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Explaining the Persistence of State-ownership in China

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Abstract

In the recent decade China witnessed an upsurge of privatization of small and medium state-owned enterprises (SOEs). In contrast to the consequent sharp reduction in the number of firms, however, the estimated share of broadly-defined SOEs that includes limited liabilities companies controlled by the State has shown virtually no sign of decline. We explain the backgrounds of this seemingly paradoxical persistence of state-ownership by looking into two distinctive types of large SOEs: traditional SOEs that remain dominant in oligopolistic industries and manager-controlled SOEs surviving in competitive industries. The two types exemplify several factors constraining further progress of SOE reform such as, financing the costs of restructuring, redefining the role of the State as the single dominant shareholder, and balancing the interests of the State and managers as entrepreneurs. Sorting these issues out will take time, which means that instabilities associated with state corporate ownership will remain in place in the foreseeable future in China.

Keywords: state-owned enterprise, corporate governance, China's economic reform
JEL classification: L29, L32, P26

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I. Introduction

After more than a quarter of a century of the transition process beginning in the late 1970s, China is now probably one of the most competitive market economies in the world. In many industries in the country, one can witness an overwhelming number of firms engaging in throat-cutting type of competition. Growth in demand invites almost endless new entries and building-up of new capacities, which inevitably push profitability down to the extreme low. While the government occasionally tries in vain to control entries into or investment in those sectors, this “excessive” competition so is often alleged eventually turns out to be the very driving force of the industrial development in contemporary China.

One can reasonably expect that this apparent progress in transition to a market economy would accompany an ever-dwindling share of state-owned enterprises (SOEs) and massive privatization. It surely does, at least in many industrial sub-sectors where market entry is relatively easy. But when we look into the value-added share of broadly-defined state-owned firms that includes corporatized companies in which the State retains dominant equity, we find that the presence of state-ownership has shown little sign of decline in recent years. Rather, it has been more or less stabilized at the level of one third of the industrial value-added and seems to be slightly increasing most recently. Besides, even in some of the competitive sub-sectors like consumer products there remain a handful of state-owned firms successfully surviving harsh competitions.

The motivation of this paper is to show that, behind these seemingly paradoxical phenomena, there are several important dilemmas that China faces in restructuring SOEs, especially those of which scale is so large that their fates are likely to incur significant influences on regional economies where they are located, industrial sub-sectors to which they belong, or even the national economy as a whole. Those dilemmas are of politico-economic or purely economic nature rather than political. China is still in the process of finding ways to resolve them. This in turn means that potential instabilities in corporate governance associated with state ownership would remain in place in the foreseeable future.

The following sections are organized as follows. Section II roughly sketches the progress of the reform of SOEs in China so far, focusing mainly on the tide of privatization of small and medium SOEs and corporatization of large enterprises that has accelerated since the second half of the 1990s. Figures that show the persistence of state-ownership are provided. Sections III and IV focus on two “polar” cases of large state-owned enterprises and explore dilemmas they face in restructuring themselves. Section V concludes with presenting some future prospects.

II. China's SOE reform: Progress so far

During the first decade beginning in the early 1980s, reform of SOEs had focused almost solely on enhancing the managerial autonomy, which means delegation of managerial decision-making rights from supervisory government bureaus (either central or local, depending on the original affiliation of the SOE in question) to the management. This early stage of SOE reform, in line with increasing pressure from newly-emerging competitors such as township and village enterprises (TVEs), undoubtedly promoted more market-oriented behavior of SOEs. Econometric studies that measure productivity growth in China's industrial sector show that in this period SOEs as a whole experienced improvement in efficiency, while the margin of improvement was slim in comparison with non-SOEs, especially TVEs[1].

Aside from the efficiency improvement of more or less limited scale, the reform that focused on managerial autonomy also produced a new dilemma, i.e. the balance between the autonomy of the management and the control right of the state as the single largest shareholder of SOEs. Government bureaus in charge of supervising SOEs were obliged to monitor the management to prevent managerial slack or embezzlement of state-owned assets by the management. At the same time, excess intervention was apt to affect efficiency, which in turn would result in instant deterioration of financial performance under the increasingly competitive market environment. It was always almost impossible to draw the line between legitimate monitoring as the state shareholder and inefficient government intervention. These limitations in the first phase of the reform led to the second stage of reform in China: privatization of small and medium firms and corporatization of large firms.

Upsurge of privatization

The first turning point came in the early 1990s, when the Communist Part of China declared that the goal of the economic reform is the realization of a so-called "socialist market economy." which virtually means full transition to a standard market economy, with the State keeping control by way of state ownership in "key sectors" (although exactly what "key sectors" means has never been clearly stated). As for the enterprise reform, the Part Communiqué in 1993 authorized local governments to experiment with "various measures" including straightforward sellout of small SOEs.

This political sea change came at the moment when local governments saw financial performance of small and medium SOEs under their jurisdiction deteriorate seriously owing mainly to ever-increasing competition with TVEs and private enterprises. This triggered acute

[1] See Jefferson and Singh (eds.) (1999).

budgetary crises especially in county- or ward-level governments, which used to depend on tax from SOEs for much of their revenue. As the new policy had become more firmly confirmed through the second half of the 1990s, a growing number of local governments, with a view to shedding off financial burden, set off to wholesale small and medium SOEs that were mostly losing money[2].

Despite the fact that the process has been underway for a decade, we can by no means accurately assess the progress of privatization so far due to unavailability of reliable data. The Communist Party of China (the Party) and the government still refrain from officially endorsing privatization in order to avoid political disputes. Privatization is, together with other forms of reform such as corporatization (which does not necessary involve change of ownership) or merger (which may be a merger with another SOE), labeled rather ambiguously as "property rights restructuring (産権改革 or 改制)." Aside from sample surveys conducted sporadically, no official data is published as to the progress of privatization or even "property rights restructuring". Thus, what we can do is to call upon some proxy measures that are likely to represent the trend best of all.

Among them the most representative one is the number of SOEs published annually from Ministry of Finance (Table 1). It is important to note that this statistics covers not only traditional SOEs which are wholly owned by the State (国有企業or国有独資企業: WSOEs), but also corporatized firms of which majority equity is still in the hand of the State[3]. The latter type of firms is officially designated "state-controlled enterprises" (国有控股企業: SCEs). We call the two categories combined together "broadly-defined SOEs".

The data show that the number of SOEs declined drastically from 1995 to 2003. It is quite likely that the trend has remained basically unchanged to date, as another data which I will refer to in the next subsection suggests[4]. During the recent decade the number of SOEs has been almost halved. Despite the lack of disaggregated data for recent years, it is apparent that the overwhelming majority of the decline is attributable to small-scale firms, most of which fall under the jurisdiction of municipal, county, and ward governments. The number of medium-scale firms, which usually belong to local governments, declined considerably too.

