State Firms in Transition

- The state sector was the “commanding height” of the planned economy
- The state sector continues to be the “pillar” of the economy
  - Dominates in strategic industries
  - Pays more taxes
  - Gets more bank loans and stock market finance
- The problem of state-owned enterprises is at the root of the labor and financial sector problems
- Caution:
  - Their roles in the economy have been declining during the reform years because of the rise of the private sector
  - But they are more significant than some statistics show, for example, most listed companies are controlled by the state

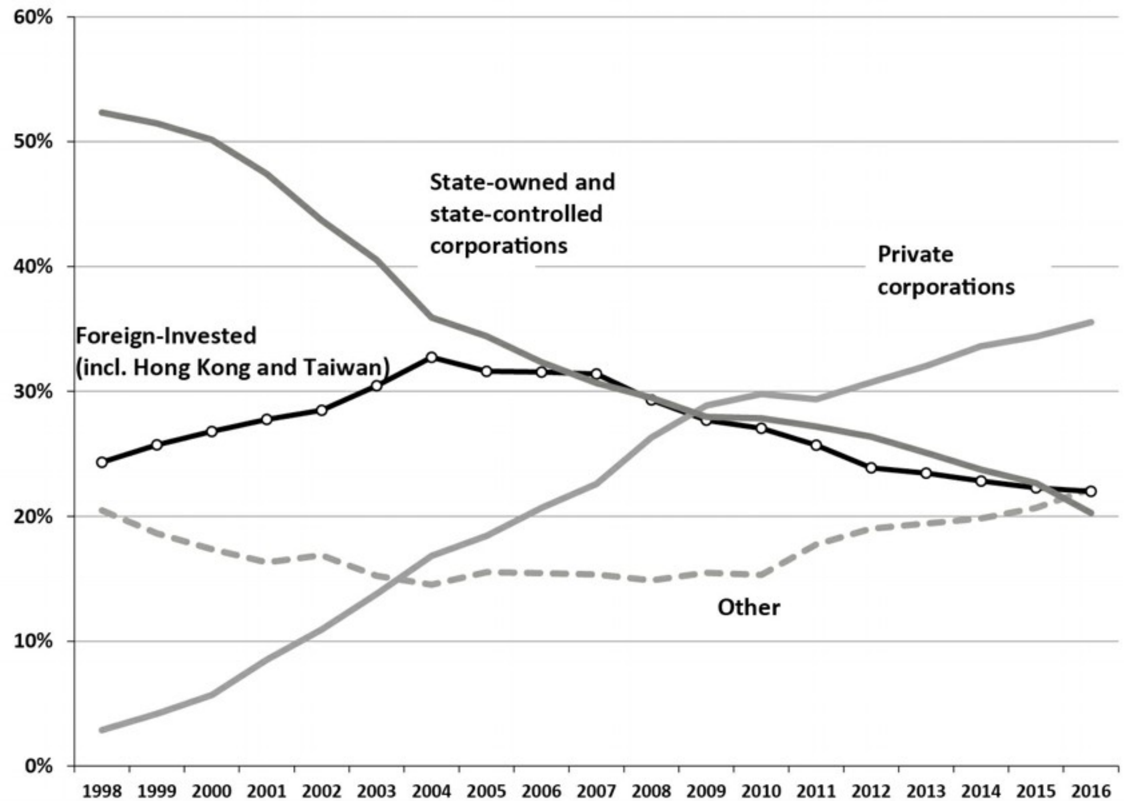


Figure 14.1

Ownership composition of industrial sales revenue.

