10. Ownership Reform

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Topics

Contents

1 What is known about the firm?

What are the attributes of a competitive firm?

- Enterprises, or the firm, are the basic production cells of a market economy
- Profit maximization and private ownership are presumed
- Issues for the theory of the firm:
  - Who controls the firm?
  - Where is the boundary between firms and markets?

Does profit maximization make sense?

- Firms may pursue multiple objectives such as profits, market share, employment, climate change
- Alternatively, the behavior of a firm can be modeled as to maximize profits subject to multiple constraints
- Why is profit maximization critical? It leads to:
  - Cost minimization (efficiency)
  - Innovation of new products and processes (dynamism)

Competition and monopoly

- The argument for an efficient market economy rests on the belief that markets are competitive and profit maximization leads to price = marginal cost
- If market are not competitive, then price <> marginal cost with profit maximization
- Monopoly is the extreme case, resulting in higher price and smaller supply. A monopoly arises when proprietary technology and products are protected. Such monopoly is said to be conducive to innovation
- With higher markups, firms with market power tend to pay more to factors of production

Ownership and governance

- A public (its shares traded in an exchange) company is typically owned by shareholders but controlled by managers
- Corporate governance is about ensuring that management (agent) pursues the interest of owners (principal) and about balancing the relationship between majority shareholders (insiders) and minority shareholders (outsiders)
- Also relevant is the interests of stakeholders such as workers, creditors, communities, and the government

What is the best model of corporate governance?

- The Anglo-American market-based system. Mergers and acquisitions, and especially hostile takeovers, provide effective discipline
- Recently, private equity funds have played the role of voracious vultures
- The continental or Japanese control-based system may have stakeholders including banks supervise corporate management
- In Germany, unions are also represented

How is a company controlled?

- It can be a collective if it is owned jointly by all or some employees
- It can be a private business with a dominant majority owner such as a family business
- It can be a public company (with shares sold to the public) controlled by a majority owner, or diverse ownership
- It can be a private company owned by the state, or a public company controlled by the state

The border between firms and the market

- Within a firm, there is a planned economy. The market connects firms
- A firm may operate globally or in many unrelated sectors (in the case of a holding company)
- A recent trend is outsourcing and offshoring
- Some leading companies play the role of a dragon head, subcontracting many activities and tasks to others

Key points

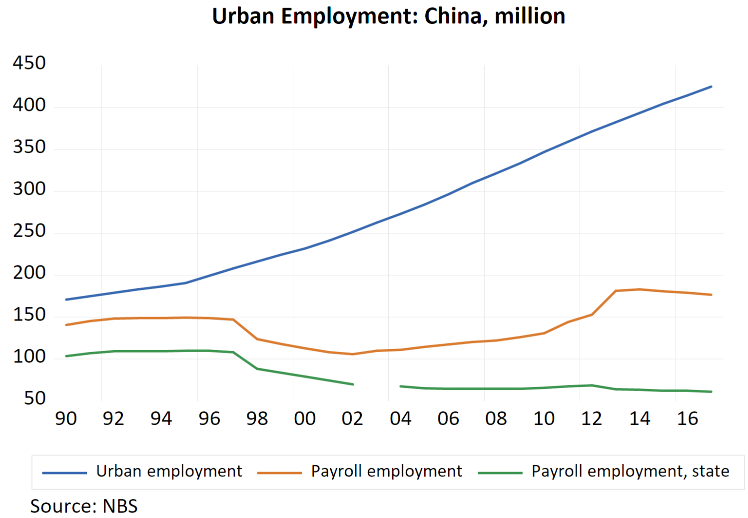
- Profit maximization provides the right incentive
- It is compatible with private ownership
- It generates the competitive pressure for efficiency and dynamic vitality
- Governance is about aligning the interests of managers and owners
- In addition to oversight by owners, it is also necessary for government and society to erect a set of constraints