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[2] For privatization of small and medium SOEs, see Tenev et al. [2002] and Chapter 2 of Imai (ed.) [2003].

[3] To be exact, according to the official definition, following three types of firms are classified as "state-controlled enterprises." 1) Firms of which more than 50 per cent of the equity is owned by the State. 2) Firms of which the State owns less than 50 per cent of the equity but still is the largest shareholder. 3) Firms in which the State is not the largest shareholder but effectively control the management by means of agreement with other shareholders.

[4] According to a large-scale survey conducted by the Development Research Center of the State Council in 2004, the number of "property rights restructuring" of SOEs increased sharply in 2003 (Zhang [2005]).

Table 1 The number of SOEs (excluding the financial sector)

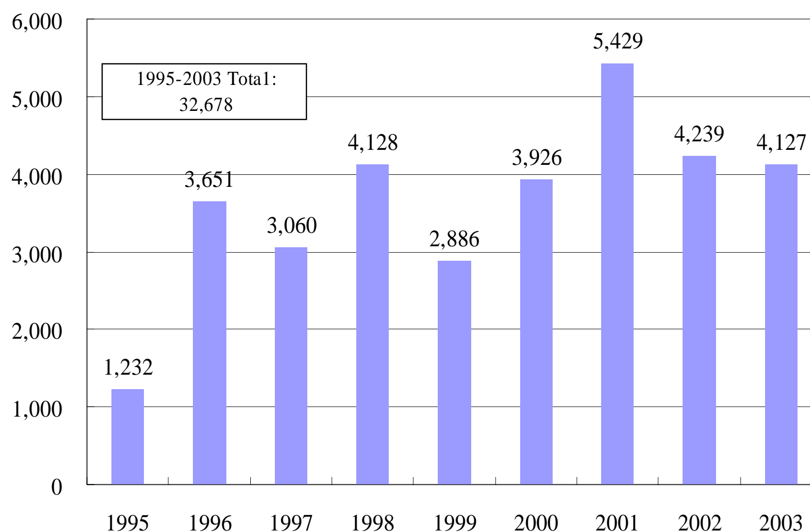
	1995	2000	2001	2002	2003	2004	1995-2002 change
Broadly-defined SOEs	253,525	190,508	173,504	158,712	146,000	137,753	-45.7% *
Large	8,442	9,283	9,453	9,436	n.a.	n.a.	11.8%
Medium	38,413	27,672	27,527	27,886	n.a.	n.a.	-27.4%
Small	206,670	153,553	136,524	121,390	n.a.	n.a.	-41.3%
WSOEs	218,582	144,406	n.a.	n.a.	n.a.	n.a.	-33.9% **
SCEs	14,283	32,146	n.a.	n.a.	n.a.	n.a.	125.1% **

Note) 1) The criteria of the scale of firms is the one prior to the revision in 2004. 2) *1995-2003. **1995-2000.

Source) 1995-2003: Ministry of Finance. 2004: State-owned Assets Supervision and Administration Commission.

Figure 1 summarizes the number of bankruptcy cases of SOEs filed to the court. As bankruptcies of large SOEs are strictly controlled by the government, the great majority of the cases are supposed to be those of smaller firms. Accumulative total of the cases filed amounts to around one third of the decline in the number of SOEs in the same period. Thus we can assume that privatization roughly accounts for the remaining two thirds of the decline.

Figure 1 The number of SOE bankruptcy cases filed to the court



Source) *Law Yearbook of China*, various years

In view of the fact that in 2004 there still remained more than a hundred thousand of small and medium SOEs nationwide, full privatization or liquidation of them may take more time than conventional wisdom predicts, in spite of prevailing enthusiasm on the side of local governments for privatization[5]. There are a number of factors that may deter smooth transition.

Surveys show that in many cases privatization of small and medium SOEs take place by way of buyout by incumbent managers (management buyout: MBO) or employees including managers (management-employee buyout: MEBO)[6]. Privatization by outsiders such as acquisition by private businessman remains minority, due probably to factors such as serious information asymmetry between insiders and outsiders, aversion on the side of insiders, or just a sheer lack of investment value. Whichever way of privatization is to be chosen, pricing of state-owned equity is always a controversial issue. Managers or outside investors are often alleged to have acquired state equity at "unfair" prices, which usually mean significantly lower than the book value (I will return to the pricing issue in section IV). Privatization also frequently invites labor disputes. In some cases, employees are forced to buy state equity in return for job guarantee.

These frictions in the process of privatization invite occasional interventions by the central government aiming at "institutionalizing" the tide of privatization of small and medium SOEs. Local governments often try to avoid letting firms go bankrupt that incurs financial burden such as compensation to dismissed workers. Nevertheless, both the central and local governments have been convinced that in the long run leaving those small and medium firms owned by the State, many of which have been losing money for years, costs much more than letting them be privatized or liquidated by whichever way that is feasible. In this context, there is little chance that the trend of sweeping privatization of small and medium SOEs will be reversed.

At the same time, it is noteworthy that the number of firms designated as "large", which usually employ more than thousands of workers, shows little sign of decline at least up to 2002. Then the question is, *has the sharp decline in the number of firms led to a shrinking share of SOEs in China's economy?* Unfortunately enough, the Ministry of Finance statistics provides no data on output or sales of SOEs. In order to find a tentative answer to the above question, we need to focus on the industrial sector (mining, manufacturing, and public utilities), of which

[5] The pace of the decrease of SOEs varies widely across provinces. While some provinces have their SOEs slashed by more than 70 percent during the past decade, in municipalities like Beijing, Shanghai and Tianjin the decrease has been relatively moderate (20 to 30 percent). No apparent correlation is found between the provincial decrease in the number of SOEs and variables such as per capita GDP, GDP growth rate, and fiscal conditions, suggesting political rather than economic environment may play a more decisive role in promoting or deterring privatization.

[6] In recent years MBO rather than MEBO has become prevailing because the former is generally superior to the latter in terms of efficiency in decision making and incentive structure. See Tenev et al. [2002], Chapter 2 of Imai (ed.) [2003], and Zhang [2005].

output data by ownership are available.

Persistence of state-ownership

Table 2 presents the number of industrial SOEs and their share in the sector in terms of value-added. Because of the unavailability of output data that covers all industrial firms, we use value-added of the industrial sector in the national income statistics, i.e. the industrial sector's component of GDP, as denominator[7].