Varieties of State Firms: By Level of Control

- Four levels of government control
  - Central
  - Provincial
  - Municipality
  - County
- About ¼ of SOEs are directly controlled by the central government, and the rest by local governments (mostly by municipal governments)
- Implications
  - Diverse local government policies on SOE reform
  - Local interests may differ from national interests, for example, local protectionism in automobile industry

Varieties of State Firms: By Firm Size

- Large vs. small SOEs: Two different worlds

Industrial SOE distribution by size (1993)

	number	output	employment	assets	Taxes and profits
Large	5%	57%	43%	62%	67%
Small	95%	43%	57%	38%	33%

Varieties of State Firms: By Region

- Northeast
  - Soviet type industrial base
  - Many large and old SOEs
  - High proportion of state firms
- Coastal
  - Fewer state firms (such as Guangdong, Fujian, Zhejiang) for historical reasons
  - Closer ties to overseas firms
- Inland
  - Transportation problems
  - Many defense industries (also Third Front)

SOEs: Changing Pattern of Finance

- SOE financing sources: From the government budget to bank loans
- Implications:
  - Heavy reliance on indirect financing (bank financing)
  - Very high debt-equity ratios

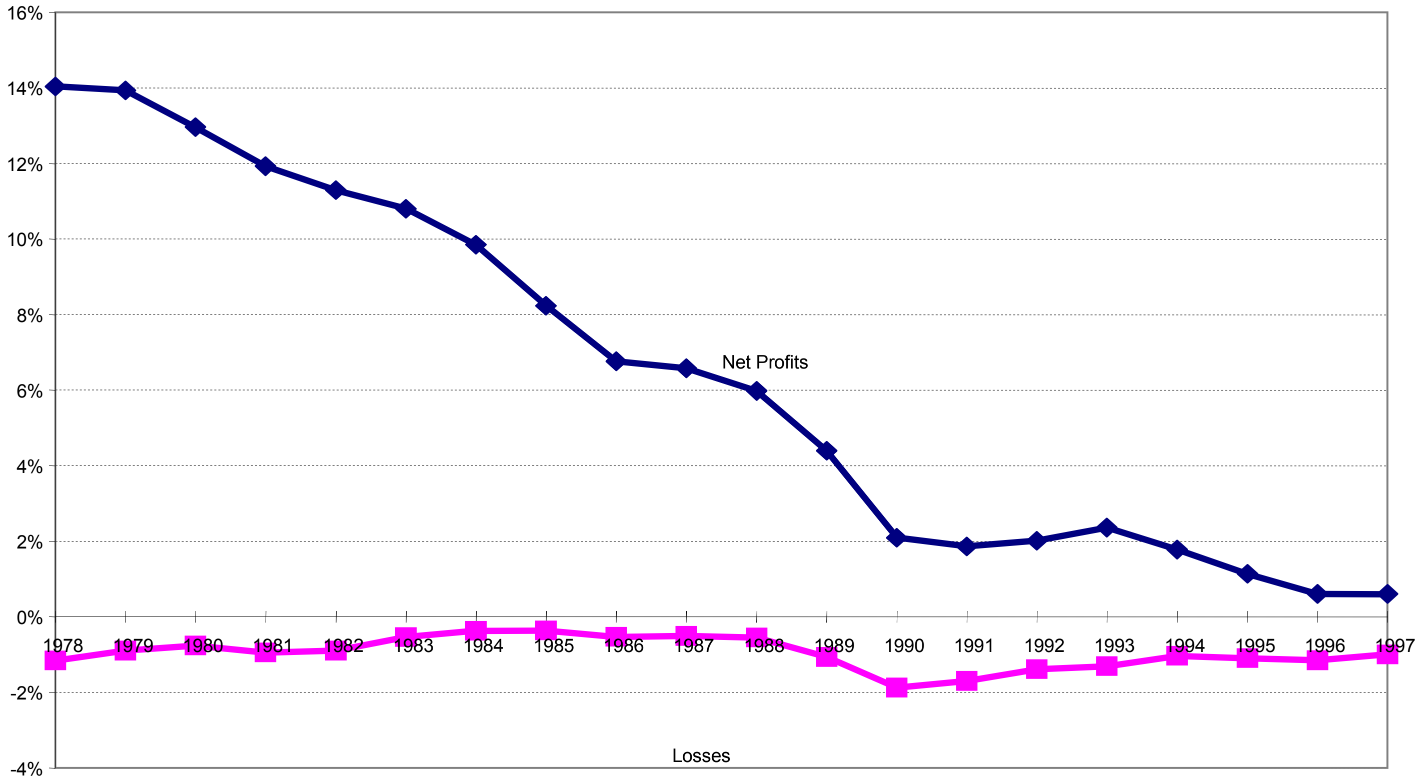
SOEs: Bank Loan Financing

	1978	1991
Budgetary capital expenditure/GDP	15%	5%
Share of fiscal budget in financing	61%	27%
Share of bank loans in financing	39%	73%

