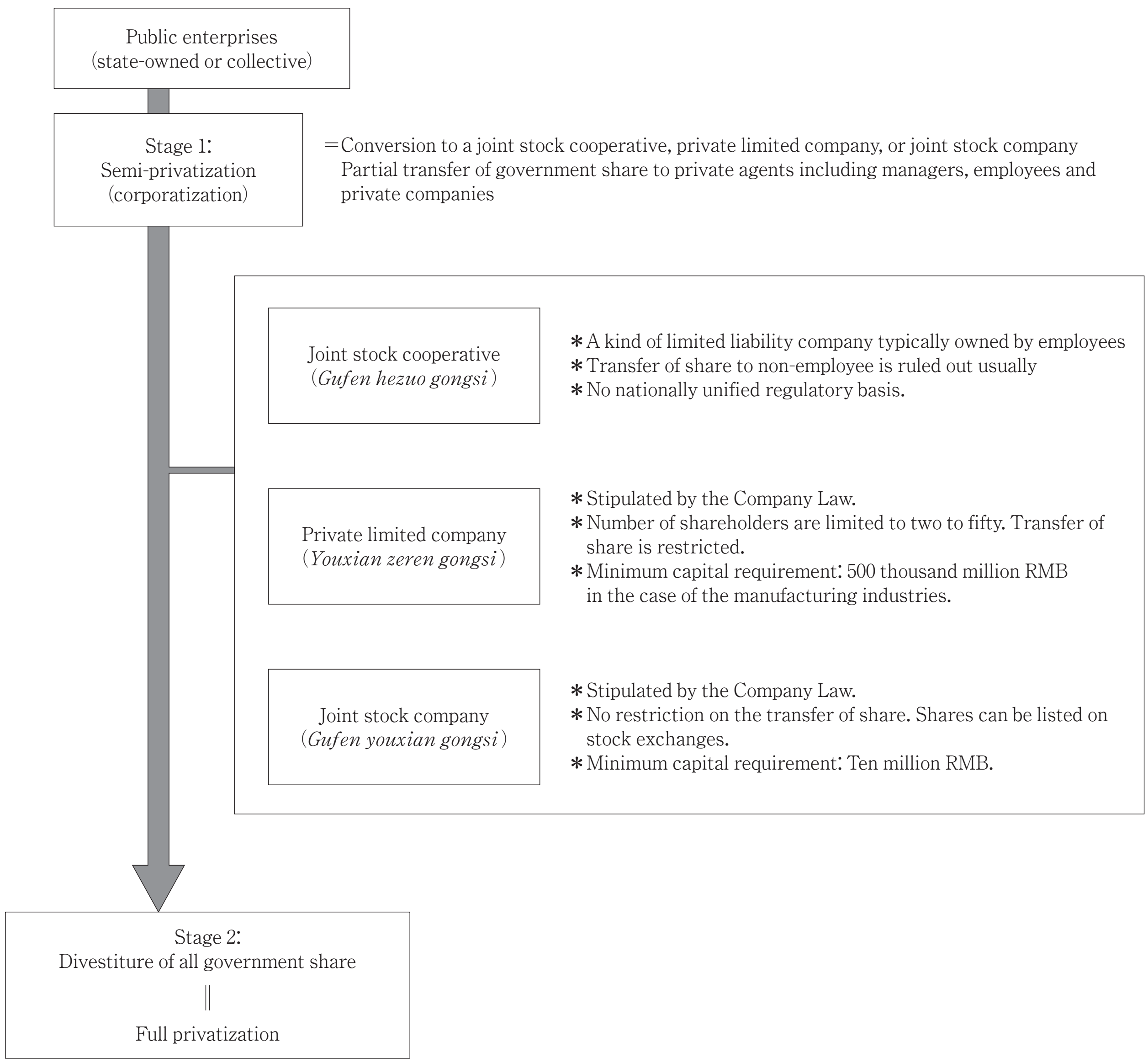
1.1 Subject of Analysis

The privatization of public enterprises in China is the new development that only in recent years started to move into high gear. Due in part to China's circumstances where the term "privatization" still is something to be avoided, there is no publicized material yet that offers a comprehensive overview of privatization in China.[2] This report relies primarily on case studies to describe the progress being made in the privatization of a variety of Chinese enterprises, thereby making it possible to grasp an overall picture of the ongoing process of privatization. In addition to state-owned enterprises, this report also refers occasionary to the privatization of urban collective enterprises, which come under jurisdiction of local governments and beset with problems basically akin to those at state-owned enterprises.