Table 2 The number and share of SOEs in the industrial sector

	Number of firms			Share of SOEs in the sector* (Value-added, %)		
	SOEs Total	WSOEs	SCEs*		WSOEs (%)	SCEs** (%)
1993	n.a.	80,586	n.a.	n.a.	51.5	n.a.
1994	87,084	79,731	7,353	n.a.	40.8	n.a.
1995	n.a.	87,905	n.a.	n.a.	33.6	n.a.
1996	n.a.	86,982	n.a.	n.a.	30.1	n.a.
1997	84,397	74,388	10,009	34.0	28.4	5.6
1998	64,737	n.a.	n.a.	33.2	n.a.	n.a.
1999	61,301	50,651	10,650	34.6	23.4	11.2
2000	53,489	42,426	11,063	35.3	18.5	16.8
2001	46,767	34,530	12,237	35.7	14.6	21.0
2002	41,125	29,499	11,626	34.2	14.1	20.2
2003	34,280	23,228	11,052	35.5	13.5	22.0
2004	31,750	n.a.	n.a.	37.0	n.a.	n.a.
2005	29,229	n.a.	n.a.	34.2	n.a.	n.a.

Note) * Value-added of SOEs divided by GDP produced by the industrial sector. All GDP data excluding the year 2005 are figures prior to the upward revision announced in 2005.

** SCEs includes limited liability companies owned wholly by the State.

Source) National Bureau of Statistics and the author's calculation.

So far as the number of firms is concerned, the data show a much similar trend as the previous all-industry data in Table 1 does. The decline in the number of SOEs is far more outstanding than in the case of the all-industry data. WSOEs almost solely account for the

[7] From 1997 onward, China's industrial statistical system has revised so that it covers only (1) all of broadly-defined SOEs and (2) non-SOEs of which annual sales are no less than five million Renminbi. As a result, the majority of small enterprises are excluded from the statistics. When compiling national income statistics, National Bureau of Statistics makes up for this lack of coverage by means of estimation based on sample surveys (Xu [2000], p.26).

decline. It had also been accompanied by a sharp reduction in the share of the output of WSOEs in the industrial sector at least up to 2003, the latest year of which relevant data is available.

It should be noted, however, that the share of broadly-defined SOEs in the sector has shown *no apparent sign of decline* since the late 1990s. It had been hovering around 34 to 36 percent until 2002. In 2003 and 2004 it even slightly increased, after which it returned to the previous level[8].

While the data remains patchy due to frequent changes of format in original sources, this seemingly paradoxical stability of the share of SOEs is undoubtedly attributable to the growing share of SCEs that compensates the steep decline of the WSOEs share. Hence our next question: *what sort of firms are those growing SCEs?* Because of the unavailability of systematic data that shows the detailed composition of SCEs, it is difficult to get a conclusive answer to this question. We can presume, however, that the most important contributors to the growth of SCEs are joint stock companies of which the State remains to be the single largest shareholder, especially listed companies, which are capable of mobilizing capital through the stock markets at low cost.

The overwhelming majority of the dominant shareholders of companies listed on the Shanghai and Shenzhen stock exchanges are so-called state-shareholders, i.e. the central government, local governments, or SOEs which are entrusted with the state-owned shares (国有株), as Figure 2 indicates. Despite growing number of acquisition of listed companies and initial public offerings by private enterprises, sources suggest the dominance of state-shareholders remains basically unchanged to date[9]. Nearly 60 per cent of shares issued by listed companies in China are estimated to be owned by the State[10]. In many cases, state-owned shares are entrusted with SOEs which are parent bodies of listed companies.

Although value-added data of listed companies in the industrial sector consistent with the data in Table 2 is not available, the growth of the total sales of listed companies relative to GDP supports our presumption that listed companies largely account for the output growth of

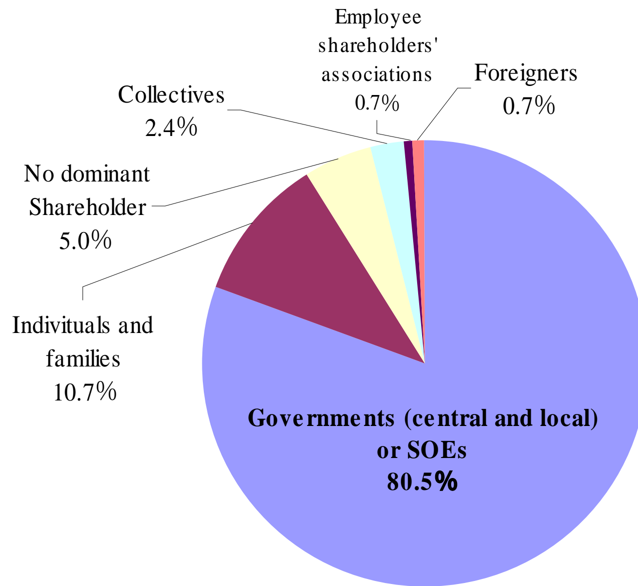
[8] Whether this increase is real or not remains an issue. Our estimation for the period prior to 2005 does not reflect the upward revision of GDP based on the first economic census in 2004. In 2005, the year for which the post-census data is used, the estimated share of SOEs decreased. This suggests that pre-census statistics seriously underestimated the recent growth of the private sector.

[9] A report compiled by the Research Center of Shanghai Stock Exchange estimates that as of the end of June, 2003, only 17.5 per cent of A stock-listed companies are defined as non-state domestic companies (Lu and Zhang [2004]). Note that this includes collective companies which are (at least legally) not deemed to be private enterprises.

[10] State-owned shares are classified into two distinctive categories. (1) “State shares” (国家股) that are (at least in theory) owned directly by government ministries or local governments. (2) “State-owned legal persons’ shares” (国有法人股) that are entrusted with SOEs or other state-owned institutions. Official statistics show that state shares account for 51 per cent of shares issued as of the end of 2003. As for the latter no systematic data is available. According to some estimates they roughly account no less than half of legal persons’ shares (which themselves account for 12.3 per cent of shares issued in the same year).

