Privatization in China: Experiences and Lessons

Jie Gan
Hong Kong University of Science and Technology

JEL Classification: G34, L33
Key Words: Privatization, Chinese Economy, Transition Economy, Corporate Governance
Introduction

Privatizing state-owned enterprises (SOEs) is a major step in transforming centralized economies into market economies. Indeed, an important component of the economic transformation in China has been the privatization of its SOEs. Unlike the “shock therapies” used in transitional economies in Central and Eastern Europe, China took a gradual approach to its enterprise reform. Due to its ideological aversion to capitalism, the government could commit to privatization only after earlier attempts at reforms failed. Large-scale privatization occurred in late 1990s. Between 1995 and 2005, close to 100,000 firms with 11.4 trillion RMB worth of assets were privatized, comprising two-thirds of China’s SOEs and state assets and making China’s privatization by far the largest in human history.

This “delayed” privatization means that, at the time of privatization, most SOEs were losing money and were deeply in debt. This poses significant challenge in restructuring the SOEs so that they could be sold. On the other hand, the market and the legal-institutional conditions for private ownership were much more developed than were their counterparts those during mass privatization in other transitional economies.

Depending on the ease of restructuring and the incentives and ability of local governments to bear the social cost of restructuring, China adopted multiple approaches to privatizing its SOEs. These approaches included share issue privatization (SIP), joint ventures with foreign firms, management buy-outs (MBO), and sales to outsiders, etc.

China’s privatization is of great importance, not only due to its sheer size, but also because of its distinct differences from other privatization programs. China’s experience can provide valuable insights into privatization designs in general. So far, however, little is known about the full picture of China’s privatization. Most of the existing studies are on SIP, for which data are available. However, only a tiny proportion (1%) of the privatization programs in China occurred
through SIP. There are no systematic data for most of China’s privatization programs, given that the firms have remained private after privatization.

The survey by Gan, Guo, and Xu (2008; GGX hereafter) is an important step in filling this gap. The survey was conducted in early 2006 on about 3000 firms. It was based on stratified sampling by region, industry, and company size. In this article, I draw from the descriptive statistics of the GGX survey as reported in Guo, Gan, and Xu (2008) in my discussion of non-SIP privatization programs.

This paper proceeds as follows. The next section describes the background of the privatization of China’s state-owned enterprises. Sections III and IV describe the different privatizations methods employed in China and the key characteristics of firms after privatization. Section V presents the effect of China’s privatization on the firms’ operating performance. Section V concludes the paper.

I. Background of China’s Privatization

More than twenty years of reforms in China are marked by the government’s piecemeal and gradual approach. The reform of the state-owned enterprises is no exception. Instead of outright privatization, China concentrated first on productivity improvement by initiating enterprise governance structures that stressed autonomy and better incentives and then later by adopting long-term managerial contracts with pre-specified financial targets (such as profits and taxes). Instead of introducing markets and liberalizing prices overnight, China first created markets at the margin, parallel to the planned economy, by introducing the “dual-track system” in the state industrial sector and by lowering bureaucratic barriers to entry to the once state-monopolized industries. Admittedly, the reforms brought about fundamental improvements in output and productivity. The marginal
productivity of labor increased by 54 percent and the growth in total factor productivity (TFP) was 4.68-6 percent per year during 1980-89 (Li, 1997; Groves, Hong, McMillan, and Naughton, 1994).

This gradual reform approach, however, had its limits. When the reforms started in 1979, most SOEs were profitable at least on paper. Since the reforms began, despite significant output expansion and productivity gains, the profitability of the SOEs declined substantially and most of them were losing money in the early 1990s. As a result, many SOEs were deeply in debt and, by 1994, close to half of the SOEs had zero or negative equity. The decline in profitability was due to two reasons. First, without clear allocation of property rights, the SOEs’ obligations were on the profit side but not on the loss side, which reduced the SOEs’ incentives to improve their operating efficiencies. Second, SOEs operated under unfavorable conditions due to both their many social responsibilities (e.g., social security, housing, and education) and external price controls imposed by the dual-track system. These policy burdens put the SOEs in a disadvantaged position in their competition with the rapidly growing private sector. Policy burdens also made it difficult for the state to impose hard budget constraints via bankruptcy of money-losing enterprises. Meanwhile, the dual-track system created enormous opportunities for corruption. In the end, the state acted as the residual claimant, absorbing the losses and the consequences of the diversion of state assets. This imposed a severe strain on the country’s banking system. With SOEs relying on 70-80 percent of all bank credit, the banks were saddled with as much as US$200 billion in uncollectible debt, which accounted for, by conservative estimates, a quarter of all outstanding bank loans (USA Today, Sept. 8, 1997).