Privatization in general can be addressed as a two-stage approach (Figure 1). In the first stage, state-owned or collective enterprises are reorganized into joint stock companies (including pricvate limited companies and joint stock cooperatives). At this stage, the government either still controls all or a majority of capital, or at least remains as the largest equity holder (semi-privatization). In the second stage, all or most of the government's equity stake is sold off, leading to the "genuine" privatization in the sense that private-sector entities control capital (full privatization). Either case of these privatization steps involves legal changes in the form of business organizations or equity participants. Thus, they should be called "*de jure* privatization." For small and medium enterprises, full privatization in a single step is common, but the privatization of large enterprises usually proceeds in two stages.

In China ahead of the advent of the "de jure privatization," the authority over management had been gradually transferred from the government sector to enterprises since the 1980s, when economic reform was launched. With the acceleration of transition toward a market economy in the 1990s, autonomy of corporate management was further expanded, and in some cases, managers came to exercise almost complete control over management. The gradual process of the transfer of management authority from the government to corporate managers can be interpreted as "*de facto* privatization." There are not a few instances where "*de facto* privatization" provides impetus toward "*de jure* privatization." For this

Figure 1 Two Stages of Privatization



Notes: Small and medium public enterprises are usually privatized directly without going through the semi-privatization stage.

reason, this paper takes "*de facto* privatization" into its perspective as the stage preliminary to "*de jure* privatization," and analyzes the privatization in a broader sense.

Below, this chapter gives an overview of the overall trend of privatization in China as the starting point for discussions in the following chapters.

1.2 Momentum toward Privatization

Until the early part of the 1990s, China's state-owned enterprises had been placed under the strong influence of administrative authorities that had jurisdiction over industries. Local governments, given strong incentives to increase revenue in the wake of fiscal reform in the 1980s, encouraged enterprises under their control to expand investment and production. By that time, enterprises were also strongly motivated to pursue profitability as a result of enterprise reform that gave a greater share in profits to them. Aggressive investment and the expansion of production activities at the initiatives of governments served as a booster to China's high economic growth through the early 1990s.

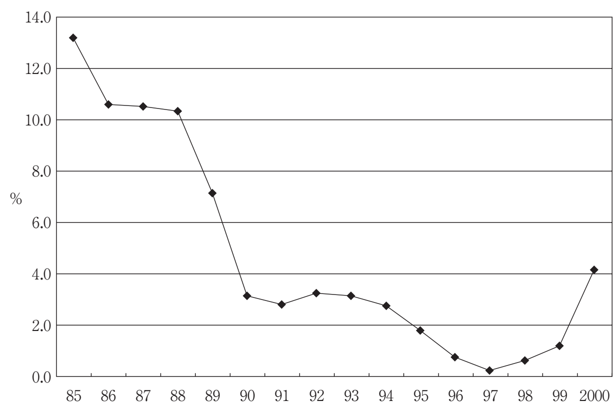
However, this system had the crucial weakness in the lack of self-responsibility for investment decisions. While both the government sector and enterprises had the strong incentives to expand investment, not infrequently, no one took any responsibility for investment failures. Enterprises were bailed out with loans from state-owned banks. Thus, as the scale of business operations grew, investment efficiency declined considerably, giving rise to serious overcapacity problems in industry areas where heavy investment concentrated. The unusual expansion of investment seen from the latter half of the 1980s through the early years of the 1990s gave rise to the serious macroeconomic instability.

In the 1990s, meanwhile, foreign-affiliated companies and private enterprises emerged as powerful competitors. With the gigantic vacuum of the markets created in the early period of China's economic reform all but filled and the general shortage of goods eliminated, the Chinese economy gradually but increasingly came to show signs of making the transition from a sellers' market to a buyers' market. Amid the mounting pressures of competition, state-owned and public enterprises saw their profitability decline significantly (see Figure 2).