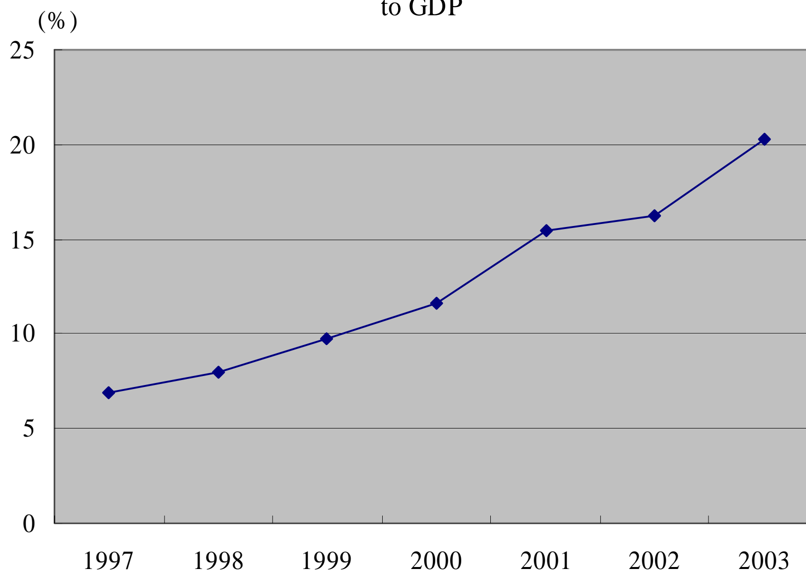
SCEs (Figure 3).

Figure 2 Composition of listed companies by the nature of dominant shareholder



Note: 1) 1,050 listed companies as of 2001. 2) Companies of which no single shareholder's share exceeds ten per cent are classified as "No dominant shareholder".
Source: Compiled from Zhang et al. [2002].

Figure 3 The ratio of total sales of listed companies to GDP



Note) Sales figures cover only major business sales of each company.
Source) *China Listed Company Reports*, various years.

While China's large SOEs today are very much diversified, there are two distinctive cases in which SOEs remain viable under sharply contrasting market environments. On the one hand, in industries where minimum capital requirement is significantly large, SOEs' dominance has not been fundamentally challenged to date. SOEs still take hold of their established positions in these industries mainly on account of the oligopolistic nature of the market environments (we call it "case I" here). On the other hand, even in some highly competitive industries, there still exist a handful of SOEs successfully surviving harsh competition ("case II"). Their survival and growth under adverse market environment depends on ingenious entrepreneurship of managers per excellence.

Needless to say, the dichotomy here cannot be too rigorously applied in reality. The majority of SOEs probably lie somewhere between the typical case I and II. However, if a SOE is endowed with neither an oligopolistic market environment nor a capable manager (i.e. it lies in the "middle" of the typical case I and II), the chances are that it is doomed to decline as time elapses. Hence the convergence to the two polar cases.

Notwithstanding the contrasting market environment, many SOEs both in case I and II share a common structure: they had their core business reorganized into subsidiary joint stock companies (JSCs) and had the JSCs' shares listed on stock exchanges. This made them capable of cashing in on the drastic growth of China's capital market. In the following two sections, to explain the persistence of state corporate ownership in China, we focus on these two distinctive types of large SOEs, based primarily on case studies. They can well exemplify the most important issues China's large SOEs face, which is the reason why we pick them up.

III. Case I: Traditional large-scale SOEs in oligopolistic industries

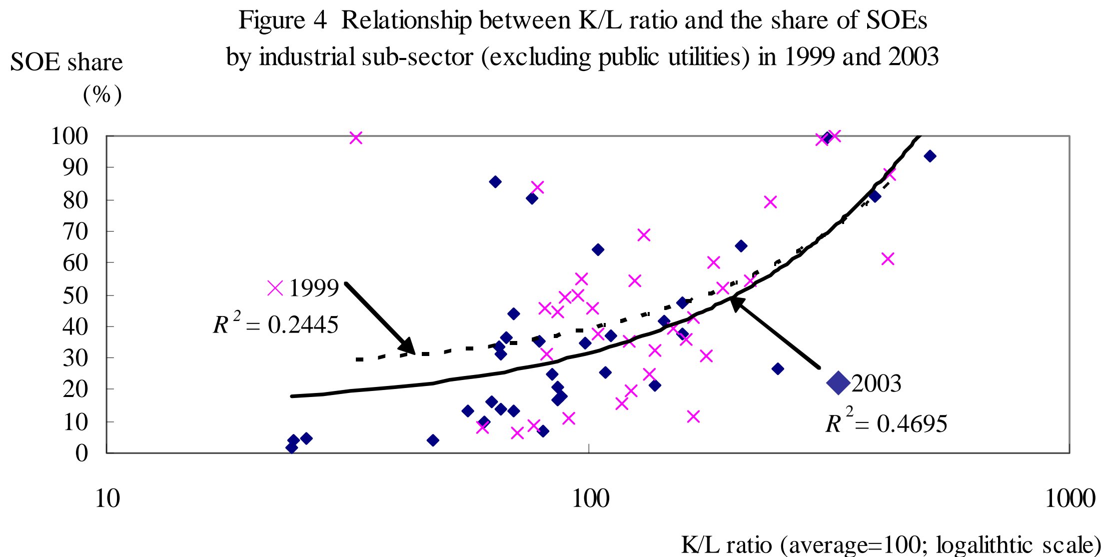
Corporate ownership structure differs widely across industries in China. As far as the industrial sector is concerned, SOEs have retained their dominance in heavy industries above all, where entry barriers are higher due to large minimum requirement for fixed investment[11].

Figure 4 illustrates the point by showing relationship between average capital/labor ratio and the share of broadly-defined SOEs in 34 industrial sub-sectors. It indicates that, mainly on account of the continuous decline of SOEs' share in less capital-intensive industries, capital

[11] Except for the tobacco industry, where private capitals are basically barred out in consideration for preserving tax base, the great majority of mining and manufacturing industries are basically open to entries by private capitals. Although there still remain explicit or tacit restrictions, they tend to be circumvented and finally abolished.

intensity and the share of SOEs has become more strongly correlated. The dominance of SOEs still remains more or less intact in industrial sub-sectors such as mining, petrochemicals, ferrous and non-ferrous metals, and transportation equipment[12]. Competition do exists in these industries too. A handful of private companies are growing so vigorously that they may pose serious threat to the incumbents. However, since the scales of the incumbents, which are mostly state-owned, are overwhelmingly larger than the newcomers, markets remain to be oligopolistic at least by the standard of the highly competitive environment of the Chinese economy. Although few statistical data in connection with ownership attributes is available outside the industrial sector, it is apparent that in some highly capital-intensive service sectors such as telecommunication or transportation the dominance of SOEs is much more confirmed.

Figure 4 Relationship between K/L ratio and the share of SOEs by industrial sub-sector (excluding public utilities) in 1999 and 2003



Note:
1) K/L ratio is calculated by dividing nominal fixed assets net of depreciation by the number of employees. 2) The shares of SOEs are biased *upward* because of the coverage problem of industrial statistics (see footnote 7 to the text).
Source) Calculated by the author based on *Statistical Yearbook of China*, various years.

