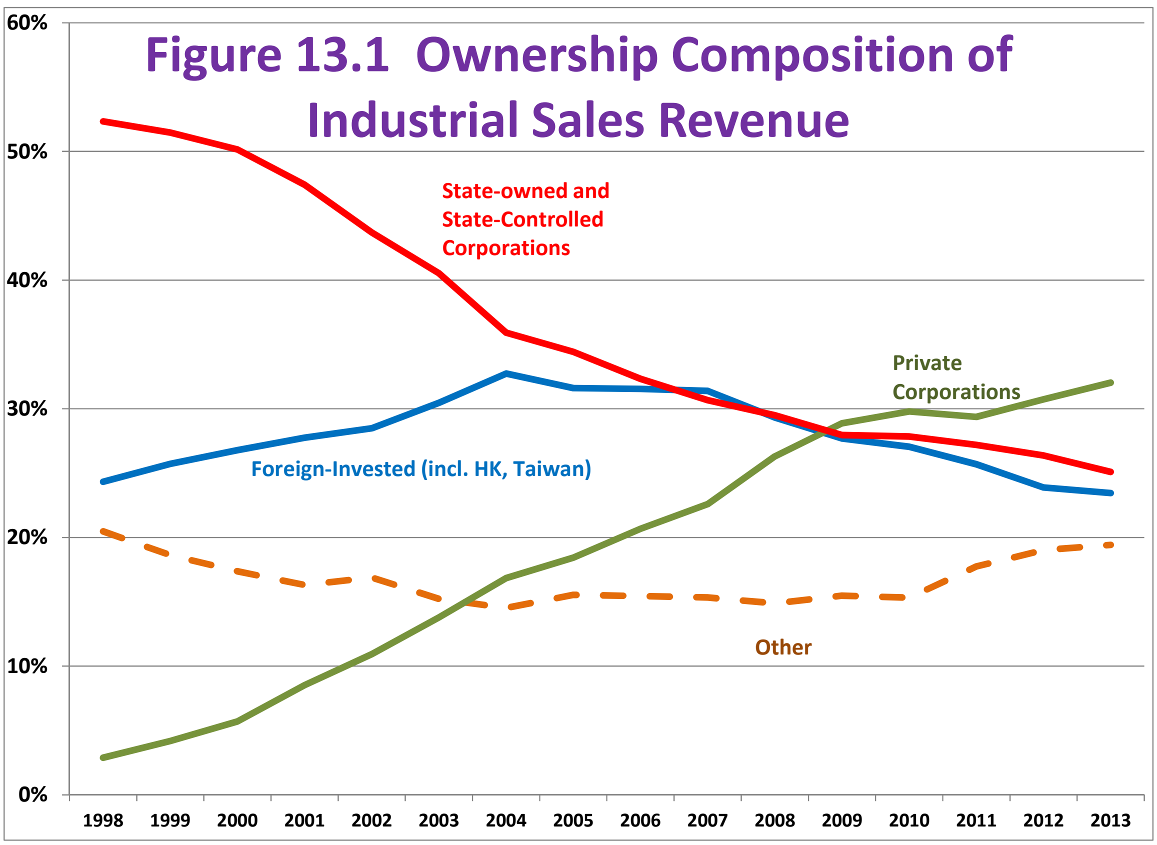
13: Industry: Ownership, Governance and Industrial Policy

Since 1978, China has gone through multiple industrial revolutions. Nearly every aspect of the technological and institutional foundations of Chinese industry has been transformed. Industrial output was about forty times in 2013 what it had been in 1978, and industrial growth has driven the transformation of the Chinese economy (Chapter 6). Whole new industries have been created; structural change has been enormous; and China has emerged as the industrial workshop of the world. This chapter addresses the institutional changes that lie behind this dramatic transformation.

The transformation of industry has accomplished all of the first-round objectives of reformers and policy-makers. First, industry has long since shrugged off the institutions of the command economy and shifted to a market basis. Institutional change in industry was central to the transition from a planned to a market economy. State-owned industry was the core of the command economy, the area where government control was the most pervasive, and where the most compelling national objectives and vested interests were in evidence. The transformation was difficult, but it has been achieved. Second, the ownership composition of industry has transitioned away from a state monopoly to a diverse mix of ownership types. As Figure 13.1 shows, state firms now account for 25% of industrial revenues, substantially less than domestic private corporations (32%) and about the same as foreign-invested firms (23.5%). Third, the corporation has become the predominant legal form for large firms, providing a foundation for improved corporate governance. Fourth, China has developed large firms with an international presence, which serve as “national champions” that are a source of pride to China’s leaders.

These four features define the success of China’s industrial transformation up through the present: However, are they sufficient going forward? The institutional changes China carried out during the 1980s, 1990s and 2000s were clearly adequate to support China’s industrialization during the “miracle growth” phase, when rapid labor force growth, migration, and investment were fueling explosive growth. However, are these institutions sufficiently sophisticated and robust to bring China through the next stage of growth, in which innovation and steadily increasing efficiency will be required to offset the effects of steadily rising costs for labor, land and resources? As we will discuss, there are numerous institutional challenges that will need to be overcome.

Some insight into the achievement and challenges can be gained by taking a closer look at one of the most striking achievements. In the Fortune Global 500 rankings based on 2012 sales revenues, there were 85 firms from the People’s Republic of China among the top 500. Leaving aside the 5 banks and 3 insurance companies (all of which are state-owned), that leaves 77 industrial firms, a remarkable performance. However, a close look reveals some distinctive characteristics. First, almost all of these firms—71 out of 77—are state-owned. Even more striking, 45 of them are owned by the central government's State Asset Supervision and Administration Commission (SASAC), which is surely the world's largest controlling shareholder and probably the richest and most powerful organization that almost nobody in the world has heard of. Thus, despite the transformation of China's industry, the hand of the central government is still heavy in the largest firms. Moreover, a closer looks shows that "China's SOEs are far from catching up with the world's leading firms. The vast majority of the[ir] sales revenue…comes from the domestic market where they operate in sectors protected from direct competition with the world's leading firms. Chinese [state] firms have a negligible share of the world's most competitive markets in high-income countries." (Nolan 2014: 763). These firms have grown big and improved their efficiency, but are still a long way from the global frontier.



There are only six private firms on the list of Chinese Fortunate Global 500. Of course, having six firms in the top 500 world firms is in itself a significant achievement. The largest of these is Huawei, at Number 315, by any measure a strong, competitive and highly dynamic firm. Nevertheless, an external observer is left with the suspicion that, given the rapid, transformative growth of China's industry in the past forty years, that there may have been promising private firms that did *not* grow to be dynamic global firms because of subtle (and not so subtle) barriers in the domestic environment. In China, private firms are encouraged to grow, but not necessarily to grow big and powerful.

The transformation of China's industrial system is discussed here in four sections. The beginning section presents a broad brush description of change in the ownership of Chinese industry. The next section briefly discussed changes in industrial finance. Those two sections then set the stage for a more detailed discussion of institutions of corporate governance in Chinese state-owned industry. The final section covers privatization and hybrid ownership forms.

13.1 How did we get here?

The most important factor that drove institutional change in Chinese industry was the entry of new firms that steadily created an intensely competitive product market. A competitive product market is one of the most important external forces that disciplines a firm and forces it to become more efficient. In China, the entry of new firms and the emerge of a competitive product market was intimately related to the emergence of a diverse ownership structure, as township and village enterprises, and later private and foreign-invested firms, played the driving role in this transformation. At the same time, the loss of protected markets deprived SOEs of the high mark-ups and surplus earnings they had once enjoyed, and caused dramatic changes in the system of industrial finance, and in the financial position of industrial firms.