SOEs: High Debt-Equity Ratios (1998)

	Tangible assets only	With intangible assets
SOEs	3.20	1.62
Foreign firms in China	1.77	1.28
HK, Taiwan firms in China	1.93	1.43

Industrial SOEs: Profit and Losses (% of GDP)



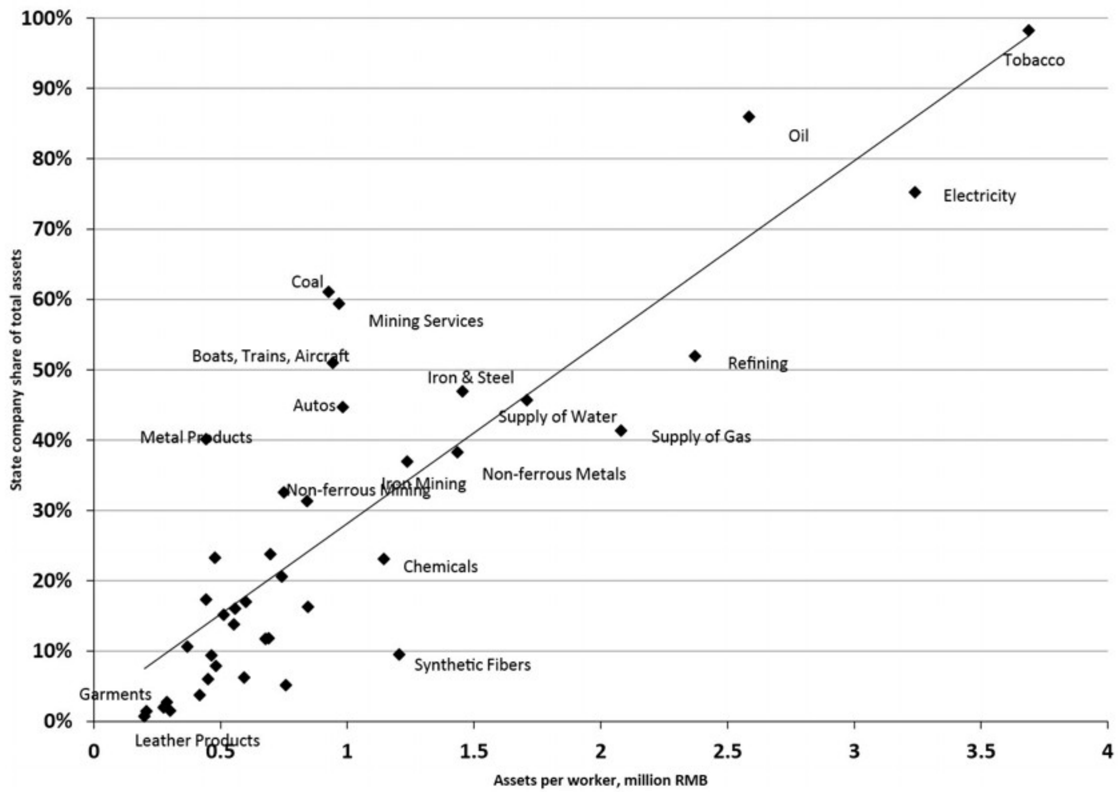


Figure 14.4

Share of sectoral assets in state-controlled companies.