Most of SOEs in these sub-sectors are traditional large SOEs. They are “traditional” in the sense that they are usually under more stringent control by government ministries and at the same time are heavily burdened with the legacy of the planned economy, such as redundant workforce, underperforming assets, and money-losing business units.

The largest ones among the large SOEs in these industries, which typically employ more than hundreds of thousand workers, are usually under direct control of the State-owned Assets Supervision and Administration Commission (国有資産監督管理委員会：SASAC) of the

[12] In some industries such as the automotive and shipbuilding industries, regulations that limit the equity share of foreign capitals below 50 per cent helps keep the dominance of SOEs.

central government[13]. Below we look into the case of SINOPEC Group as one of the most representative of traditional large SOEs in oligopolistic industries.

SINOPEC Group

SINOPEC Group Company (中国石化集团公司： hereafter "the group company") is the largest company in China by sales as of 2004, according to China Enterprise Confederation and China Enterprise Directors Association (Zhongguo Qiye Lianhehui and Zhongugo Qiyejia Xiehui [2005]). The group company was established as a result of a sweeping reorganization of the petroleum and petrochemical industries in 1998. Before the reorganization, while old SINOPEC had been defined as a business entity since the early 1980s, in fact it had been a semi-ministerial organization responsible also for the administrative control of the petrochemical industry. The reorganization in 1998 has produced two gigantic state-owned corporations that integrate development, drilling, and refining of petroleum and production of petrochemical products: SINOPEC, and China Natural Gas and Petroleum Group Company (CNPC Group). The two and China National Offshore Oil Corporation (CNOOC), which is also a WSOE, are by far the three largest competitors in China's petroleum, natural gas, and petrochemical markets. All of the three companies fall under the jurisdiction of SASAC.

In 2000 the group company separated its core business and reorganized it into China Petroleum and Chemical Corporation (SINOPEC Corp.), a JSC of which state-owned shares are entrusted with the group (Figure 5). SINOPEC Corp. had its shares listed on Hong Kong, New York, London, and Shanghai stock exchanges and successfully raised close to five billion US dollars.

The group company itself has remained wholly-owned by the State. Since most of unprofitable business units and non-business auxiliary service units have been left to the group company, it is losing money if the profit of SINOPEC Corp is excluded (Table 3). Still, it employs as many as 450,000 workforces. Legally speaking, the relationship between the group company and SINOPEC Corp. is a shareholding company as the single largest shareholder and its subsidiary listed company. However, as is illustrated by the fact that Chairman of SINOPEC Corp. serves also as Chief Executive Officer of the group company, in actuality the operation of the two companies is by no means strictly separated[14].

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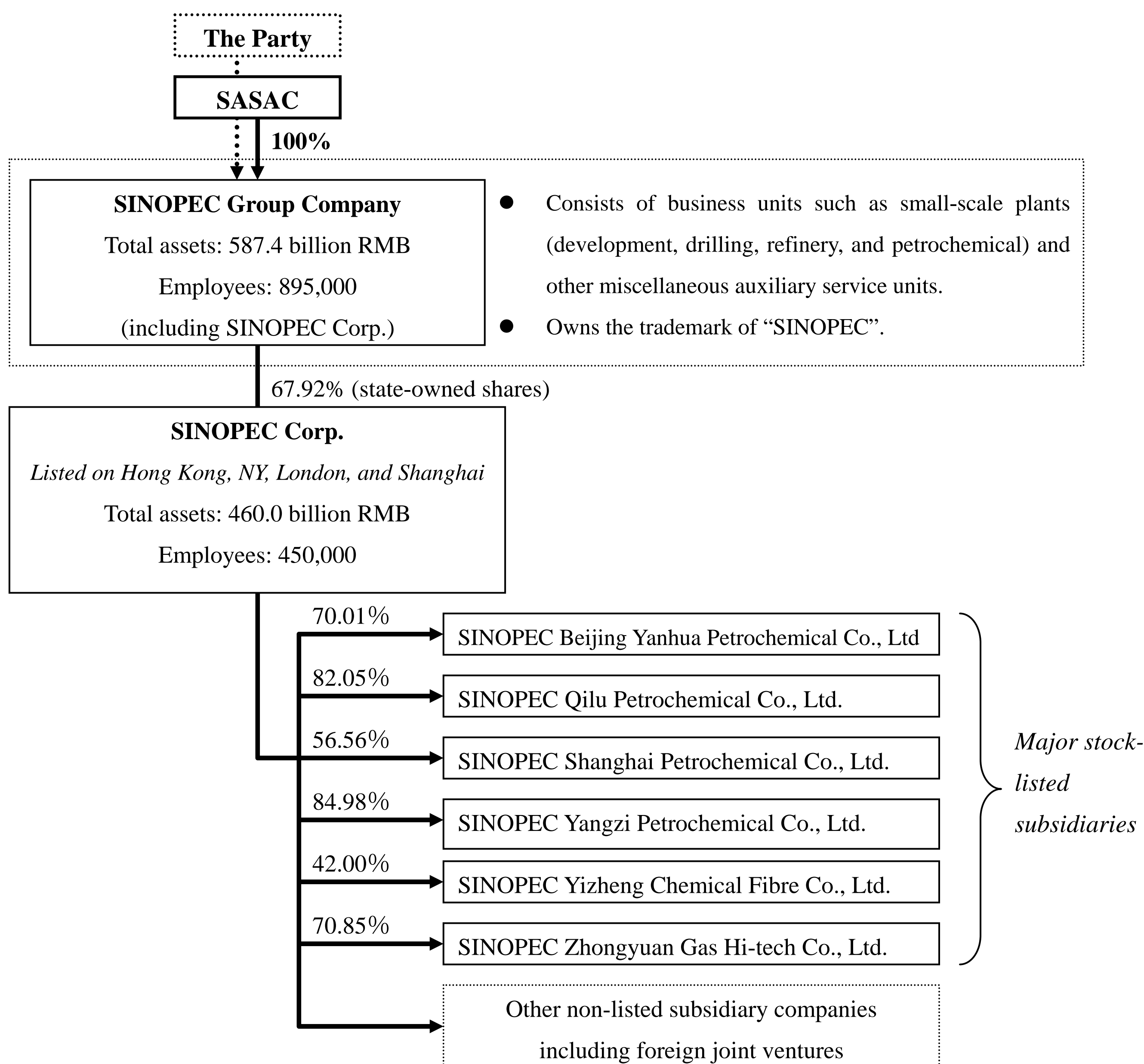
[13] SASAC was established in 2003 as a result of reshuffling of two organizations: the former State Economic and Trade Commission and the Central Enterprise Work Commission of the Party.