During the early phase of China's industrial transition (1978-1993), privatization of state firms played almost no role. Instead, entry of new firms was the dominant force that drove a realignment of the ownership composition of Chinese industry. The township and village enterprises (TVEs), described in the previous chapter, played the main role in this process early on. It was not until the end of the 1990s that privatization of state firms began to occur in really significant numbers. (Even then, privatization was never officially embraced, but was instead described with euphemisms such as "re-structuring.") A variety of ownership forms began to develop in Chinese industry during the 1980s, and only gradually was the diverse ownership structure that we see today created. Thus, while the scale of change has been enormous, there has also been continuity, most strikingly in the continued role of state-owned enterprises (SOEs). Even today, large state enterprises play an important role in the Chinese economy. The following section traces the evolution of ownership through the two periods of Chinese transition that were described in Chapter 4.

Text Box 13-1: Ownership and Governance

Ownership can be defined as the residual rights over an asset or organization. Rights are residual in the sense that they are those rights over assets or resources that have not already been explicitly promised or allocated by contract. In other words, the owner has the right to decide what happens to an asset after all the contractual obligations are fulfilled.

Residual rights can most usefully be thought of as consisting of two main types: the right to the income produced by the asset, and the right to physically control the asset itself. An asset produces income, and it is usual for some part of the income to be contractually promised to another party, for example when a firm must pay off banks and bond-holders to whom it owes money. The owner enjoys the net income left over after those contractual payments are made, and of course also bears the risk of losses. Similarly, physical control may also be shared or limited by contract or public regulation, but the owner enjoys the residual right to whatever aspect of control is not otherwise specified by contract or prohibited by law.

Corporate governance refers to the institutions that are used to make decisions that have not been specified by contract. That is, they are the means through which the residual rights of the owners are exercised. The corporate governance system specifies the distribution of rights and responsibilities among different participants in the corporation, paying special attention to the way that shareholders delegate responsibility to managers. The corporate governance system spells out the rules and procedures for making decisions on corporate affairs, and in so doing, it provides the structure through which company objectives are established, and the means to monitor performance and attain company objectives (OECD 2004).

On the eve of economic transition, in 1978, China's industry was made up of thousands of similar, publicly owned organizations. The traditional state-owned enterprise (SOE)—the "work unit" integrated into the government bureaucracy—dominated the scene, as it had since the 1950s. SOEs produced 77% of industrial output. "Collective enterprises" were factories that (like the agricultural collectives) were nominally owned by the workers in the enterprise, but were actually controlled by local governments or other state bodies. Urban collectives produced 14% of output, and rural TVEs produced the remaining 9%. Most industry was urban and middle-sized. Very small firms were practically non-existent (less than 5% of output). Each SOE typically consisted of just one factory, and cross-provincial, multi-plant corporations did not exist. The dominant SOEs carried many burdens. As the prototypical urban work unit (*danwei*), SOEs were responsible for the welfare, health, and political indoctrination of their workers. Managers had little flexibility and low rewards, and were required to fulfill plan targets, and carry out numerous other commands given by various parts of the bureaucracy. There was little accountability or risk. The new entrants, the TVEs, came into the reform era largely unburdened by these external obligations. Once allowed into the industrial marketplace, they were poised to expand rapidly. Over the eighteen years 1978-96, TVEs—collectively-owned firms in the countryside—increased their share of total output from 9% to 28%. Collective firms—including both urban and rural—reached their maximum share of output value in 1996, accounting for 36% of the total. Private firms also sprang up, primarily in the small-scale sector.

Growth of small-scale firms was the dominant story of the first decade and a half of reform. China had very few small firms under the planned economy, and the potential was huge. Chinese authorities were content to let the small-scale sector revive with relatively little interference. However, property rights protection was minimal in this early phase: Private firms faced significant obstacles if they sought to grow big. The Chinese state showed benign neglect toward private firms only as long as they remained small. Indeed, continued discrimination against private firms was one of the reasons that collective firms grew so rapidly. By the mid-1990s, China had developed a kind of tripod industrial structure, in which state, collective, and private (domestic and foreign) firms each produced about one-third of total output. Gradualist transition, in its first phase, produced dramatic growth of markets and an impressive diversification of ownership, while maintaining a large state role in the economy.

A new wave of industrial reforms began in the mid-1990s, and, as discussed in Chapter 4, reform strategies underwent an important change. A milestone was the adoption of the Company Law in 1994. The Company Law provided a uniform legal framework into which different ownership forms fit. The Company Law provided a framework for "corporatizing" SOEs, that is, converting traditional SOEs into the legal form of the corporation, more appropriate to a market economy. Once an SOE was converted into a corporation, it had the option of diversifying its ownership by selling off some of the shares of the corporation. The corporate form also facilitated eventual privatization, and provided an option for new hybrid ownership forms. In a sense, adoption of the Company Law signaled the intent of policy-makers to create a common legal framework in which any ownership form could operate, potentially creating a level playing field for competition. As a result of these changes, the distinct boundaries between ownership forms that are the basis of the classification shown in Table 13-1 began to blur after the mid-1990s. The adoption of the Company Law signaled the beginning of a new round of institutional change, the effects of which were felt only gradually (Lin and Zhu 2001). Indeed, they are still being worked out today.

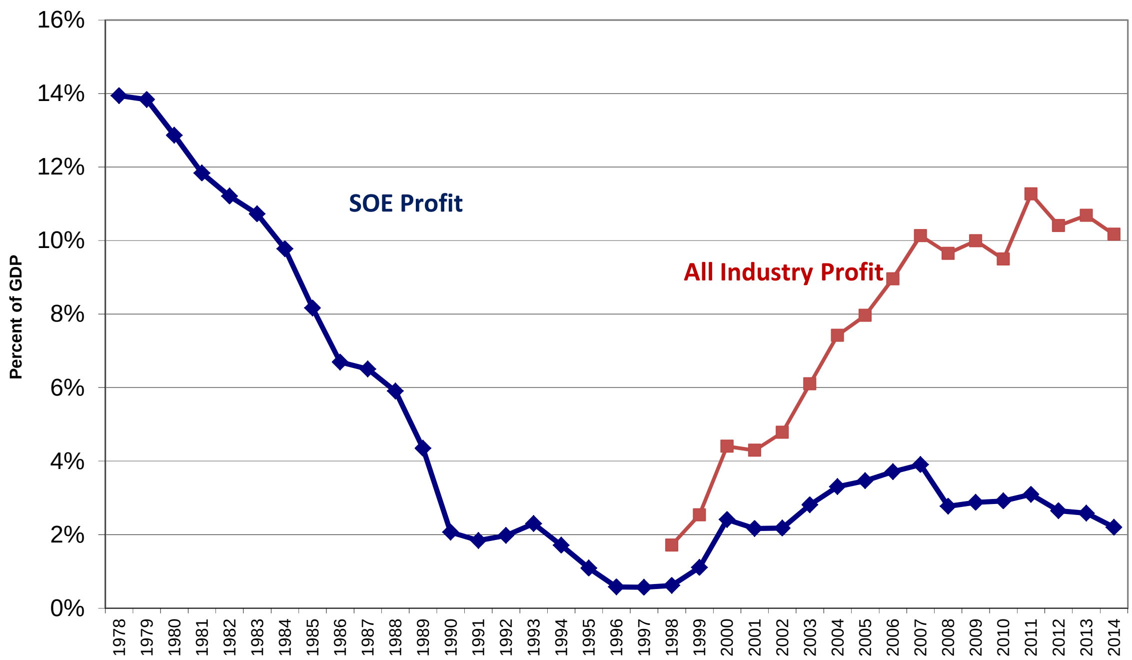
At first, the impact of gradual reorganization of SOEs was overshadowed by the massive down-sizing of the state sector that was described in Chapter 8. Tens of thousands of SOEs and urban collective firms were shut down, and millions of workers laid off. The changing ownership composition of industry was also shaped by a policy adopted at the 15th Communist Party Congress (September 1997) called "grasping the large, and letting the small go." In "grasping the large," policy-makers sought to focus their attention on the largest, typically centrally controlled firms; re-organize them into even larger and hopefully more competitive enterprise groups, and restructure and refinance them, while keeping them under state control. In "letting the small go," policy-makers were giving local governments much greater authority to restructure their own firms, and in particular, to privatize or close down some of them. Underlying the differentiation between central and local policies was the dramatically different ways the central and local state industrial sectors have evolved over the reform era. After twenty years of reform, the central government's control of industry has become increasingly concentrated on energy, natural resources and a few sectors with substantial economies of scale. These sectors were often protected by high barriers to entry, real or regulatory, and higher profitability, and the central government tried to keep control of these firms. By contrast, local governments in the 1990s still ran factories across the gamut of industrial sectors. As a consequence, local government-run factories were not only much smaller than those of the central government; they were also much more exposed to competitive pressures and consequently less profitable. In fact, in the mid-1990s, all the state-owned small-and-medium enterprises put together began to lose money. Local governments were motivated to get rid of loss making enterprises, and also confident that they could privatize firms in competitive sectors without many problems.