These problems ushered in a new stage of more fundamental reforms. In 1993, the Third Plenum of the Fourteenth Chinese Communist Party Congress endorsed the creation of a modern enterprise system. In particular, it approved the development of diversified forms of ownership through privatization, which would allow SOEs to compete on equal terms in the marketplace. In
1995, the central government decided on the policy of “retain the large, release the small” (zhuada fangxiao). That is, the state was to keep the largest 300 SOEs in strategic industries and allow smaller firms to be leased or sold. The Chinese Communist Party’s 15th Congress (1997) gave a green light to privatizing the majority of SOEs nationwide. Regional governments were granted de jure ownership of SOEs within their jurisdictions and were allowed to sell their assets.

Large scale privatization began in the late 1990s. This “delayed” privatization brought about both advantages and difficulties in the designing of privatization programs. On the one hand, the market and legal institutional conditions for private ownership were much more developed than those during mass privatization in other transitional economies. On the other hand, at the time of privatization, most SOEs were losing money and were deep in debt. How to restructure the firms so that they could be sold off and / or how to attract buyers pose a challenge to the Chinese government. Restructuring means laying off excess labor, upgrading of plants and machinery, and injecting new capital, all of which were costly both socially and financially. Thus, depending on the cost of restructuring and the financial resources of the local governments, China adopts multiple methods to privatizing the SOEs. They include both privatization with explicit changes in ownership, such as management buy-outs (MBO) and sales to outsiders, and privatization without explicit changes in ownership, such as share issue privatization (SIP), joint ventures with foreign firms, and leasing. These different methods of privatization are discussed in the following section.

**II. Methods of Privatization in China**

Under the policy of “retaining the large, releasing the small,” various methods have been used in privatizing China’s SOEs. Except on SIP, there are no official statistics on the number of firms or the value of the assets that have been sold. In this section, I base my discussion on the
large-sample survey of about 3000 firms conducted by Gan, Guo, and Xu (2008), which is based on stratified sampling by region, industry, and company size.

Table 1 presents a breakdown of different methods of privatization reported by Gan, Guo, and Xu (2008).

2.1 Privatization with Explicit Changes in Ownership

2.1.1 Management buy-outs

Management buy-outs (MBOs) are by far the most popular method, accounting for about one half (47%) of all privatization programs. In a typical MBO, the manager becomes the largest shareholder, resulting in no separation of ownership and control. Such perfectly aligned incentives can potentially lead to improved efficiency.

Panel B of Table 1 compares MBOs with non-MBO firms. MBO firms tend to be smaller, slightly less leveraged and less profitable. There are two possible reasons for these differences. One is that insiders/managers are best able to turn weaker firms around. Thus the buy-out by the manager is a rational choice to provide insiders with the right incentives. The second hypothesis is that MBOs are better firms but their managers have deliberately suppressed their earnings prior to privatization so that they could negotiate better prices from the government in the buy-outs. It is also possible that the managers may have private information about the (good) future prospects of the company and thus choose to buy the better firms. These two possibilities suggest that MBOs are not random and that self-selection needs to be carefully accounted for in the empirical analysis of performance improvement.

2.1.2 Selling to Outsiders
The second most important method is selling to outsiders, which is used in 22% of privatization events. The buyers include domestic and foreign firms, as well as wealthy individuals. Again, as shown in Panel B of Table 1, in this type of privatization, the firms tend to be smaller, less leveraged, and more profitable.