2 Ownership reform

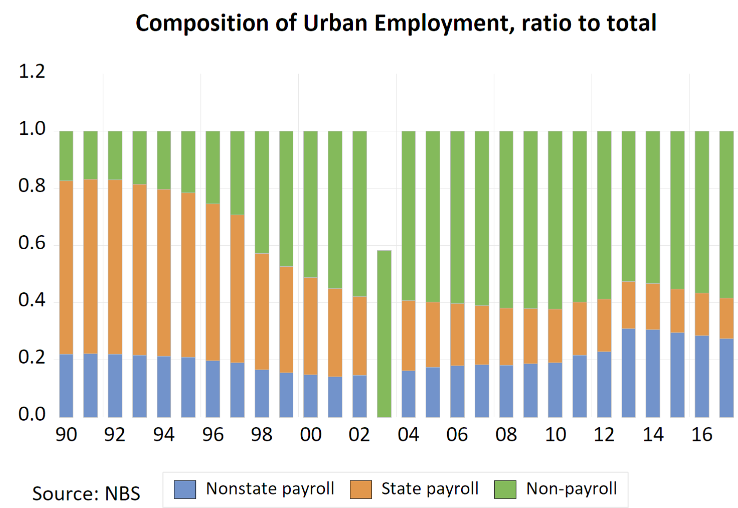
Features of state-owned enterprises (SOEs)

- No profit incentive
- No clear ownership and property rights
- Most of them are involved only in production, not much in R&D, marketing, finance, and supply management
- They are also the basic unit that provides all the social services such as housing and social insurance
- They form a grassroots unit of the communist party
- Business decisions are mixed up with political/social decisions