Complex forces of restructuring, competition, and privatization thus began to reshape Chinese industry after the mid-1990s. Starting in 1998, statisticians began to collect complete information only on "above scale" firms, that is, state-owned firms and non-state firms with an annual output value of more than 5 million *yuan* ($600,000)—shown in Figure 13.1. Small-scale industry is extremely important, but trends in the small-scale sector since the mid-1990s are not entirely clear. Up through 1998, small-scale, non-state industry—below the 5 million *yuan* cut-off—had grown very rapidly, and accounted for 43% of total output. (That is, the large scale firms shown in Figure 13.1 covered only 57% of total output in 1998). But surprisingly we do not have a good overall quantitative picture of restructuring and transformation in the small-scale sector. Privatization and might have been expected to increase the market share of small firms, but there was also a "shake out" of Chinese firms around the turn of the millennium. More intense market competition emerged after 1997 and deprived many small firms of the sheltered niches in which they were operating; and many small firms were shut down. TVE employment growth slowed dramatically around this time. These factors might have reversed the increasing market share of small firms that had been such a consistent feature of market transition up until 1996.

13.2 Industrial Finance

Under the planned economy, industrial finance was not a pressing issue. In the protected markets in which SOEs operated, margins were high and SOEs generated ample profits. These profits were transferred to the state budget, which ploughed them back into the firms as part of the Big Push industrial investments. Figure 13.2 shows that in 1978, at the beginning of reforms, SOE profits were huge, totaling 14% of GDP. Entry of new firms (especially TVEs) created increased competition and the excess profits of SOEs were gradually competed away. By 1996, profits were almost zero. At this point, policy-makers faced crisis: SOEs could no longer depend upon protected prices to generate surpluses, and there was little choice other than accelerating reforms. The down-sizing of SOEs, the layoffs and ending of lifetime employment in SOEs, described in Chapter 8, can be seen as an ultimately inescapable response to the impact of market competition on SOEs. Figure 13.2 also shows that SOE restructuring achieved some success after 2000. A smaller, revamped state sector, concentrated in fewer larger firms, was able to increase profits; and the state sector hooked into the booming economy in to push profits up to almost 4% of GDP by 2007.

Figure 13.2 Industrial Enterprise Profit



The decline in protected monopoly profits inevitably affected every aspect of industrial finance. As SOEs turned over less money to the government, so the government provided much less money to SOEs for investment. In 1978, the government budget funded 62% of all fixed investment in state-owned units, most of it going to industry. But budgetary grants declined to less than 3% of industrial investment by 1997. The decline in budgetary finance forced SOEs to exploit new sources of financing in order to maintain investment and growth. Increasingly, SOEs turned to the banking system. Banks had not financed long-term investment under the command economy. Banks only provided trade credit—short-term financing for inventories—and this primarily to the commercial sector. Policy-makers gradually shifted over to a heavy reliance on bank loans to finance the industrial sector, a decision that had important consequences economy-wide. It was consistent with the macroeconomic changes taking place during the reform period, as government saving declined while households rapidly increased their saving rates; and it was associated with a major change in the role of banks in the economy (Chapters 18 and 19). The opening up of bank financing for industry eased the transition process, but also contributed to later problems in the banking system with non-performing loans. Within the industrial sector, firms increasingly had recourse to indirect finance (loans from banks), displacing the earlier system of direct finance (funds from the owner, that is, from the government).

Bank lending to finance long term investment in the industrial sector began just when managers were first given incentives to increase enterprise profitability. This shift to bank lending was consistent with basic incentive principles: If SOEs had to repay their investments with interest, it was thought they would surely pay more attention to the profitability and risk of their investments than if they were investing non-repayable government grants. But in fact SOEs turned increasingly to bank credit without too much concern about their future ability to repay, and the indebtedness of SOEs steadily increased. One commonly-used measure of the relationship between firms and banks is the ratio of total bank debt to shareholder equity, or the debt-equity ratio (sometimes called a leverage ratio). Equity is the residual value of the firm after contractual obligations to repay banks (and other debt-holders) have been deducted. For China, we can calculate a debt-equity indicator by first approximating equity as the value of total assets minus total debt. It is thus an imputed ownership stake, approximating the state's interest in the firm.[1] Table 13-4 shows trends in Chinese industrial SOE debt/equity ratios, along with international comparisons. Under the command economy, the debt-equity ratio was of course very low, at 12%. "As the government gradually abandoned its direct financing of industrial activity through the budget," Holz (2003, p. 140) points out, "the ratio had nowhere to go but up." By 1994, the debt-equity ratio had climbed

[1] The equity figure calculated in this way is very close to the data on "shareholder net equity" which is provided for some years by Chinese statistical sources. The debt-equity ratio is also equal to the liability/asset ratio ÷ (1 - the liability/asset ratio). As Holz (2003) explains, these indicators can only give a rough basis for comparison over time and internationally, because assets are accounted for on a cost-minus-depreciation basis, rather than on a market valuation basis; and because the scope of accounting for assets has changed over time. SOE assets now include significant urban land-use rights, as well non-tangible assets such as trademarks and copyrights. See Holz for discussion.

steadily and reached a peak of 211%. Comparatively speaking, this is a high ratio, as Table 13-4 shows, similar to that of Japan or Thailand, economies which are well known for the predominant role banks play in financing industry. Although China's 1994 ratio was not as high as that of the highly leveraged Korean firms, the rapid sustained increase and the comparatively high level, in conjunction with low profits, were enough to alarm Chinese policy-makers. By the mid-1990s, Chinese firms had gone from being nearly debt-free to being among the more indebted firms in the world in less than twenty years. Bank credit was being used to keep non-viable "zombie" firms afloat. The steady increase in debt indicated that firms were still subject to soft budget constraints, and could rely on state-owned banks to provide credit as needed to keep them afloat. Combined with the trends displayed in Figure 13.2, the table shows the difficult state into which China's SOEs had fallen by the mid-1990s. With cash flow evaporating, and debt accumulating, China's SOEs were virtually insolvent (Lardy 1998). The Asian Financial Crisis, which erupted in 1997, hit especially hard those economies such as Korea and Thailand where corporations were vulnerable due to high leverage ratios and meager cash flow; by contrast Taiwan's smaller companies with relatively low leverage ratios were much more resilient. Thus, after 1997, China's policy-makers faced serious challenges and also powerful lessons from neighboring economies. Both these factors helped convinced the Chinese government to move beyond gradual marketization and step up the pace of industrial restructuring.

Table 13-4: Debt-Equity Ratios

China: State-Owned Industry, 1978	12%
China: State-Owned Industry, 1994	211%
China: State-Owned Industry, 1998	181%
China: State-Owned Industry, 2007	130%
China: State-Owned Industry, 2014	159%
Comparison Economies: 1988-1996 Average	
Korea	347%
Japan	230%
Thailand	201%
Indonesia	195%
Germany	151%
US	103%
Malaysia	91%
Taiwan	82%

Sources: China Statistical Yearbook and Abstract; after 1998 includes SOEs and state-controlled corporations; comparisons from Claessens, Djankov and Lang (1999), p. 9.