Difficulties surfaced first at small and medium state-owned and collective enterprises under the aegis of counties (*xian*) and districts (*qu*). These uncompetitive enterprises were no match for up-and-coming village and township enterprises in many aspects including cost and management flexibility. Thus, management of small and medium state-owned and collective enterprises deteriorated remarkably already in the early 1990s. Management difficulties at these enterprises dealt a serious blow to the finances of local governments that relied heavily on tax receipts from them.

Confronted with the fragile fiscal situation, some county and district governments resorted to the ultimate choice, divestiture of enterprises under their control. This marked the start of the sell-off of small and medium

Figure 2 Profit on Asset of State-owned Enterprises (Industrial Sector)



Notes: 1) Profit on asset = Pre-tax profit / Total assets.
2) Improvement in profit in 2000 is assumed to be largely attributable to external factors including the rise in petroleum price or the debt-equity swap scheme, which reduced financial cost of large state-owned enterprises.

Source: *State Statistical Yearbook* (various years).

state-owned and collective enterprises in some regions in the first half of the 1990s. This development effectively opened the way for the privatization of public enterprises in China (see Table 1).

1.3 Inching toward Establishment of Privatization Policy

It was not that the central government was unaware of the crisis situation of small and medium state-owned enterprises. Indeed, in the early 1990s, the central government was evidently aware of the need to substantially curtail the number and distribution of state-owned enterprises and narrow the scope of enterprises to support.

At the third Plenum of the 14th Central Committee of the CPC, held in September 1993, the party leadership put forward the policy of seeking a socialist market economy, effectively breaking away from the planned economy and embarking on the road to a full market economy. The party decision at the plenum, as part of reform of state-owned enterprises, allowed a host of ways of reform, ranging from the reorganization of small and medium state-owned enterprises into joint stock cooperatives to privatization-oriented methods such as the sale of those enterprises to corporate entities and individuals. This decision had in fact set the basic tent of corporate reform, which eventually led China to embrace the present privatization policy in more recent years. Furthermore, under the "Grasp the large and liberalize the small (*Zhua da fang xiao*)" policy set out from 1995 to 1996, China encouraged an overhaul of small and medium enterprises with the slogan "Liberalize and vitalize (*Fangkai fanghuo*)."

Table 1 Trends towards Privatization

1989	Feb.	State Economic System Reform Commission et al. issued "Interim Regulation on Divestiture of the Property Right of Small State-owned Enterprises"
1992	Jan-Feb.	Deng Xiaoping's "Southern China Speech" authorized and prompted full-fledged transition to a market economy Some counties including Yibin County, Sichuan Province commenced divestiture of small and medium state-owned enterprises
	Oct.	The 14th National Party Congress established transition to a "socialist market economy" as an officially sanctioned target of the economic reform and virtually sanctioned divestiture of small and medium enterprises.
1993	Nov.	The 3rd Plenum of the 14th Central Committee of the Party officially encouraged accelerated enterprise reform virtually including privatization of small and medium public enterprises
1995		Sichuan Province announced its plan to "accomplish the reform of small and medium state-owned enterprises within three years." The Party officially announced the policy of "Grasp the large, liberalize the small (*Zhua da fang xiao*)," based on General Secretary Jiang Zemin's lecture.
1996		The state-owned industrial sector recorded net loss in the first quarter for the first time in the history of the PRC.
	Sep.	The 15th National Party Congress announced the policy of "strategic adjustment of the state economy," which virtually reconfirmed promotion of privatization of small and medium enterprises. Privatization of small and medium enterprises spread nationwide thereafter.
1998	Jul.	State Economy and Trade Commission announced "Regulatory Note on Restraining the Trend of Unauthorized Divestiture of Small State-owned Enterprises."
1999	Mar.	The 9th People's Congress passed the amendment of the Constitution, acknowledging the non-state economic sector as an "essential component of the socialist market economy."
	Sep.	The fourth Plenum of the 15th Central Committee of the CPC reconfirmed "strategic adjustment of the state economy," promoting in effect more full-fledged privatization of small and medium enterprises.
2000		Major municipalities including Beijing and Shanghai announced comprehensive restructuring plans of state-owned enterprises.
2001	Mar.	Provinces including Sichuan and Jilin announced comprehensive restructuring plans of state-owned enterprises.
	Jun.	State Council announces "Interim Regulation on Procuring Social Security Fund by Selling State-owned Share," which mandates sales of state-owned share proportionate to funds raised by initial public offering or rights offering.
	Oct.	The sales of state-share in the domestic stock markets are suspended because of collapse in stock market prices.