[14] For example, although SINOPEC Shanghai Petrochemical Co., Ltd. is a subsidiary of SINOPEC Corp., the company's auxiliary and non-business units are under the direct control of the group company (Interview with the group company, October 30, 2005).

Figure 5 Corporate structure of SINOPEC Group (as of the end of FY 2004)



Note) Since 2005 SINOPEC Corp started a comprehensive full acquisition scheme of listed subsidiaries in view of enhancing the integration of the group's business. This ongoing change is not reflected in this figure.

Source) Prospectus of SINOPEC Corp., annual reports and various sources.

Table 3 Financial performance of SINOPEC Group (FY 2003)

	Net profit (Billion RMB)
SINOPEC Group [consolidated]	28.969
[Exlcuding SINOPEC Corp.]	-6.072
SINOPEC Corp.	35.041

Source) Annual reports.

During the first half of 2005, SINOPEC Corp. enjoyed the historical surge in oil prices and saw its net profit grow by more than 20 percent year-on-year basis. Nonetheless, in the long run, dividends from SINOPEC Corp. do not suffice providing for more than four hundred thousand workforces of the group company at the same time repaying interests and principals of debts outstanding that amount to two thirds of the company's total assets (net of SINOPEC Corp.). It is reported that, among more than 400 thousand employees of the group company, more than half are in non-core business or auxiliary service units, most of which are losing money and need to be separated out from the group[15]. The cost of restructuring of labor, asset and debt is roughly estimated to be 40 billion RMB[16]. The group company has to promote the restructuring without inflicting great social disputes[17].

Apparently, the most feasible way to finance the large-scale restructuring is divesting a part of the state shares of SINOPEC Corp, as the group company itself recognizes[18]. But hasty divestiture entails a great risk of drastic disruption in the stock price and/or destabilization in corporate management, since China is still lacking in qualified investors that have financial resources and managerial capability to lead the corporate governance of large public companies. Thus it is highly likely that SINOPEC group will remain dominated by the state capital for the foreseeable future.

Being a large wholly-state owned corporation of strategic importance, the group company is supervised by SASAC that act as the state-shareholder. The officially-claimed mission of SASAC is the maximization of corporate value of companies under its supervision including SINOPEC Group Company. Recently SASAC is inclined to favor the idea that it will follow the model of Temasek, the largest Singaporean state investment company that has a high

[15] In 2004 the central government designated three largest state-owned corporate groups, SINOPEC, CNPC and Dongfeng Motor Corporation as first test cases of comprehensive restructuring focused on separation of non-core business units.
[16] *China Business Post* (財経日報), August 21, 2004.
[17] In 2002, tens of thousands of laid-off workers of Daqing Oilfield, which is a subsidiary of CNPC Group, demonstrated on the street in protest of scantiness of compensation.
[18] *China Business Post* (財経日報), August 21, 2004.

international reputation as a successful institutional investor. However, at least at present the role of SASAC seems to be more promotion of industrial policy than maximization of corporate value, reflecting its previous organizational background[19]. The sheer size of the companies under its jurisdiction – 163 large SOEs covering almost all industrial and services sectors with assets exceeding one trillion US dollars and more than nine million employees -- also rules out a quick shift of SASAC to the value-maximizing investment model a la Temasek. On top of that, it is reported that the Party still retain the appointment power of the top management of 53 ultra-large SOEs including SINOPEC Group Company.[20] This makes "politicization" (Qian [1995]) of those companies' management almost inevitable.

While the scale of SINOPEC Group Company is exceptionally large, its corporate structure and the circumstance the company faces represent to a great extent those of large SOEs in capital-intensive industries, where market still remains to be more or less oligopolistic. Many of such have separated their profitable business and reorganized them into JSCs, then had their shares listed. This is an important step towards full commercialization of SOEs, as the newly-born JSCs are free from the burden of the legacy of the planned economy (at least in theory) and exposed to monitoring by non-state shareholders.

At the same time, the task of promoting further restructuring of redundant workers, non-performing assets and excessive debts left to the original SOEs (which usually equal the parent companies of JSCs) remains mind boggling. SASAC estimates that there are approximately 1.6 million redundant workers to be disposed of in SASAC-supervised large SOEs[21]. Assuming the average restructuring per-worker cost as three to four times of annual salary (sixty to eighty thousand RMB)[22], the total scale of labor restructuring cost amounts to ninety to 130 billion RMB, which equal to 10 to 15 percent of the annual expenditure of the central government. As with the cost of writing off non-performing assets though no reliable estimate is available, there is little doubt that it exceeds the labor restructuring cost by a wide margin[23]. In view of financial constraint the central government currently faces, it is quite likely that it will take years for the task of restructuring of large SOEs to be completed.

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[19] See footnote 13.

[20] *Finance* (財経), February 21, 2005.

[21] *China's State-Owned Assets Supervision and Administration Yearbook 2005*, p.69.

[22] This roughly corresponds to the prevailing standard of labor restructuring cost (the amount paid out to a worker as a compensation for the loss of job security and welfare service as a SOE employee).

[23] The total assets of SASAC-supervised SOEs at the end of 2005 is 10.6 trillion RMB. Even if we assume five percent of the assets to be written off, it amounts to more than fifty percent of the annual expenditure of the central government.

IV. Case II. Manager-controlled SOEs in competitive industries

In the previous section we noticed the fact that SOEs today are largely concentrated in heavy industries that remain to be relatively oligopolistic. In contrast, as can be seen from Figure 4 cited above, in most of less capital-intensive industries the share of SOEs is much lower. Especially in the least capital-intensive light industries such as apparel and footwear manufacturing, SOEs' share is already close to null.

It is noteworthy, however, that even in those industries where the dominance of SOEs has long gone, there still are a handful of SOEs which survive competition and remain viable. They are surely anomalies in the sense that they account for a very tiny fraction of SOEs. But within the industries these "atypical" SOEs are often quite influential players. Below we focus on the case of Doublestar Group Corporation, the largest domestic maker of rubber-soled shoes.

Doublestar Group Corporation[24]

The shoemaking industry is, in line with other light industries, probably one of the most competitive and "privatized" industries in China. The domestic market of rubber-soled shoes is packed with a huge number of domestic manufacturers, mostly private firms or TVEs, Taiwanese OEMs, and major foreign brands such as Nike and Adidas.