2.2. Privatization Methods without Explicit Changes in Ownership

2.2.1 Share Issue Privatization (SIP)

SIP is used for large SOEs that the government intends to “retain” under the policy of “retaining the large, releasing the small.” Although most of the studies of China’s privatization are about SIP, Table 1 shows that this type of privatization accounts for only the small portion (1%) of privatization in China.

The government faced two major challenges during SIP. The first was, due to its ideological aversion to capitalism, how to ensure state control. The government first implemented partial privatization by maintaining at least 50% ownership and then declaring that all state-related shares were non-tradable so that control would not be transferred to the private sector through future trading.

The second challenge was how to restructure money-losing SOEs, which was costly both socially and financially. Thus, as reported by Deng, Gan, and He (2008), only about one-quarter of SOEs were fully restructured before going public. As a way to avoid costly restructuring of the remaining firms, the government organized the SOEs into parent/subsidiary structures, where the most profitable assets were carved out for public listing while the parent companies became the largest shareholder and kept the excess workers, obsolete plants, and debt burdens.

These two approaches to pre-privatization restructuring created very different incentives for the controlling shareholders. In an economy with very limited legal institutions, the conflicts of
interest between large and small shareholders were the main concern of corporate governance. In a complete pre-privatization restructuring, the state-owned controlling shares were typically deposited in the State Assets Management Bureau or with other SOEs that did not have close business relationships with the listed company and they tended to be passive shareholders. In contrast, in incomplete restructuring, the state-owned shares were put into the hands of the SOE parent company, which had strong incentives to expropriate resources from their listed subsidiaries to solve their own problems under state ownership. Moreover, it was common for the parent SOE to send its own managers to be the CEO or chairman of the listed company. Such personnel connections further facilitated the ability of the parent companies to expropriate from minority shareholders.

2.2.2 Leasing, Joint Venture, and Others

There are a variety of other privatization programs that did not impose explicit changes in ownership. These include joint venture (2%), leasing (8%), and employee holding (10%).

III. Characteristics of Firms After Privatization

There are several notable characteristics of China’s privatized firms. First, the state still plays a non-negligible role in firm operations. In many cases, the state retains its influence on daily corporate decision making and good relationships with the government are reported to be important for firm growth. Second, in terms of ownership and control, privatization has created concentrated ownership. Performance-based pay has become popular to enhance incentives. Third, firms are moving towards greater levels of professionalization by introducing international accounting standards and independent auditors, as well as boards of directors.
3.1 The State’s Influence

A common feature of privatization programs around the world is that they are partial in nature, i.e., the government retains significant ownership of privatized firms (Jones et al., 1999; Gupta, 2005). Among the large SOEs that the government intends to “retain” through SIP, the government explicitly retains at least 50% ownership so that state control can be ensured. According to Gan, Guo, and Xu (2008), among the smaller firms that are meant to be “released,” the average ownership by the state is close to 20%, which includes both direct government ownership and ownership by another SOE.

In the GGX survey, all firms reported that their relationships with the government and favorable government policies were important to their development. The survey showed that 57% of the firms reported no changes in their relationships with the government, 23% reported closer relationships with the government, and 20% reported more distant relationships with the government.

Thus, either through its ownership or due to the importance of government policies, the government can still exert influence on corporate decision making. In the GGX survey, the rating on overall state influence dropped from 2.8 to 1.4 after privatization (with 5 being the maximum). State influence, however, is quite important in a significant proportion of firms, with 39% firms giving a rating of above 2 (Somewhat Important) and 15% giving a rating above 3 (Moderately Important). Since the state could have political goals that differ from the goal of profit maximization, state control is likely to reduce the effectiveness of privatization.

3.2 Ownership and Incentives

1 The GGX survey asks about several dimensions of corporate decision making, including the appointment of top managers, employment/layoffs and wages/compensation, corporate financial issues, production, and operations.
As in many other countries, privatization in China has created concentrated ownership (Table 2 Panel A). On average, the largest shareholder in the firms surveyed by GGX owns 60% and the second and third largest shareholders own 26% of the shares of the privatized firms. Consistent with the observation that privatization brought no explicit change in ownership to many firms, 91% of firms that privatized by methods other than MBO or through sales to outsiders remain in the hands of the government.