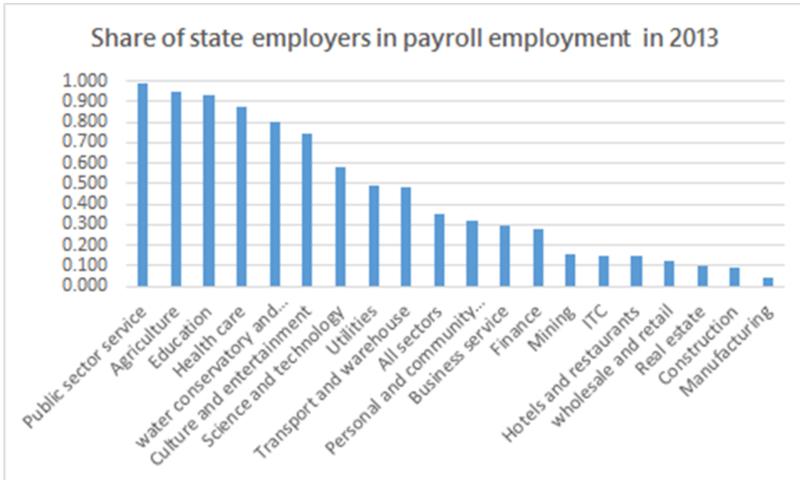
Urban employment



Composition of Urban Employment



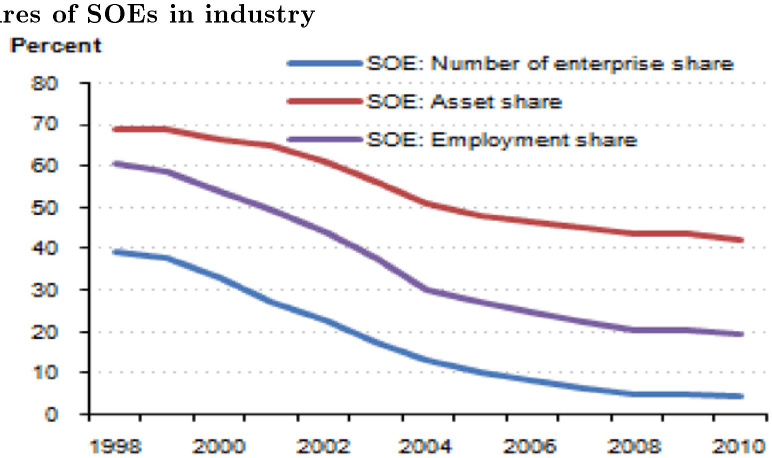
Share of SOEs employment



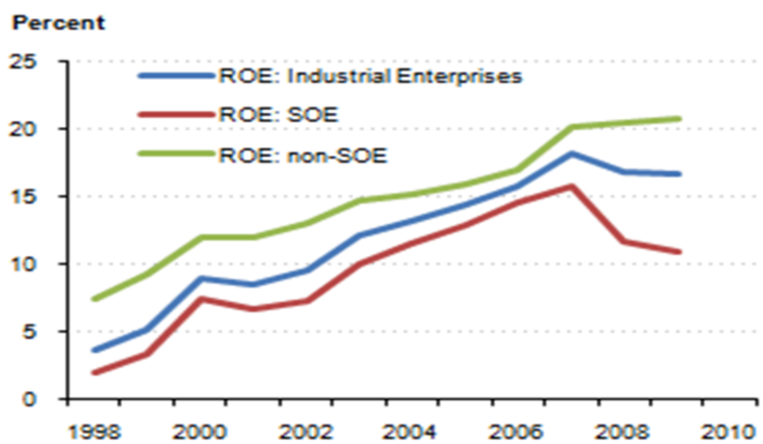
Shares of SOEs in industry, 2010

Variable	SOEs share, %
Number of enterprises	4.5
Gross output value	26.6
Total assets	41.8
Total profits	27.8
Taxes	37.2
Employment	19.2

Shares of SOEs in industry



Return on capital



How prevalent are SOEs/SCEs?

- In terms of employment, SOEs are more prevalent in services such as education, health and media than in goods-producing such as manufacturing and construction
- In industry, they account for merely 5% of (payroll) employment, but they tend to be capital-intensive and technology-intensive sectors
- They contribute more taxes more proportionately
- Their returns on equity/capital have been lower

Two steps in reforming SOEs

- The period of 1978-1995
  - Managerial responsibility contracts
  - Entry of non-state enterprises (TVEs, foreign invested enterprises, and joint-stock companies)
- The period of 1996 through the present
  - The Company Law of 1994 provides a unified legal framework (with separate provisions for SOEs)
  - Grasp the large and release the small
  - Restructuring and corporatization

Composition of industrial output by ownership, %

Ownership type	1978	1996
State owned	77	33
Collective	23	36
TVEs	9	28
Private		19
Foreign invested		12
Foreign		7
Overseas Chinese		5

Composition of industrial output by ownership, %

Ownership	1998	2004
SOEs/SCEs	49.6	38.0
Joint-stock companies	6.4	42.1
Foreign invested companies	24.7	30.8
Collective enterprises	19.6	5.3

Problems arising from profit retention

- Profit retention is to induce market behavior under the dual-track within the framework of planning institutions
- Individually negotiated contracts of profit retention do not provide an equal and transparent playground for enterprises
- With the owner being absent, profit retention results in soft budget constraint, investment hunger, excessive debt leverage

Soft budget constraint

- Soft budget constraint refers to the absence of bankruptcy risk and effective owner of a state-owned enterprise, or local government
- Supervising government agencies have vested interests to protect local enterprises, which is reinforced by the production based tax system
- Soft budget constraint leads to investment hunger

Corporatization

- Implementation of corporatization has been slow, because it entails more fundamental change in attitudes and behaviors
- At the end of 2003, there were still 23,000 TSOEs, producing 1/3 of state-sector output, while 11,000 state-controlled JSCs produced the other 2/3
- On the government side, SASACs started to replace industrial ministries/bureaus as the agent of the state

- But it takes time to finesse its division of labor with the communist party that appoints top management

Corporatization: 1996 through present

- Corporatization is to restructure state-owned enterprises in accordance with the unified legal corporate structure
- The aim is to elevate the role and interest of shareholders
- Management performance is evaluated against the profit and share price criteria
- In turn, the legal relationship with creditors (banks) can be more clearly defined
- Defaults are bankruptcies become enforceable

Restructuring in 1996-2000

- Adopt the new accounting system and reassess the balance sheet
- Offload non-essential activities and reset debt obligations (loans owed to banks, liabilities to employees and laid-off and retired employees)
- Convert into a limited liability company according to the Company Law
- State owner is changed from industrial bureaus/ministries to state asset supervision and administration commission (SASAC)
- If possible, the restructured company may sell shares to the public or strategic investors

Issues about SASAC

- Lack of independence in appointing top management. But there is an informal division of labor with the Party
- SASACs do not have control over the collection and use of after-tax profits (dividends). The profit incentive is constrained
- They are actively involved in corporate restructuring and formation of large enterprise groups
- In this regard, the institutional setup is effective but prone to abuses and corruption