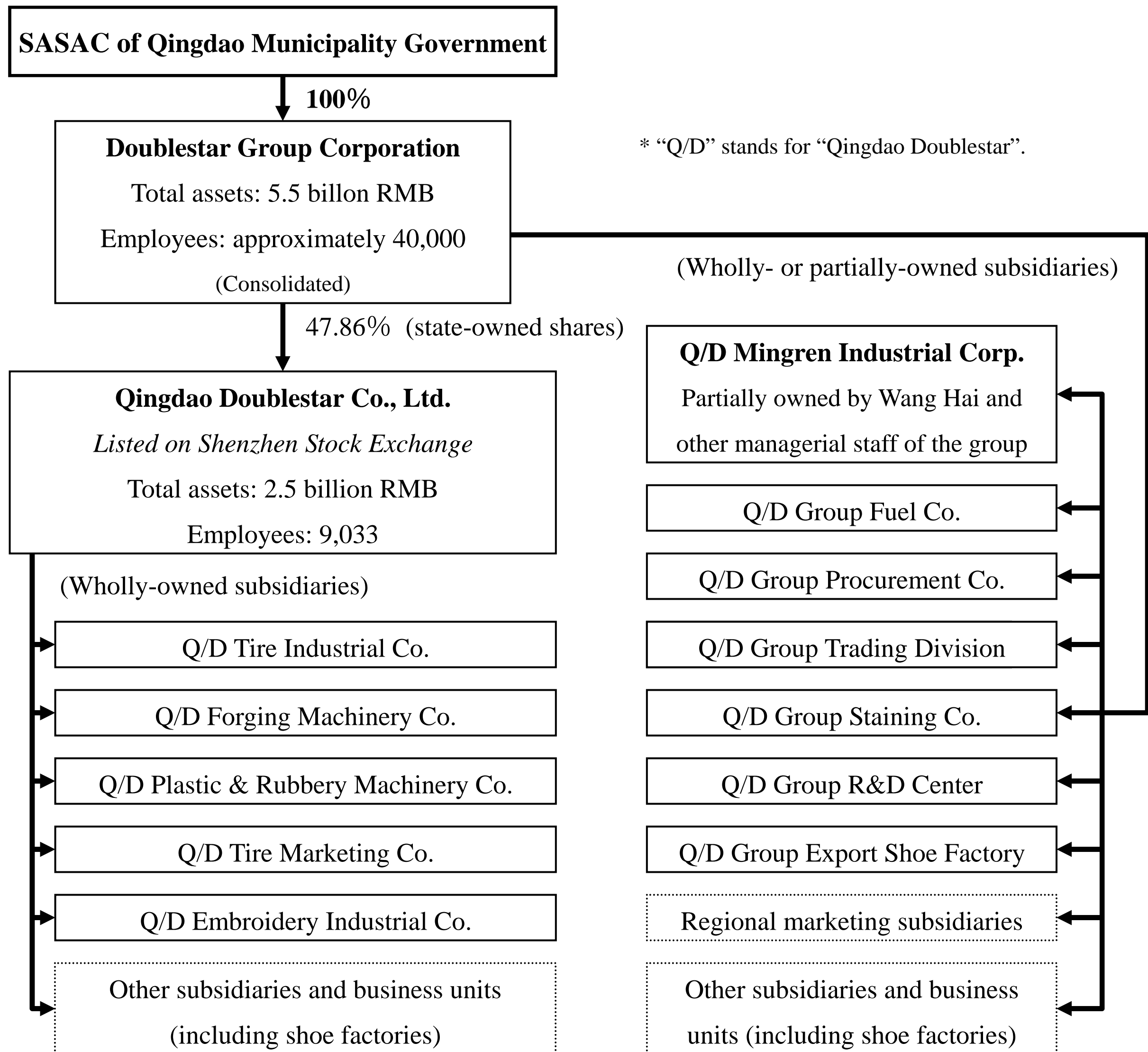
Doublestar Group Corporation (双星集团公司： hereafter "the corporation") is probably the only SOE that remains viable in the industry. Figure 6 describes the present organizational structure of the corporation. It was a medium-scale factory subordinate to Qingdao Municipality Government, producing the cheapest type of rubber-soled shoes until the mid-1980s, when it faced rapid piling-up of inventory due to the abrupt change of the domestic market. Being unimportant factory in a non-strategic sector, the factory could enjoy little support from the local government. In consequence the factory's financial position deteriorated seriously.

The major reason the factory survived the crisis and increasingly harsh market competition thereafter is that it could swiftly adjust product lineup and build a marketing network of its own, making itself possible to go around the traditional inefficient channel of state-owned distributors. Along with putting great emphasis on improving product quality, the factory created its own brand "Doublestar" and successfully promoted the brand to the market, becoming the largest domestic manufacturer of rubber-soled shoes. In 1992 it changed its company name after the brand name and reorganized itself as "Doublestar Group Corporation," a wholly-state-owned limited liabilities company under the direct supervision of Qingdao

[24] Description of the corporation is based on two interviews on September 20, 1996 and October 28, 2005, annual reports of Qingdao Doublestar Co., Ltd. and various materials.

Municipality Government[25].

Figure 6 Corporate structure of Doublestar Group (as of the end of FY 2004)



Source) Annual reports and interviews by the author and others.

The corporation soon established a JSC consisting of a part of its shoemaking business and listed it on Shenzhen Stock Exchange in 1996. However, a large part of the original business including the production of low-end rubber-soled shoes, has remained as business units within the corporation. The listed company has been diversifying into the tire industry by

[25] Before the corporatization the factory had been supervised by the Bureau of Chemical Industry of the municipality government. The bureau was later abolished together with other industrial bureaus.

acquiring several tire manufacturers in recent years.

The corporation is one of the few SOEs in Qingdao that have been successfully adapted to ever-changing market environment of the transition period. It is widely acknowledged that the success of the corporation is to a great extent attributable to President Wang Hai (汪海), an army veteran who was appointed as Party Secretary of the original factory in 1983 and has been commanding control of management thereafter. While the corporation itself still remains to be a WSOE supervised by the Qingdao Municipality Government, the local government rarely intervenes into the management of the corporation. The management control of the corporation is so centralized that any nonrecurring expenditure exceeding two thousand RMB requires approval by the president[26]. In principle a manager of SOE has to retire at the age of 60. But the municipality government decided in 2005 to grant three CEOs of two SOEs and one urban collective enterprise, including Wang Hai, who was already 63 at that time, three years' special term extension[27]. The behavior of the Qingdao Municipality Government to a large extent reflects the market oriented nature of local governments in China, which is particularly evident in the coastal region where market competition prevails.

The management of the corporation is so personalized that it looks quite close to a private enterprise. As result of rapid expansion the majority of workforces are migrant workers from rural areas, making the corporation capable of flexibly adjusting labor in response to the market. The dilemma is, however, as long as it remains wholly owned by the State, the municipality government retains the ultimate control right of the corporation. The president has no legal claim to the net assets of the corporation, although it is no doubt that as a virtual entrepreneur he has made an essential contribution for creating it.