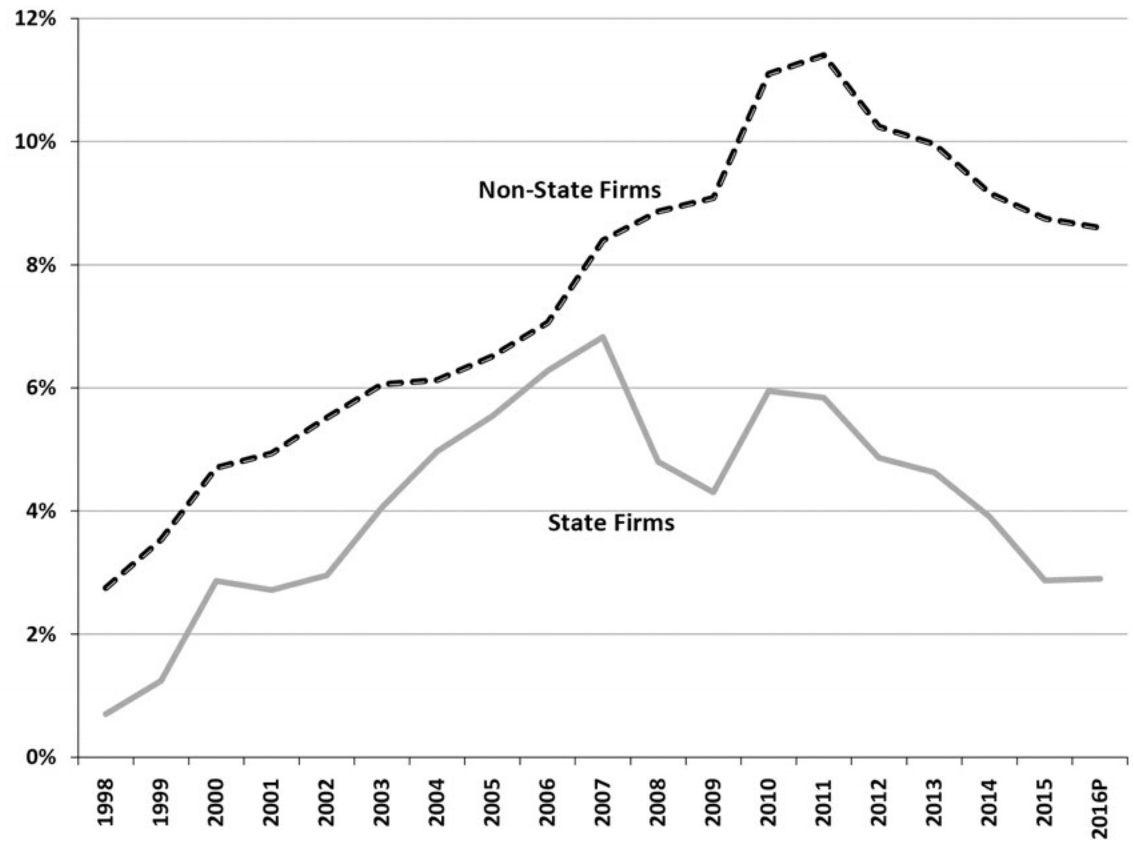


Figure 14.3

Rate of return on industrial assets.

SOE profits over time

- After reduction in profits after reforms, increase in profits due to consolidation in monopolistic sectors and more capital-intensive sectors, …
- … but losses after 2008 crisis when SOEs were mobilized to prop up the economy.

Main Themes of SOE reforms: 1978-1993

- Expanding enterprise autonomy
  - Production decisions
  - Marketing decisions
- Increasing profit incentives
  - Workers bonuses
  - Profit retention for welfare improvement (housing etc.)
- “Managerial contract system”
  - Link manager’s pay to enterprise profit
  - Wants to mimic agricultural household responsibility system
  - Industry is much more complicated than agriculture
  - Land vs. capital
- What wasn’t done
  - No privatization
  - No layoffs of workers (SOE employment continue to expand)

Evaluation of SOE reforms: 1978-1993

- Limited success
  - From improved incentives and autonomy
  - From increased competition
- Problems
  - Autonomy is limited – Government intervention continues
  - Contracts are short term – Incentives are biased toward short run profits
  - Contracts are tailor made to each enterprises – negotiation on contractual terms more important than performance
  - Firms gain when they make money, but do not lose when they lose money
  - Limited ways to punish failure