Managerial abuses

- Asset stripping
  - Asset stripping is a common occurrence when managers sell underpriced assets to themselves or their friends
  - Solutions: set up a transparent venue (auctions) for discovering fair market prices
- Related-party transactions
  - Related-party transactions occur when the assets or profits of a listed company are peeled off to the private companies of majority shareholders
  - Solution: more transparent information disclosure and comprehensive regulations

Privatization

- The primary way to "release the small" is to sell small SOEs and collective enterprises to managers and employees, and in some cases, to outside investors
- The privatization process has been highly controversial. Critics have exposed pervasive asset stripping, i.e., undervaluing state assets

Key points

- Reforming SOEs is a core aspect of turning China into a market economy
- The first step is profit retention and managerial responsibility contract in the 1980s
- The second step is the corporatization in the 1990s through grasping the large and letting go the small
- In the current status, SOEs/SCEs are less efficient and less innovative, largely aided by monopoly, licensing, and subsidies
- The logical final step is to remove
  - the special advantage accorded to SOEs/SCEs in a true market economy
  - party control
- But instead, the CCP wants to entrench the special status of SOEs/SCEs by enabling them become bigger and stronger

3 Current issues

What should be the role of SCEs?

- A common complaint is that SCEs are too powerful and extensive, with the playing field in their favor. At present, they dominate in finance, resources, media, telecommunications, and others.
- It is argued that the sector list of SCEs dominance should be shortened. The scope of natural and administrative monopolies should be trimmed, such as separating power generation and power transmission.

Where should SCEs operate?

- Beside the profit motive, SCEs can pursue other socially important objectives as well.
- With effective control over top management, the Party feels more secure in governing China.
- Being large, SCEs can compete with global companies of other countries.
- Selling large SCEs into the hands of rich families and foreign companies is politically unappealing.

Mixed ownership and professional management

- Today's SCEs are very different from SOEs in the past. Many of them are profitable, such as in banking, though not necessarily due to their own performance.
- A current idea is to expand mixed ownership and hire professional managers. There is room for marginal tinkering, but it is doubtful whether reducing the share of state ownership would lead to better performance, since the profit motive may not always be the appropriate criterion.
- Selling SCEs appears to be politically unpopular.

The holding and investment company model

- There are too many SCEs for the SASAC to run. So it is decided to form some holding companies to manage SCEs.
- A holding company can control a wide and complex web of companies. Profit and asset appreciation should be important performance measures, though not necessarily the most important one.
- This policy initiative is mainly about improving the control and monitoring mechanism.

How much should top managers be paid?

- A recent issue is the pay scale of top managers of SCEs in the context of the anti-corruption drive.
- Top managers are appointed by the Party in the same way as party and government officials, and they are often swapped for party and government posts. When they are paid more than their peers in other posts, there is tension.
- So it is recently decided to scale down their annual pay below one million yuan.

The arguments for shrinking SCEs

- Where SCEs compete directly with NSEs, it is critical to maintain a fair playing ground.
- With more FTA's being signed and implemented, it is difficult to keep the special treatment for SCEs.
- SCEs have been a rich source of corruption. It is impossible to keep the Party clean when power and money are mixed together.

Xi's model of SCEs

- Firm control by the CCP
- In fact, Xi wants to set party organization even in non-state enterprises
- SCEs should produce what he and the Party needs, anything he cannot buy from the West, and grip securely all key sectors such as resources, finance, media, telecommunications, and defense
- As a result, profit motive cannot play a decisive role, and soft budget constraint remains
- This may be an important aspect of "socialism with Chinese characteristics for the new era"

Key points

- The issue of SOEs/SCEs matters critically with respect to what kind of a market economy China wants to be
- For a market economy consistent with advanced economies, SOEs/SCEs should be scaled down substantially and their special status removed
- If Party-controlled SOEs/SCEs is to become stronger and larger, China would be in conflict with the rest of the world

- The idea of promoting mixed ownership is not a fundamental solution to the problem of inefficient SOEs/SCEs
- Xi's model of SOEs/SCEs is rolling back what has been achieved in reforming SOEs since 1978

Review questions

- What was done to reform SOEs after 1996?
- What have been accomplished and what problems have remained? Is there a perfect solution for corporate governance? From whom should the Chinese learn now?
- What are the current issues about state controlled enterprises?