Source: Compiled by the author based on various materials.

But conservative forces within the CPC and ideologues that support them put up strong opposition to the line of policy, causing heated debate over the "Grasp the large and liberalize the small" policy.

The speech by General Secretary Jiang Zemin at the 15th Party Congress in September 1997 marked a major turning point for the full-fledged privatization policy. The Jiang speech offered the broad definition that public ownership includes state capital and public capital in the mixed ownership system, and put forward the policy of "strategic adjustment of the state economy" under which the central government reinforces its control over the overall economy by concentrating state capital on a few core areas of the national economy. This effectively reaffirmed the legitimacy of the "Grasp the large and liberalize the small" policy, and meant that the party leadership has authorized the promotion of full privatization in non-core industries.

Even after the 15th Party Congress, the dispute dragged on between the reformist and conservative camps over the interpretation of the Jiang speech. Things began to move already, however. Interpreting the Jiang speech as the green light for privatization, local governments started to sell small and medium state-owned and collective enterprises aggressively. The overly rapid spread of the sell-off of small and medium enterprises alarmed the State Economic and Trade Commission, prompting it to issue a notice in July 1998 seeking to put the brake on the frenzied sale of enterprises by local governments.[4] But this episode had little impact on the overall situation. At the fourth Plenum of the 15th Central Committee of the CPC, held in September 1999 as the first meeting in the CPC's history devoted solely to the single agenda of the problem of state-owned enterprises, the decision was taken to reaffirm the policy of "strategic adjustment of the state economy."[5] This decision effectively established the policy for the privatization of state-owned and collective enterprises in non-core industries as the party leadership's policy, largely eliminating political constraints over privatization.[6]

The removal of the political constraints helped substantially expand the scope of enterprises subject to privatization from late 1999 onward. Since the fourth Plenum, not only counties, which led the early phase of privatization in China, but also major cities successively announced their intention of pushing for the "exit of state-owned capital" from non-core industries, irrespective of the size of enterprises concerned. Privatization seems to have made a considerable headway for small and medium enterprises, which usually are relatively easy to sell off (see Chapter 2).

The wave of privatization began to spread to large enterprises as well. There have emerged some moves for the sale of relatively large state-owned enterprises under the jurisdiction of local governments to their managers or collective management. In recent years, the central government has been pushing for stock listings of large state-owned enterprises. In most cases, however, the government or parent state-owned enterprises remain as the top shareholders in listed companies, largely undermining the effectiveness of stock market as a vehicle of corporate governance. Following the decision at the fourth Plenum to lower the ratio of state shares in listed companies, an experimental measure for the disposal of state shares was put into force in 2001 (see Chapter 5).

It is evidently impossible to complete the privatization of large enterprises in a short space of time, even in the context of only technical aspects, such as how to deal with surplus labor or how to identify potential purchasers. Against all odds, however, China's current policy for privatization is steadily moving toward the gradualistic privatization of large state-owned enterprises.

1.4 Changes in the Environment

It took almost five years before the basic policy of corporate reform, laid out by the decision at the third Plenum of the 14th Central Committee of the CPC, evolved into the policy for full privatization by overcoming ideological opposition and wariness about political backlash. The changes in the environment that took place during those years certainly helped the privatization policy take firm root in China.

Previously, the governments of all levels regarded state-owned and collective enterprises under their control as the tools to realize policy objectives such as increasing tax revenue, enhancing employment effectiveness and promoting industrial development. However, the effectiveness of state-owned and collective enterprises as the policy tools apparently declined[7] as market competition intensified and financial performance of a majority of them deteriorated as a whole in the 1990s.