The Problem of the "Soft Budget Constraint" (Janos Kornai)

- The Phenomenon
  - The government (or banks or other organizations) keeps bailing out financially troubled firms
  - A general problem, but especially wide spread in countries like China
- Consequences
  - Anticipating the relaxed financial discipline, firms behave opportunistically and irresponsibly
  - Examples: choose unprofitable projects, take unnecessary risks, divert funds for own benefits, hire more labor than needed, conduct related party transactions (friends and relatives)
  - Why? Because someone else will eventually pay

The Problem of the "Soft Budget Constraint" (Janos Kornai)

- The reasons for the Soft Budget Constraint
  - The government's threat to punish financial failures (such as let firm go bankrupt) is not "credible"
  - It means by the time the firm is already in trouble, the government feels it is in its interests not to let it fail
- Why?
  - Political objectives (believe in socialist ideology, avoid workers' riot, need for political support of SOEs)
  - Social objectives (avoid unemployment problem)
  - Economic reasons (bad investment is sunk, by gone is by gone, good money chases bad money)
- Most of the above are related to public ownership and government control of firms and financing sources

SOE Reform: Since 1994

- 1994: 300 thousands SOEs (100 thousands in industry)
  75 million employees (43 million in industry)
- Government policy changes
- 1996: A general policy: "Grasping the large, letting go the small"
  - Privatization of small SOEs
  - Layoffs of excess workers
- 1999: the state sector retreats from "competitive sectors" and concentrates to four subsectors:
  (1) industries related to national security
  (2) natural monopoly
  (3) industries providing important public goods and services
  (4) pillar industries and backbone enterprises in high-tech industries

Privatization of Small SOEs

- Known as “transformation of ownership” (*zhuanzhi*), not privatization
- Most small SOEs are gone (in particular, those controlled by county governments)
- Patterns of privatization
  - Transferring existing stocks from the state to private
  - Increasing new private investment
    - Dilute state shares
    - Expand business activities
- Stakeholders in privatization
  - Enterprise employees
  - The state bank as a major creditor
  - The state as equity owner
  - The local government as tax collector

Case: Zhucheng, Shandong Province

- The first publicized SOE privatization by the county government, generated controversy
- Started in September 1992, 37 out of 50 SOEs were privatized (235 out of 238 urban collectives were also privatized)
  - 3 incorporated into limited liability companies
  - 32 converted into "stock cooperatives"
  - 1 bought by a Beijing SOE
  - 1went bankrupt
- "Stock cooperatives"
  - enterprise employees and managers own substantial shares of the firm
  - these shares are restricted in trade (for example, employees must sell them after they leave the firm).