After the 1990s, SOE debt levels declined, stabilizing at around 130% over the 2004-7 period. The decline in debt-equity ratios reflects both some improvement in financial health, and a dramatic write-off of non-performing bank loans. It is not possible to entirely disentangle the two causes. On the one hand, banks tightened their lending standards and began to behave more like commercial banks after the mid-1990s. This shift in bank behavior came during a period of macroeconomic austerity, and coincided with the government's new willingness to let non-viable firms fail. As a result, many of the most highly indebted firms simply closed up during the mid-1990s, forcing banks to write off large amounts of unpaid debt. The government injected billions into the banking system to allow banks to write off bad loans and restructure debt for existing firms thought to be still viable. As part of restructuring, additional debt was sold back to the government by the banks, and converted into new equity. In several rounds of recapitalization, the government injected a sum equal to at least 30% of GDP into the banks, allowing them to write off bad loans (Chapter 19). Obviously, this produced a substantial reduction in the leverage ratio of state-owned industry.

On the other hand, state-owned industry's financial position has improved, in part because of the reduced interest burden in the wake of mass loan write-offs; and in part because the worst performing firms have been jettisoned. The large, centrally controlled state firms have regained profitability, in part due to their protected market positions. Debt-equity ratios in Chinese state-run industry are no longer unusually high. However, since the Global Financial Crisis, Chinese SOE debt levels have climbed again, and averaged 159% in 2014. They are roughly equal to those in an economy such as Germany, where the bank role is very important. Debt-equity ratios are significantly higher than those in Taiwan, or in the US. More importantly, most new finance of firms continues to be from banks, rather than through capital markets. Debt levels this high (or higher) are typically associated with a financial system in which banks play a dominant role, and are in a strong position vis-à-vis their industrial clients. As Chapter 19 discusses, until recently more than 80% of enterprise funds years have come from banks, with a small role for net fund-raising from the stock market. Corporate bonds only began to be important after 2010. Thus, substantial reliance on bank credit continues to be an important characteristic of Chinese industrial SOEs, and access to bank credit is an important determinant of a firm's ability to invest (or survive), and banks have large claims on the industrial sector.

The ability of banks to enforce their claims against state-owned enterprises is, however, somewhat murky. During the crisis years of 2008-9, banks were under enormous pressure to lend to state firms: in other words, budget constraints were softened during those years. One of the challenges of corporate governance reform in China is to regulate the competing claims of banks and equity holders in industry. After all, one of the most basic requirements of a sound system of corporate governance is that it provides some assurance to those who provide finance to an enterprise that they will receive a return on their investment.

13.3 Transforming Corporate Governance in the State Sector.

A vast distance separates the enterprise under the planned economy from the modern, market-oriented corporation. Under the planned economy, what was called the "enterprise" was really a constituent part of a vast bureaucracy. The enterprise was like a branch plant of the single vast undertaking that was Socialism, Incorporated. It did not possess any of the strategic planning, marketing, logistics, or personnel capabilities that we associate with a market business. But in addition to production, the socialist enterprise also served as a multi-functional social unit, the *danwei* (Chapter 5). In theory, the enterprise was owned by "the public," and in practice the government, and its hierarchically organized bureaucracy, exercised all of the real powers of ownership. The government took all the enterprise's profit and made up its losses. Managers were kept busy fulfilling myriad different commands and tasks assigned by planners, in the name of the public, and were effectively hemmed in by a web of overlapping controls and restrictions. But none of the disciplines under which managers labored motivated them adequately to increase firm productivity or profitability. To transform a socialist enterprise into a profit-oriented company required change in multiple dimensions. At a minimum, the enterprise needed to change its organizational form ; its objective function (the performance for which a manager is rewarded); the prices or signals to which it responds; and it needs to face a "hard budget constraint," that is, it needs to be responsible for its own financial performance and debts. A schematic version of these elements with respect to state enterprises is shown in Table 13-5.

Table 13-5: Industrial Enterprise Transition: Elements of Analysis

	Pure Plan	Transition A 1979-1993	Transition B 1996-current	Pure Market
Organizational Form	Element of Hierarchical Bureaucracy	"Incentivized" Bureaucratic Element	Re-organized into Corporations	Multi-form, Strategic Corporations
Managerial Objective	Plan Fulfillment Interests of *danwei* (Work Unit)	Profit by Contract Interests of *danwei* (Work Unit)	Profit, but with Qualifications	Profit; Discounted Present Value of Future Profit Stream
Price system	Planned Prices	Dual Track Prices	Market Prices, with Government Intervention	Market Prices, with Regulation
Budget Constraints	Soft	Soft	Hard, but with Qualifications	Hard

In the different transition economies, there have been two basic approaches to achieving this multi-dimensional transformation. The approach followed in Russia and many of the Eastern Europe economies was to break down as quickly as possible the hierarchical relationship in which enterprises were embedded. By stressing privatization, reformers advocated a quick complete rupture with the hierarchy, and a rapid conversion of ownership. Reformers accepted that price reform was a pre-requisite for ownership reform, but as soon as prices could be liberalized, they advocated a rapid move to privatization. In this way, they hoped to set enterprises free from their bureaucratic supervisors quickly. Deprived of bureaucratic sponsors, firms would soon face hard budget constraints, and the new owners could be relied on restructure the organizational forms and managerial objectives through their own self-interest. That, anyway, was the theory: rapid privatization could be the driving force of realignment in all the elements of enterprise management. The Chinese approach in the initial phase of enterprise reform was nearly the opposite: it sought to make use of the hierarchical relationship in which enterprises were embedded, remaking incentives and organization, while simultaneously creating “dual track” market prices. Reformers sought to make managers, as agents of the government, devote greater effort to improving enterprise productivity and profitability. They launched the package of incremental changes shown as Transition A: 1979-1993 in Table 13-5. (See Chapter 4).

In this first stage, the organizational form of the enterprise was only slightly altered, and the enterprise remained tied to the bureaucracy. Reformers were reluctant to disrupt the work unit that wrapped industrial workers in a cocoon of stability. Instead, reformers experimented with a variety of incentive devices, strongly increasing the rewards given to managers, and tying incentives closely to profitability. Some of these incentive devices mimicked those that had succeeded in the agricultural sector: successful experiments from the rural sector were brought into the core of the planned economy, state-run industry. There was also a progression from "low powered" to "higher powered" incentives through the 1980s. At first, profit incentives simply consisted of modest bonus and investment funds, which were inevitably a small percentage share of total enterprise profit. This meant that the *marginal* share of profit retained by the firm was small. This approach was accompanied by the so-called "dual track" pricing system. Firms, including SOEs, were allowed to buy and sell at market prices, once they had fulfilled their plan responsibilities. Since the size of a typical firm's plan production was fixed, even SOEs faced market prices at the margin (Byrd 1991). With market prices and high-powered incentives at the margin, managers were motivated to expand market-oriented activity. The result was that an increasing share of transactions took place on the market. Gradually, the industrial economy grew into the market, and grew out of the plan. The "incentivization" approach helped to dismantle the bureaucratic economy and reorient firms to respond to market competition.