On the other hand, private-sector companies and foreign-affiliated firms, which were only beginning to open their buds in the 1980s, achieved rapid growth particularly in the Coastal Region in the 1990s. People could realize the outcome of market competition through the improvements of goods and services in terms of both quantity and quality, and were beginning to show confidence in the efficiency of the market system. At the same time, in regions where transition to a market economy has made greater way, the view was beginning to take root among local governments that development of an environment conducive to growth of private-sector companies and foreign-affiliated firms is a more efficient way of achieving policy objectives than pouring limited resources into inefficient state-owned and collective enterprises.[8]

Amid this sea change in the environment, China's leadership came to believe that it would be imperative to make its economy more efficient ahead of accession to the World Trade Organization (WTO) and that it would be inevitable to sell off state-owned capital in order to avoid fiscal crisis of the central government. This awareness provided the immediate impetus for the CPC leadership to effectively embark on the promotion of privatization from 1997 onward.

1.5 Direction of Privatization

The enterprise system reform in China has been undertaken by the trial-and-error method, as with the case of economic reform in other areas. The privatization policy, too, was born out of this process of trials and errors. Even now, after the privatization of a great majority of state-owned and collective enterprises has become a well-established course of action, China's central government has not yet come up with a clear policy that defines the methods, scope and timetable of privatization. Nevertheless, in reality, the enterprise system reform, including privatization, appears to be heading for several clearer directions according to differences in the size of enterprises and political significance.

Convergence of Ownership and Management

Privatization of small and medium enterprises in its early stage mostly took the form of the shift of ownership to employees, including joint stock cooperatives. But the egalitarian distribution of equity ownership by employees often hampers efficiency in making decisions. The awareness of this down side prompted moves to encourage the concentration of capital ownership in the hands of executive managers. Not limited to small and medium enterprises, the number of acquisitions led by corporate executives is now increasing for middle-standing enterprises with relatively large capital. Together with acquisitions by outside companies, small and medium enterprises as well as middle-standing enterprises are now increasingly moving toward the convergence of ownership and management. Chapter 2 of this report analyzes the rapidly-paced privatization of small and medium state-owned enterprises and urban public enterprises in the latter half of the 1990s by focusing on the concentration of capital in the hands of corporate managers and management executives. Chapter 3, based on case studies, analyzes the evolution of emerging large state-owned enterprises that attempted to break from the de-facto control by managers in favor of "genuine" privatization.

Corporate Governance through Stock Markets

It is often difficult to privatize large enterprises at a brush. In a period of transition to full privatization, therefore, there is the stage of mixed ownership where both the government and private sectors get involved in corporate governance. Chapter 4 of this report looks at the dynamics of corporate governance at large public enterprises with mixed ownership, while Chapter 5 examines recent privatization initiatives that is unfolding on the stock markets.

Privatization itself, needless to say, is a transitional phenomenon. What is really important is not privatization per se, which should come to an end in the not-so-distant future. What we have the greatest interest in is how China's enterprise system is going to evolve through privatization, and how that evolution is going to influence China's economic system as well as its political and social systems. We present a measure of vision on these issues in the last chapter.

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Notes:

1. The success and debacle of Changhong Electronics, one of China's biggest color television makers, is a typical example of how flaws in corporate governance structure in a state-controled listed company destabilize corporate management (see Chapter 4).
2. The following two books are available as a comprehensive research into the privatization of Chinese enterprises ever published in China: Zhongguo gaige yu fazhan baogao zhuanjiazu, *Xianshide Xuenze: Guoyou Xiaoqiye Gaige Shijiande Chubu Zongjie,* Shanghai Yuandong Chubanshe, 1999; and Liu Xiaoxuan and Han Chaohua, *Zhongguo Qiye de Minyinghua: Zhong Xiao Qiye Gaizhide Xuanze,* Zhongguo Jingji Chubanshe, 1998. But their analysis only addressed small and medium enterprises.
3. State Economic and Trade Commission, "Notice Concerning the Problem of Restraining the Trend of the Sale of Small State-Owned Enterprises" (July 1998)
4. Compared with the Jiang speech at the 15th Party Congress, the decision at the fourth Plenum took a further step forward, more specifically narrowing down the industry areas where state control should be maintained.
5. However, consensus is yet to be firmly established over full privatization of large enterprises.
6. It came as a great shock to policymakers when the state-owned sector (mining and manufacturing) as a whole slipped into the red for the first time ever in China's history in the 1st guarter of 1996.
7. The new line of thinking entertained by local governments in the Coastal Region is symbolized by the slogan, *"Buqiu suoyou, zhiqiu suozai"* (Attracting investment is more important than owning enterprises).