Case: Zhucheng, Shandong Province

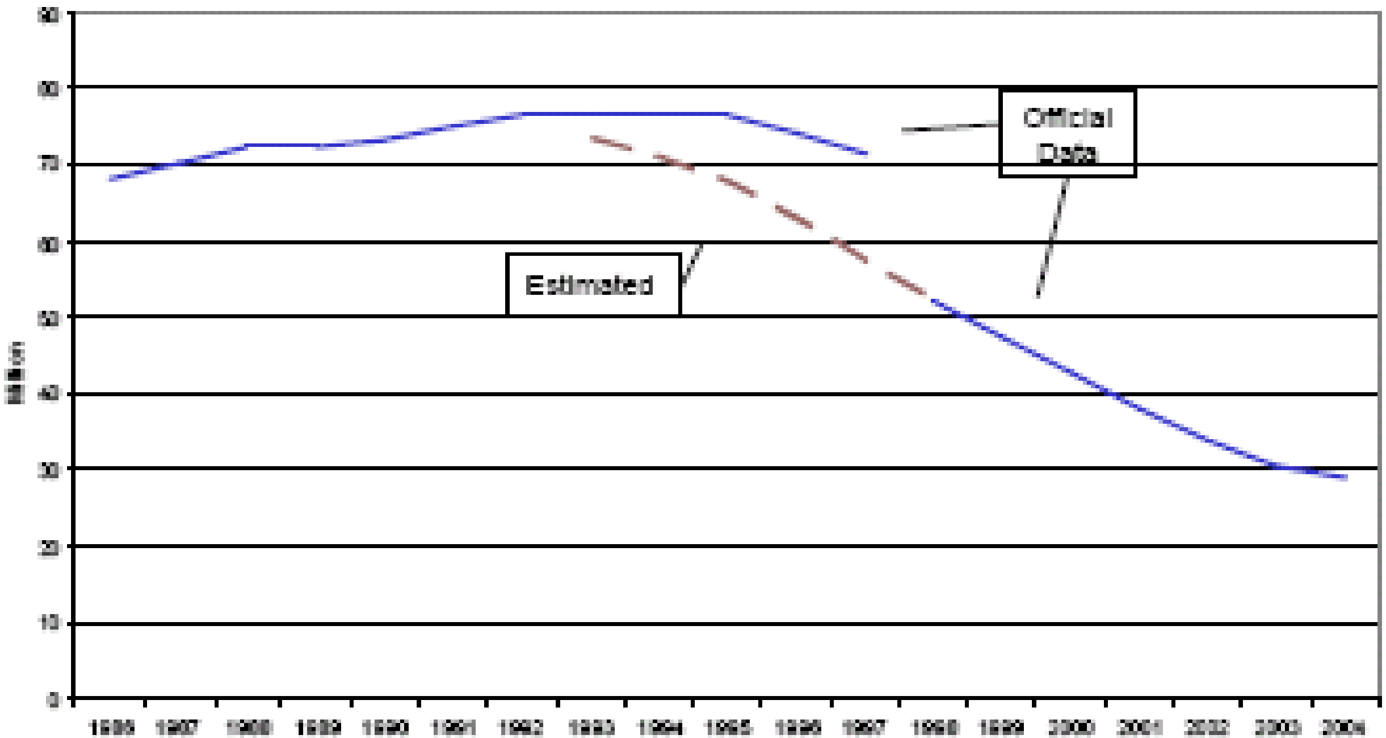
- An example: Sida Insulation Material Company
  - total assets: 15.6 million yuan
  - total liability: 10.9 million yuan
  - net worth: 4.7 million yuan
  - subtract:
    - land use rights: 1.9 million
    - housing liability to employees: 1.2 million
    - employee reallocation fee 0.3 million.
  - Net equity: 1.3 million sold to 340 employees
  - < 4,000 yuan per employee
- Thousands of people from all over the country visited Zhucheng to learn its experience

Massive SOE Layoffs

- *Xiagang* (stepping down from one's post), or furlough
  - Definition: Those workers "who went home from enterprises due to poor performance of enterprises but still maintained some nominal relationship with their enterprises" as these employees received "subsistence level of salary" or other kinds of benefits (such as housing or health care) from their enterprises
  - An institution substituting for the lack of social insurance program
  - Localized programs: vary by regions
- Massive
  - A large portion of 75 million SOE workers

Massive SOE Layoffs

Fig. 4-4: State-owned Enterprise Workers



Corporate Governance

- A universal problem in corporations, especially in publicly held corporations (Berle and Means, 1932)
  - Conflict of interests between managers (corporate insiders) and investors (outsiders)
  - Conflict interests among different types of investors: large shareholders vs. small shareholders, shareholders vs. creditors, private investors vs. institutional investors
- Three sets of laws applied to corporate governance
  - Company laws governing all firms (state corporate laws in the U.S.)
  - Securities laws governing publicly traded firms and securities firms (federal laws in the U.S.)
  - Bankruptcy laws governing creditors and debtors
- The central issue: how to make sure managers serve the interests of investors so that investors are willing to invest