In the mid-1990s, a new program of enterprise reform was launched. The centerpiece of the new program was corporatization, but it gained in importance because it signaled a willingness on the part of the Chinese government to move ahead in many different areas simultaneously, which together set the stage for significant reform movement. Most important, Chinese reformers significantly hardened the budget constraints faced by enterprises. Chronic loss-making "zombie" enterprises were finally closed down or sold off on a large scale. The total number of industrial SOEs dropped from 120,000 in the mid-1990s to only 34,000 by 2003, including all state-controlled corporations. Some of the worst shuttered firms had been idle for years, and simply needed to be put out of their misery. Reformers were now prepared to begin peeling off the multiple non-core functions that the urban work unit had taken on. After 1999, enterprises began rapidly privatizing their housing, transferring work unit apartments to individual ownership. Similar programs advanced with respect to schools and clinics. None of these programs were 100% successful, but together they provided a set of institutional alternatives to the *danwei* system, and allowed enterprise reforms to go forward. These crucial changes allowed the downsizing of SOEs to take place at a political cost the regime judged to be acceptable. The overall institutional environment shifted, bringing together elements to form a distinct reform strategy, listed as Transition

B in Table 13-5. The reform initiatives were inter-related, such that progress in each gained from complementarities with the other main initiatives.

13.4 Corporatization and the Company Law

The foundation of the policy of "Corporatization" was the Chinese Company Law, part of the burst of reform measures in 1993-1994. We noted above the importance of the Company Law in providing a vehicle for the diversification of ownership, including partial or complete privatization, and the creation of legal level playing field. Here we stress the other important function of the Company Law, which was to improve governance in state-owned enterprises. Under the Company Law, individual SOEs were to re-organize into corporations gradually, one-by-one. As Clarke (2003) explains, traditional state-owned enterprises (TSOEs) would essentially disappear as each was converted either into a joint-stock corporation (JSC) or a simpler limited liability company (LLC), intended for a smaller and more closely-knit group of owners.[2] From the standpoint of state ownership, corporatization under the Company Law was designed to continue the trend of giving managers more authority, but also establish a better system of oversight to ensure that managers pursue the same interests as their government owners.

13.4.1 Objectives and Principles

Effective corporate governance aligns the interests of a firm's management with its owners. The crucial institution is the firm's Board of Directors which the Company Law specifies is the supreme authority in the corporation. The state appoints the members of the Board in its capacity as a shareholder in the firm. The Board of Directors then gives direction, oversees, and hires and fires managers. In this way, the state is to exercise its ownership rights by redefining its role as a pure shareholder. In principle, these organizational changes should produce three inter-related advantages:

- Autonomy. It gives the firm greater autonomy within a clear legal framework, since the firm's managers are now accountable to the Board of Directors, and only to the Board of Directors. The manager should no longer be obliged to take orders from multiple government agencies, or adapt their organization to the bureaucracy's organization. Instead, government interests and objectives are supposed to be transmitted to the corporation through the Board of Directors appointed by government agencies and any other owners.

[2] A special type of LLC was even provided for firms 100% owned by a single government agency.

- Profit Maximization. If more than one party—including multiple government parties—shares ownership, the interests of the various parties are reduced to a common denominator, equity, and the new shareholders have only one way to voice their interests, shareholder voting. The shareholders now share a common interest—distributable profits—which encourages the owners to focus on the single target of profitability (Clarke 2003).
- Encouraging specialized government oversight. Some of the biggest problems with public ownership come from the lack of a specialized "ownership agency" designed to aggressively advocate the public interest. The firm is monitored by one or many agents of the state, but these have ill-defined and sometimes conflicting missions. No one of these agents really has strong incentives to press the firm to achieve higher levels of efficiency, since none has a direct interest in profitability. Monitors may be negligent, or captured by the interests they are supposed to monitor. Corporatization does not directly resolve this problem, but by clearly specifying ownership rights and responsibilities, and linking this with the appointment power to the Board of Directors, the corporate form encourages the designation of an attentive government monitor with a strong derived interest in profitability.

How have these objectives been achieved in practice?

13.4.2 SASAC and its Agenda

A milestone in the evolution of corporate governance in China was the creation of SASAC in early 2003. SASAC was established as an authoritative "ownership agency," empowered to exercise the government's ownership rights over government firms. SASAC's establishment marked the end of a period of creative destruction, in which the main thrust of state enterprise reform had been the disruption of protected bureaucratic relationships and the dramatic down-sizing of the state sector. Immediately before SASAC was established, central government state firms had been operating without a real owner for almost five years, since Premier Zhu Rongji had abolished most of the industrial ministries in 1998. State firms simply carried on as before, embedded in a web of interests and traditional bureaucratic relationships, with weak accounting-style oversight exercised by an impotent "State Assets Management Bureau." The creation of SASAC as an ownership agency with clear powers was part of an effort to enable more systematic restructuring within the state sector.

Upon creation, SASAC was given ownership of a specified list of 196 corporations. Crucially, this meant that central SASAC had no ownership claim on the thousands of other state-owned companies (or on any banks or other financial companies.) For the first time, the vast majority of state firms were henceforth fully "owned" by local governments (which gradually set up their own "local SASACs"). The localities had, of course, been managing them in the state's name for decades, but the unambiguous grant of ownership rights meant that local governments now had greater freedom to restructure and privatize firms, and transform their industrial sectors without being paralyzed by conflicting national and local interests and policies. Meanwhile, government ownership of banks and other financial institutions was gradually consolidated under a different new agency, the Huijin Corporation. SASAC's clarified ownership over some state firms was designed to allow the restructuring and privatization of other smaller, local firms to be carried out more smoothly and rapidly.

Reflecting its origins in the predominantly reformist administration of Premier Zhu Rongji, central SASAC began life with an ambitious two-stranded agenda: First, dramatically improve corporate governance; and second restructure state-owned firms so that they were concentrated in sectors in which they had some comparative advantage and there was an economic justification for continued state ownership. While the overall state sector shrank and then stabilized, SASAC's firms grew steadily. The *number* of central SASAC firms declined slowly but steadily, to only 110 by 2015. However, these firms grew bigger, and central SASAC grew both in the number of workers and the total value of assets. Workers in central SASAC-controlled industrial firms grew from 5.9 million in 2002 to 7.9 million in 2012 (including all sectors, workers in SASAC controlled firms grew from 8.6 million to 12.7 million). The capital in central SASAC industrial firms grew to 14 trillion RMB, two-thirds of all state-owned industrial capital. (SASAC Yearbook 2013). China's state sector has stabilized, but also become increasingly centralized, and SASAC has been a prime instrument in this centralization, particularly in industry.

The profitability of SASAC firms rebounded strongly after SASAC was set up. Back in the late 1990s, the entire state industrial enterprise sector had in aggregate virtually no profits: after losses of loss-making enterprises were deducted from profits, net profit was only 0.6% of GDP (Figure 13.2). State enterprise profitability has recovered significantly since that time: most loss-making firms were shut down; surviving firms shed millions of redundant workers; and firm management improved significantly. State industry today is smaller than it was in the 1990s, but much more profitable. SASAC firms have been an important part of this transformation. Most SASAC firms are industrial, but they also include telecom and construction firms that are important contributors to overall profits. SASAC firm profits quadrupled from 2002 to just shy of one trillion RMB in 2007, increasing from 2% of GDP in 2002 to 3.8% of GDP, as shown in Figure 3.2. (For comparison, ExxonMobil's record $40.6 billion profit in 2007 was equal to 0.2% of U.S. GDP). With substantial sums of money at their disposal, SASAC firms have financial clout that reinforces their economic importance. Indeed, the wealth of these large firms became a public issue in China in the wake of the publication of the eye-watering 2007 figures. In any event, the arrival of the global financial crisis a few months later dealt a major blow to SASAC firm profitability. After 2009, profits recovered, but never to the level they reached in 2007. This decline in SASAC firm profitability is a complex phenomenon that has not been properly studied. On the one hand, state firms faced an increasingly challenging market environment as China's growth slowed and the miracle growth phase ended. On the other hand, SASAC firms may have subtly de-emphasized profitability: with excess borrowing during the financial crisis (to maintain stability) and increased emphasis on technology and innovation (see Chapter 15), policy-makers sent SASAC firm CEOs a subtle but unmistakable message that profits weren't the only thing in the world.