The obvious solution to this dilemma is privatization. But the central government still takes a negative stance against privatizing large SOEs. It strictly prohibits giving-out or "underpriced" selling of state shares of large SOEs to managers by local governments. Besides, it is extremely difficult to sort out exactly what amount of equity the president can justifiably claim. Notwithstanding these constraints, the corporation seems to be already preparing for promoting privatization by a more of less covert way probably with a tacit approval of the municipality government. It established Qingdao Doublestar Mingren Industrial Co., Ltd. (Mingren Industrial) , a JSC with its shares jointly owned by the corporation and a group of senior managerial staff including Wang Hai[28]. The corporation owns only the minority of Mingren Industrial's shares, while exactly how many shares are owned by Wang Hai and others

[26] Interview with managerial staff of the corporation (October 28, 2005). However, how exactly this rule is obeyed is questionable.

[27] The other two are CEOs of Haier and Tsingtao Beer, both of which are widely known as successful survivors among public enterprises in extremely competitive industries.

[28] Incidentally, *Mingren* (名人) means "celebrity" in Chinese.

remains undisclosed. The corporation has begun to use the brand name of "Doublestar Mingren" interchangeably with the original "Doublestar" brand, which suggests that Mingren Industrial will become the future platform of privatization of the corporation.

There are several outstanding SOEs like Doublestar, which have survived the challenge of transition to a market economy and realized spectacular growth so far under the initiative of managers who functioned exactly as entrepreneurs, while they are the minority distinctive from the majority of SOEs in China that remain inadaptable to the market economy. They can be labeled as "manager-controlled" SOEs, in view of the extreme concentration of control to the managers. Those companies face the same dilemma as Doublestar does[29]. Generally speaking, local governments in charge of supervising them are inclined to "let them go off" by granting managers state equities at prices lower-than book value or just without charge. On the other hand, the central government put stringent restrictions on MBO or MEBO of large SOEs as it has strong interest in securing the source of financing SOE restructuring and filling the serious shortage of pension fund due to the painstaking transition from the pay-as-you-go system to the fully-funded system. The central government also worries that once the restrictions are relaxed local government are apt to rush for wholesaling of SOEs with massive discount, which may arouse discontent on the side of workers, as the ongoing experience of the privatization of small and medium SOEs illustrates.

V. Prospect: Groping for a way out

In recent years there have been a growing number of econometric studies focusing on assessing the effects of corporate ownership on efficiency in China[30]. Despite wide divergences in methods applied and specific conclusions, most of the studies agree that state ownership is detrimental to efficiency, thus supporting privatization either explicitly or implicitly. We need to note, however, the fact that the superiority of private ownership does not mean that state-owned enterprises can be privatized right away.

The Party and the central government have long recognized that corporatization and diversification of ownership of large SOEs are necessary both for efficient management and effective governance. Since the late 1990s to the beginning of the century they have further conceded a gradual exit of state investment from "non-strategic sectors", which are rather

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[29] Huang [2003] explores the failure case of privatization of Mailyard Group, once the largest OEM manufacturer of men's suits for the Japanese market, which was also a typical case of "privately-controlled" SOE.
[30] For example see Tian [2001] and Liu [2003].

vaguely defined as sectors in which market mechanism function works sufficiently and that do not concern with fundamental development of the economy and national security. They have also acknowledged that the dominance of state investment in listed SCEs needs to be decreased whichever industry they belong to[31].

In spite of these progresses in the political arena, our estimate indicates that the share of broadly-defined SOEs has remained basically unchanged since the late 1990s. In the preceding two sections we looked into two cases of distinctive types of SOEs that remain viable. They are in a clear contrast with each other, especially in the sense that their survival and success in the markets depends respectively on oligopolistic position and improvisational entrepreneurship. At the same time, both of them capitalized the emergence of stock markets beginning in the late 1990s for financing their rapid expansion and diversification. The two cases illustrate several factors constraining further progress of SOE reform such as, financing the costs of restructuring, redefining the role of the State as the single dominant shareholder, and balancing the interests of the State and managers as entrepreneurs.

In 2005 the government set off a comprehensive scheme of step-by-step conversion of state-owned shares and non-state-owned legal persons' shares, both of which were previously defined as non-tradable shares, into tradable shares, i.e. shares that can be freely traded on the stock exchanges. No doubt the conversion, now underway at an unprecedented pace, will be a big step towards establishing a well-functioning market of corporate ownership. But how far the reform will reshape the current ownership structure of large corporations in China in coming years remains to be an open question.

Apparently, foreign capital and private enterprises are the major candidates that will replace the State as the dominant shareholder of large corporations. Acquisitions of large SOEs or a part of their equity by foreign capital have been surely increasing; on the other hand, at least at present, they are by and large concentrated a limited number of industries where regulations and/or existing network in the domestic market induce foreign investors favor acquiring incumbent Chinese companies (e.g. the banking industry and the beer industry). Private enterprises are growing rapidly, some of which have the financial capability to acquire a number of large SOEs. However, it is often the case that those emerging companies by themselves, having grown out of nothing within a very short period of time, lacks internal stability to be capable of managing large complex organizations such as China's SOEs[32].

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[31] The Party still emphasizes keeping control of the most important large SOEs. To what extent the Party will concede diversification of corporate ownership of these companies is a very political issue, which we cannot afford to discuss further here.

[32] D'Long Group (德隆集団)'s rise and fall is the case in point. D'Long, established as a small business concern by the Tang brothers and grew mainly stock market speculation, acquired four stock-stock listed SOEs in succession within several years beginning in the late 1990s. The group, however, fall dramatically due to excessive debt burden and the sudden tightening of monetary policy in early 2004,

Then emerges our last question: what kind of consequences will the persistence of state-ownership have on China's economy? On surface, with the aggregated saving rate being close to 40 per cent, the momentum of the growth does not seem to be seriously hurt by inefficiency in resource allocation. Besides, competition in the product markets will continue to exercise pressure on surviving SOEs to improve efficiency, so as to make them converge to the behavior model of private enterprises.

At the same time, however, in view of the Chinese government's strong orientation for pursuing high speed growth and underdevelopment of monitoring by outside investors, it is highly likely that state-ownership will remain to be an important source of short-term macroeconomic instability by encouraging excessive investment. Furthermore, in the long run, in order to sustain growth momentum China needs industrial upgrading, which is to be supported by evolution of corporate organization. Weakness inherent in corporate governance under state ownership will be one of the central issues that must be addressed in the process.

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leaving debts as much as ten billon RMB approximately.

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