Special Issues in China

- Governance structure: Co-existence of the new system with the old
- Introducing new institutions for corporate control
  - The Shareholders' Meeting
  - The Board of Directors (often Chairman of the Board is CEO)
  - The Supervisory Board (like the German system)
- But without dismantling old representative bodies
  - The Party Committee (Party Secretary is the real boss)
  - The Employee Representative Committee
  - The Workers' Union
- The central issue
  - The principle of "Party controlling personnel"
  - Managers still have a cadre rank (e.g., vice minister or minister level manager)

Special Issues in China

- The double problem of corporate governance in China
  - The political interference problem
  - The agency problem
- The fundamental dilemma
  - Delegating more control rights to managers provides them with incentives, but also enables them to plunder state assets
  - Maintaining Party control over the selection and dismissal of managers serves to check managerial asset stripping but also gives rise to political interference
- Some reform measures
  - Independent directors (up to 1/3 of all board directors)
  - Regulatory authority of China Securities Regulatory Commission

Special Issues in China

- Ownership issues
  - In traditional SOEs: Government is the sole owner
  - In most publicly traded firms: Government is the largest investor
- Reform directions
  - Diversifying ownership structure by introducing multiple investors, domestic and foreign
  - Reducing the proportion of state shares in publicly traded firms

SASAC

- State-Owned Assets Supervision and Administration Commission (SASAC)
  - Non-financial firms
  - Central SASAC and local SASAC
- Central SASAC (end of 2014)
  - 105 firms (reduction in numbers via mergers)
  - Net assets: 1.11 trillion yuan
  - Total profits: 105.2 billion yuan
    - PetroChina: 60 billion yuan

China's Largest Firms (2019, in sales)

- 1. Sinopec
- 2. China National Petroleum
- 3. State Grid Corporation
- 4. China State Construction Engineering
- 5. ICBC
- 6. Ping An Insurance
- 7. China Construction Bank
- 8. Agricultural Bank of China
- 9. SAIC Motor
- 10.Bank of China

China's Largest Firms (2019, in sales)

- 11. China Life Insurance
- 12. China Railway Engineering
- 13. China Mobile
- 14. China Railway Construction
- 15. Huawei
- 16. China National Offshore Oil
- 17. China Development Bank
- 18. China Resources
- 19. Dongfeng Motor
- 20. FAW Group

Large SOE Reforms in Reality

- Going Public (*shangshi*)
  - NYSE and NASDAQ
  - Hong Kong Stock Exchange (H-share vs. red chips)
  - Shanghai and Shenzhen Stock Exchanges
- Dual purposes
  - Raising funds
  - Restructuring corporate governance and control
- Different legal environments in New York, Hong Kong, and Shanghai
  - Laws are different
  - Enforcement is different
  - Investors are different

Examples

- Lenovo Group (formerly Legend Group)
  - IPO in 1994, listed on Hong Kong Stock Exchange
  - Largest PC maker in Asia excluding Japan
  - Bought the IBM PC unit in 2005
- PetroChina
  - IPO in 2000, listed on NYSE (PTR)
  - A listed company of China National Petroleum Corporation (CNPC)
- China Netcom (now part of China Unicom)
  - IPO in 2004, listed on Hong Kong Stock Exchange and NYSE (CN)
  - Previously 10 northern provinces of China Telecom

Large SOE Reforms in Reality

- Over 1,000 companies on two stock exchanges
  - Shanghai Stock Exchange, Shenzhen Stock Exchange
  - Three classes of shares
    - state shares
    - institutional shares
    - personal shares
  - The state is the dominant owner (either directly owns or indirectly through its institutions)
  - Until 2004 only about 1/3 of shares (i.e., about 1 trillion yuan) are personal shares which are publicly tradable

Large SOE Reforms in Reality

- Does public listing improve firm performance?
  - To examine the relationship between ownership structure of publicly listed companies and their performance
- One study found
  - Neither state shares nor personal shares help firm performance
  - But institutional shares help firm performance
- Another study found
  - Public listing is associated with sharp deterioration of financial performance of companies
  - Ownership concentration does not help
  - A more balanced ownership structure among top shareholders helps firm performance