SASAC firm profitability is highly concentrated. Every year, about half of SASAC profits are produced by four firms: the three big oil companies and China Mobile (the dominant mobile phone provider). In 2006, nine firms contributed 69% of total SASAC profits. In subsequent years, the top ten firms typically accounted for about two-thirds of profits. While the name list changes from year to year as natural resource prices and government policies fluctuate, it typically includes, besides the oil companies, the giant central government coal conglomerate Shenhua Coal; China Aluminum ("Chinalco"); and the State [Electrical] Grid. These resource and energy companies operate in protected markets that keep profit margins fat. They are also highly sensitive to government regulatory and price policy. A key feature of China's state firm strategy coming out of the 1990s was the creation of protected markets with limited competition. They are not, strictly speaking, monopolies, of course but rather tightly controlled oligopolies.

A focus on the biggest SASAC enterprises is certainly justified, but it could also be misleading. Most of the big enterprises directly under SASAC are in fact umbrella organizations that own and run many subsidiary companies. Figure 3.3 provides an overall view of the state enterprise sector in 2008, which permits both a broader and a more precise picture. By the end of 2008, the top SASAC firms had been reduced to 142, after several rounds of consolidation. But the total number of companies subordinate to SASAC was a remarkable 17,638. The average top level SASAC firm—which probably evolved from a former ministry—had more than 120 subsidiaries, sometimes organized in two or three layers of companies. It is useful to think of the central state sector as a gigantic pyramid. The pyramid is being transformed by a long and drawn-out process of change. The former bureaucratic edifice has not been completely dismantled, but it now more closely resembles a network of businesses. The largest firms sit at the top of the economy, with their near-monopolies giving them a privileged position. Presiding over the top of the pyramid, SASAC has advanced a vision in which the public sector would be gradually transformed into a system where all firms are converted into joint stock companies, managed efficiently, and controlled by their owner through capital market operations, much as a sovereign wealth fund manages its investments. At the bottom of the pyramid, many of the best enterprises have been thoroughly restructured into market-oriented corporations, and quite a few thrive in the face of vigorous competition. However, the transformation process still has much to accomplish in the least-reformed "middle layer." In this middle layer, a tangle of competing interests mixes bureaucratic recalcitrance, agency loss, lack of transparency, and stubborn problems that have been swept under the rug. SASAC seeks to gain and retain control over this realm, and also to rationalize and modernize its holdings in accordance with a modern economy.

13.4.3 The Slow Progress of Corporatization

Notwithstanding the central importance of corporatization—and the urgency of the reform challenge—the actual conversion of enterprises into corporations has been an astonishingly long and drawn-out process. Once the legal framework provided by the Company Law was in place (in 1994), the actual pace of reorganization was decided by the supervisory departments of the traditional SOEs. Transformation of enterprises on a case-by-case basis was inevitably a long, drawn-out process. Up until 2002 (the year before SASAC), only 30.4% of the firms that came under SASAC's control had been reorganized under the Company Law, after eight years of efforts. SASAC was therefore keen to accelerate the pace of corporatization. However, by the end of 2008, this share had increased to 64.2%, which is a significant increase, but not much of an acceleration. Thus, fourteen years after the adoption of the Company Law, a third of SASAC's firms have still not been converted (Ji Xiaonan 2010). Even this overstates progress because, after all, the largest firms, the holding companies at the top of the pyramid are the most important firms. Less than half of these have been converted into corporations under the company law, so the majority is still traditional state-owned enterprises with "managerial responsibility systems" (SASAC Yearbook 2009: 57-58).

Why has this process been so slow? Some enterprises possess extremely valuable assets. This creates a completely different set of incentives: there may be a struggle for control, or bureaucrats may seek ways to corporatize rapidly, especially if that enables them to list a joint stock corporation on the stock exchange, which can raise money quickly. The most striking examples of this process were China's petroleum companies. In 1998, three existing oil companies were restructured into partially competing potentially integrated oil companies: Sinopec, CNPC (Petrochina) and China National Overseas Oil Corporation (CNOOC). Each firm packaged its highest quality assets into a fully corporatized subsidiary, and between April 2000 and February 2001, listed them on the New York and Hong Kong Stock Exchanges. Sinopec sold a minority stake for $3.5 billion, with BP, ExxonMobil and Shell taking significant stakes in each of the companies. Domestic listings followed later: But it was not easy to list only the valuable assets. To make the new listed companies attractive, severe over-staffing had to be addressed. Some 360,000 workers were laid off from CNPC by 2000, creating unrest and violent demonstrations in Daqing and other parts of northeast China (Zhang 2005; Downs 2008). Lay-offs were only part of the story. Government ministries carved out the attractive productive assets and stripped them of their burdensome liabilities (social services and bank debt). This ensured that listings were successful, but virtually all listed SOEs left behind significant employees and assets, often low-quality, in a non-listed parent firm. Steinfeld (1998) described how this process worked for the Ma'anshan Steel Company. In the petroleum industry, virtually all the valuable oil and gas producing and refining properties were put in the listed vehicles, while most of the money-losing services and welfare firms were put into "successor" (cunxu) or "left behind" firms. For example, after CNOOC (the China National Offshore Oil Corporation) was listed, it had 1,000 employees in its listed firm, but 16,000 employees in left behind firms. The former was highly profitable, and the dividends were used to offset the significant losses of the left-behind firms.

SASAC's response has been to try to restructure the top-tier firms into higher quality corporations with two attributes: they would be "100% listed" (that is, all of their assets would be incorporated into the listed company) and they should have functioning boards of directors with outside, independent directors. Unfortunately, progress on this ambitious agenda has been slow. As of the end of 2008, only some 20 SASAC firms could be considered to be "100% listed," even by a loose definition, and 24 SASAC firms were carrying out "experiments" in which independent Directors make up half or more of the Board of Directors (Ji Xiaonan 2010). This shows SASAC's intent, but also the difficulties and delays it has experienced in carrying out its agenda. Nearly everyone agrees that these large state firms are much better managed than in the past. But progress has been limited in setting up structures of authority within the firm that guarantee independence and transparency.

13.4.4 Restructuring the State Sector

In addition to transforming corporate governance, SASAC has sought to drive a restructuring of central government assets. From the beginning, their approach has been dynamic and flexible, and they have held to the idea that state ownership could expand in some areas, while it should retreat in others. The existence of a minimum level of competition is a pre-requisite for everything else. I focus here on three consistent principles that have guided SASAC's actions, and which are especially prominent in the words of Li Rongrong, the head of SASAC from its creation in 2003 until his retirement in 2010:

(a) Sectoral Concentration: SASAC has consistently held that its job is not to reduce state ownership per se, but rather to optimize the value of state assets by making them more fluid and concentrating value in sectors where there is some rationale for public ownership. In practice, this means sectors with national security, natural resource or natural monopoly characteristics. In 2005, SASAC head Li Rongrong specified that this meant “full control” in seven sectors: military industry, electricity, oil, telecommunications, coal, civil aviation and transport. In these sectors, government capital should increase and be optimized, while key enterprises should be developed to become internationally competitive firms. In nine other sectors—including steel, electronics, machine-building, and autos—the center should maintain control over a number of technologically advanced keypoint enterprises.

(b) Market Leadership: Taking a page from the playbook of Jack Welch, legendary CEO of General Electric, Li Rongrong has repeatedly declared that central SASAC’s firms should be number 1, 2, or 3 in their main business, or should be shut down. This means a consistent focus on “core business” and a sustained attempt to get SASAC firms to pull out of, or spin off, their “non-core” enterprises. As SASAC consolidates firms, Li Rongrong repeatedly insisted that by 2010, the number of central SASAC firms should shrink to 80-100 total firms (and certainly less than 100). As part of this, the ground should be cleared for the emergence of 30 to 50 globally competitive firms. Good firms should grow and only the strong firms should survive.

(c) Restructuring via Capital Markets: SASAC declares, in effect, that it should pay its own way. Purely administrative reshuffling should not be used to restructure the state sector, since now “ownership” has been clearly defined and should be respected. As owner, SASAC can, of course, still tell state firms what to do. However, restructuring should be carried out through capital markets to acquire and sell assets. In order to do this, SASAC needs financing, and SASAC embarked on a long campaign--eventually successful--for a “Capital Asset Management Fund” to finance the restructuring process.

Based on these principles, SASAC has continuously tried to remake the state sectors in the years since its creation.

As is the case with respect to corporate governance, progress in restructuring has been uneven. One of Li Rongrong’s most cherished goals, the consolidation of SASAC firms into 100 or fewer firms by the end of 2010, was not achieved. The target was abandoned about the time Li Rongrong retired, and there were still 122 top-level SASAC firms as of the end of 2010 (SASAC 2010). Central firms to continue to sprawl into most parts of the economy. By one standard Chinese classification, there are 99 total economic sectors. Of these 99, the top level SASAC firms are represented in 41, but their first level subsidiaries are represented in 81, and the next level subsidiaries in 87, sectors (Ji

Xiaonan 2010). Clearly, state firms are having some difficulty "withdrawing" from some of the sectors they ought to be vacating.

13.4.5 Limitations on SASAC's Authority

The achievements of state sector reform should not obscure its limitations. In three important respects, progress has been much less than would be desired. First, reform and transparency have progressed relatively slowly in the "middle layer" of firms in between the "top" (SASAC) and the "bottom" (especially firms listed on the stock markets). This middle layer is extremely complex, characterized by diverse organizations that run the gamut from worthless shell companies to rich and powerful conglomerates. SASAC presides over not so much a portfolio of enterprises as a grab-bag of semi-bureaucratic intermediate agencies. In China's stock market today, most listed companies have parent firms that are also state-owned firms. Those parent firms, typically labeled something like group companies (jituan gongsi), or investment companies (touzi gongsi), are much less transparent than are the listed companies. These parent firms do harvest profits from their subsidiaries. Dividends are paid up to this middle layer, which currently has the authority to control and reinvest these funds. This creates an enormous scope for non-transparent related-party transactions between parent and subsidiary, which are linked by multiple ties and numerous types of business transactions. The resulting lack of transparency has been an enormous drag on the Chinese stock market for years. Indeed, some of these corporate parents are utterly dependent upon their listed subsidiaries to pay their bills (including paying interest on debt assumed from the subsidiary).

However, these middle level firms are not necessarily poor and economically dependent. Quite the contrary, since the middle level firm still controls both the profitable and non-profitable firms, the middle level firms often operate with enormous discretion. Since these firms were carved out of the ministries, they can rely on strong networks of cooperating bureaucrats and officials, and they are not very transparent. Particularly following the revival of state sector profitability, some of these organizations are extremely rich and powerful. The state companies under central SASAC's purview include, for example, the State Electricity Grid and the big Electricity Companies, some of the biggest and least transparent companies in China, and military-linked companies like Baoli and the Nuclear Industry Corporation. These companies have long standing links to top Communist Party officials, in some cases specific families. They have power as well as money. This middle layer of the state economy is the least transparent and least reformed part of the state economy.

Understanding the middle layer of the state economy helps to reveal the other limitations on SASAC's role. Ironically, despite the fact that SASAC is a modern "ownership agency," it does not fully dispose of the two most salient characteristics of ownership. Until very recently, SASAC has had no direct control over the stream of net income—the profits—that SASAC firms earn. In terms of the pyramid we described earlier, profits move upward but only up to the "middle layer," where they are quarantined by the parent companies. Only in recent years has SASAC been able to collect a proportion of profits as government "dividends."

The third limitation on restructuring is the fact that SASAC does not directly appoint the most important managers of the companies it "owns." To be sure, SASAC is supposed to possess appointment power, since that is the means through which its control of state assets ought in theory to be realized. But the reality of a Communist Party system is that the Party makes the ultimate decision about all key personnel matters (Chan 2009). Central SASAC shares appointment power with the highest organs of the Communist Party. Unusually, specific details of the arrangements have been openly published: for the 53 largest SASAC enterprises, the top manager and chairman of the Board are appointed directly by the Communist Central Committee Organization Bureau (Communist Party of China 2003). These positions are simply too important, as patronage posts and controllers of resources, to slip out of the hands of the Party. Typically, the head of these firms has ministerial rank in the Chinese system, which is prized. As a result, true SASAC personnel power begins with the smaller firms and at the vice-manager level for the largest firms.

The Communist Party uses its control over the personnel process to reinforce or pre-empt the emergent institutions of corporate governance. Virtually all of the state-owned enterprises have a government controlling share greater than 51% of the total equity outstanding. This means that in appointments to the Board of Directors, the traditional (i.e., Communist Party-run) personnel appointment procedures are not really controversial. The challenge will be to take this system one step further toward truly diversified ownership. SASAC achieved a great deal in its first few years of operation, but it's reform agenda seemed to run out of steam after a few years. Whether it can be rejuvenated depends on the re-vitalized reform program that emerged out of the November 2013 Third Plenum (see below).

13.5 Typology of Corporate Governance Systems

In order to understand Chinese progress and challenges, it is useful to review the main systems of corporate governance in use worldwide. How are managers motivated and overseen in other systems, when the owners themselves are not directly engaged in managing? Large corporations have long since institutionalized a substantial separation between ownership and managerial control. The two main methods through which managers' incentives are brought in line with the objectives of the owners, often classified into two systems, are discussed in this section.

The first method through which oversight of managers is exercised can be called "market based." Primary reliance is placed on the stock market to implement effective corporate governance in what is also sometimes called the "Anglo-American" system. In the US and UK, share-holders are widely dispersed, and do not generally have insider information about the individual company. As a result, these systems have relatively strong requirements for disclosure of public information, and relatively strong emphasis on the protection of minority shareholders in law and regulation. The system exercises oversight over managers because the Board of Directors has unambiguous power to appoint and remove managers, and shareholders have clear authority over the Board of Directors. Dissatisfied "owners" exit the company by selling their shares, so share price is a sensitive indicator of performance, and low share price often leads to a replacement of management. In the extreme, low share prices may lead to a hostile takeover and the replacement of managers by a new group of investors. In this system, managers may also be share-holders, or earn options to buy shares, further aligning managerial interests with owners' interests.[3]

The second main method of oversight might be called "control based." In practice, banks or founding families typically monitor managerial performance. This system is sometimes called the "Continental" or "Japanese" system, because in continental European and Japanese economies, banks play a much more important role in monitoring corporate behavior. In this system, oversight exercised by groups that have access to insider information about the firm, either through the banking relationship, or through supplier and customer relationships. The system accommodates the interests of a wider range of stakeholder groups than does the Anglo-American system. For example, worker interests are represented in the German Supervisory Boards, and *keiretsu* (related company business group) interests have a voice in Japanese corporate decision-making: some of these interests are "insiders." The strength of this system may be its ability to accommodate the interests of many stake-holders in the elaboration of a long-run development program; the weakness is that the system may result in a lack of responsiveness and long delays in changing business strategy. Because of large strategic share-holdings by banks and related companies, ownership and control usually cannot be contested: hostile takeovers are extremely rare. Oversight is exercised by the bank and other related parties watching over the shoulders of managers. As long as management is effective and honest, there is little interference; if banks see problems begin to develop,

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[3] An additional strength of this system is that it has evolved to support complex chains of agency relationships. Intermediate institutions, such as pension funds and mutual funds, now hold the majority of shares, and because of their large stakes, they monitor managers carefully. The system continues to work fairly well because most actors share a common focus on profit and stock market value.

based on their inside information, they step up their interference and may even, in the extreme, replace management groups.

Chinese state ownership may at first seem like a variant of a control based system. Certainly the state exercises oversight while also accommodating a range of state-holders. As Table 13-4 showed, China since the 1990s has had a relatively large reliance on banks as providers of capital, and the important banks are all state-run. In most cases, state control of important firms listed on stock markets is not contestable. But there are important differences. In most bank-centered systems, banks are privately owned and traditionally independent (Korea, however, is an exception). Banks are powerful actors who vigorously enforce their interests. In China, however, the legal system provides banks very few ways to enforce their interests: for example, they have low priority in repayment in the case of bankruptcy. Banks are not allowed to own stock directly. And most important, because of their long tradition of state-ownership, banks have neither the capability nor a clear to aggressively monitor enterprise performance. In China, although the pattern of financing reveals the importance of banks, the system of corporate governance has no corresponding role for bank oversight. This then returns us to the fundamental question: what institution is capable of exercising the oversight over managers needed to protect the public interest?

Discretionary Authority of Managers: Lack of Constraints

The factors discussed in the preceding sections lead to a serious lack of oversight of managerial discretion. Capital markets do not demand sufficient accountability to exercise sufficient restraint on managerial decision-making. Neither of the two systems of corporate governance described above is really effective in China. Stock market listings have been achieved for a large number of the biggest firms (1,377 at the end of 2004), but they serve a very weak disciplinary role. In the majority of cases (79%), the listed firm has a parent company, and that parent generally has a controlling stake that cannot be challenged (Bai *et al* 2004). Because of the low contestability of control of most state-owned firms, the stock market cannot effectively discipline managers. But banks are also unable to effectively discipline managers because Chinese banks are weak in experience and legal standing, and are rarely able to intervene in company decisions.

In theory, the government directly monitors managers through its control of the Board of Directors. But this instrument is blunted by the lack of consensus about state goals. While the creation of SASAC, and its centralization of some aspects of ownership authority are important steps forward, the project is still plagued with multiple objectives within SASAC, and division of authority over personnel between the Communist Party and SASAC. The extraordinary authority of managers emerges from the analysis above, and is evident in many phenomena in China. However, one of the most persuasive pieces of evidence is the testimony of the managers themselves. The Shanghai Stock Exchange polled managers of listed firms and asked them to identify the most important internal and external constraints on their authority. The answers are shown in Table 13-6. Only 29% of managers choose the Board of Directors as their most important internal constraint, and remarkably, the second most internal constraint, named by 25.8% of respondents, was "self-restraint," meaning that they perceive no significant internal restraints on their decision-making at all. Another 20% of respondents identified the Annual General Meeting as their most important internal restraint, a factor that is unlikely to wield much influence over managers during most of the year. The answers to external constraints were even more overwhelming: only product markets exercise a significant disciplinary influence over managers. By their own testimony, Chinese enterprise managers have achieved extraordinary discretion and autonomy.

Of course, this autonomy is not absolute. Managers must negotiate their authority with their controlling share-holders (Lee and Hahn 2004). As Tenev and Zhang (2002) point out, the boundaries between listed firms and their parent companies are new and arbitrary. Controlling shareholders sometimes exploit their firms for their own benefit, to the disadvantage of other shareholders. For example, they may borrow money on soft terms, use listed firms as guarantors for their borrowing, or buy and sell goods and assets at unfair prices. Conversely, listed firms sometimes rely on their parents for assistance. At the same time, managers serve at the pleasure of the Communist Party. The Party has the ability to remove, transfer or promote managers, and managers are expected to follow Party instructions. This is the main limitation on managerial identification with a specific enterprise (even though the Party rarely dislodges apparently successful managers), and constitutes one of the main arguments for continued Party supervision. But blurred authority is not an effective substitute for clear accountability. In fact, Bai *et al* (2004) found that stock market valuations were lower as firms controlling shareholders had a larger stake, and valuations higher when other shareholders had more concentrated stakes. They interpret this to mean that potential competition for corporate control had a positive influence on valuation. In a related fashion, Chang and Wong (2004) found that the rates of return of listed firms were negatively related to the influence exercised by the local Communist Party committee in the firm. In both these studies, the increased costs of closer surveillance outweighed the gains from reducing excess managerial authority.

Managerial Abuse: Asset Stripping and Related Party Transactions

The extremely broad scope of managerial discretion inevitably leads to abuses in some cases. Although the penalties for corruption are severe, the overall institutional environment makes corruption relatively difficult to detect and punish, unless it is particularly overt. Managers have wide discretion to establish subsidiaries and joint ventures. The scope for related-party transactions is wide. It is relatively easy to sell public resources for a price slightly under the true market price to a related party. It is relatively easy to set up a subsidiary, staffed by family members, that receives preference from the public enterprise in a range of business activities. Such activities are believed to be prevalent in China, but there are no good data. This does not mean that China is unusually corrupt. In fact, the Corruption Perception Index for 2004, published by the anti-corruption watchdog group Transparency International, places China right in the middle of the countries surveyed (71st out of 146 countries). By this standard, China perhaps displays slightly less individual corruption than would be expected given its per capita income (perceptions of corruption decline as per capita GDP increases). The challenge to corporate governance in China is less individual corruption, and more the danger that large and inter-connected groups of insiders will divert resources from the broader public interest to their collective and institutional interest. Thus far, institutions like the stock market may have improved the situation, but have not yet brought transparency and external oversight fully into the state corporate sector.

13.6 The New Round of Reform: Conclusion

Enterprise reform is arguably the central problem in the entire transition process. The Third Plenum of 2013 placed state enterprise reform squarely in the center of its broad reform agenda. The reform document advanced a new vocabulary, but in many respects the reforms it was calling for were a restatement of the principles that were adopted in the late 1990s and which were expected to be carried out by the newly-formed SASAC. In a sense, then, the reform renewal of 2013 is also a recognition that the state enterprise reform program stalled out after the mid-2000s, and needed to be reinvigorated. However, as of this writing, it is still extremely unclear how thoroughly the restated principles will be implemented, and how much additional momentum will be given to state ownership reform.

It is clear that the new reform agenda envisions the Chinese state remaining a large wealth-holder. There is nothing in the document on privatization and no indication that the Chinese government would relinquish a substantial ownership stake in productive assets. However, the document has a number of important principles:

- Complete the long-overdue conversion of SOEs into “modern enterprises,” i.e., joint-stock corporations with up-to-date corporate governance. (This is the clearest indication of continuity with a stalled out past agenda).
- Develop “mixed-ownership systems,” including those in which private parties have controlling stakes. This is the most uncertain and potentially controversial part of the reform program. It could mean “little or no change” from the partial listing process already familiar, or it could herald a substantial reduction in government controlling stakes and a shift towards a passive wealth-owner approach (see next item).

- State management should transitions from “assets” to “capital” [i.e., arms-length portfolio management], with several, separate state investment funds which potentially would compete and benchmark against each other.
- Reduce monopoly systems as much as possible.

Looking back on the transformation process, one is struck both by the huge successes, and by the persistent failures. The first period of transformation must be judged an unambiguous success, despite the limits that circumscribed reform strategy during that period. The overall command structure was eroded and dismantled, without an abandonment of the state-run enterprise and without, perhaps as a result, a catastrophic economic decline. The second phase of transformation has gone far beyond the first stage, but in comparative terms, the achievements are less impressive. Chinese privatization was delayed too long: there is no good reason for government to hang on to firms in ordinary competitive sectors, and privatization can improve performance (Megginson and Netter 2001). Even with the delay, Chinese privatization has been plagued by some of the same problems that afflicted the hasty privatization programs in Russia and Eastern Europe. Undoubtedly, the negative impact of China’s insider privatization has been far less than of that in, say, Russia, since the privatized companies are much smaller and highly dispersed, and the largest companies have remained in state hands. But an opportunity to create a more broadly based system of private ownership has so far been lost.

Notes: Figure 13.1. Data from Statistical Yearbook, 2013: pp. 478-497; Statistical Abstract 2014, p. 111. Data is for revenue from principal line of business. State firms include traditional state-owned enterprises plus joint stock and limited liability corporations in which the state has a controlling interest.

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