Concentrated ownership has both its advantages and disadvantages. On the one hand, concentrated ownership has the benefit of mitigating the free-rider problem in monitoring managers and, in the case of insider ownership, aligning managerial interests with those of shareholders. On the other hand, concentrated ownership comes with a well-known cost. That is, a large shareholder can expropriate resources from outside minority shareholders. This expropriation problem is potentially strongest in countries with weak property rights protection, where much privatization occurs.

Privatized firms have started to adopt equity incentives for top managers (Table 2). Interestingly MBO firms do not have more equity incentives than other firms have. Firms that were sold to outsiders are two times more likely to have equity incentives than the overall sample. The 7% of firms that have equity incentives in the overall sample, however, seems low, which makes one wonder if privatized firms without explicit ownership changes can motivate their managers.

Another factor contributing to enhanced incentives in privatized firms is the hardening of soft budget constraints. The soft-budget constraint is an important reason for why the firms had few incentives to improve their efficiency. In the GGX survey, about 18% of the firms experienced financial distress before privatization and 3% of the firms experienced financial distress after privatization. Before privatization, in 27% of the distress cases, the firms had direct help from the government; more than half obtained bank loans (56%) or loans from other, presumably state-
owned, firms (57%). As a result, only 17% were reorganized before privatization despite their financial distress. After privatization, the government, banks, and other SOEs provided help in only 19%, 31%, and 19% of the cases, respectively, and 29% of the firms in financial distress were reorganized.

3.3 Professionalization

Privatization is associated with significant personnel changes in firms. Over 62% of the firms changed their core members of the management team after privatization, whereas only 15% of private firms made similar changes in the GGX survey. Presumably, the new managers are hired based on their ability to run the firms, rather than political concerns as in the old SOEs. Thus, such top-manager turnover is a step towards professional management in privatized firms.

About 8% of the firms have adopted international accounting standards, whereas the number is significantly higher among MBOs (11%). Meanwhile, about 76% of firms have established boards of directors and the number, again, is significantly higher among MBOs (84%).

IV. Understanding the Efficiency Gain of China’s Privatization

It is well known that Chinese SIP does not improve efficiency; rather it reduces operating performance (Sun and Tong, 2003). Deng, Gan, and He (2008) point out that the root cause of the failure of SIP is the conflicts of interest between large shareholders and minority shareholders. Based on detailed firm-level data on related-party transactions, the authors document two channels through which large shareholders expropriate resources at the expense of minority shareholders. One is through related-party transactions, including transfer pricing of goods and services, assets
sales, and extracting trade credits; the other is through dividend policies so that corporate resources are kept in the firm and under their control.\textsuperscript{2}

In contrast to SIP, little is known about the outcomes of other methods of privatization, which accounts for 99\% of all privatization programs in China, simply because the firms remain private and thus there are not any publically available data. The existing studies are mainly based on regional data of selected cities/provinces. For example, Li and Rozelle (2000) studied 88 privatized township enterprises in Jiangsu and Zhejiang provinces. Song and Yao (2004) and Garnault, Song and Yao (2005) used firm-level data covering 683 firms in 11 cities from 1995-2001. The study by Liu and Lu (2005) was based on survey data collected from 451 firms in five cities and four sectors during 1994-1999. Yusuf et al. (2005) reported on a survey of 736 firms from five cities and seven sectors from 1996 to 2001. All of these papers found that privatization improved profitability. But generality of the results is not warranted, nor do these studies explain \textit{why} privatization in China has improved efficiency.\textsuperscript{3}

The survey by GGX (2008) is an important step to fill the gap. Based on simple summary statistics from the survey, both profitability and productivity have increased. Moreover, among all the privatization methods, only those with explicit ownership change and especially MBOs improve efficiency. These results are strong and robust to endogeneity concerns. Interested readers should refer to GGX (2008b) for details of the analysis.

The success of privatization other than SIP in China is in contrast to the findings in the previous literature on Eastern Europe and Russia that insider privatization does not improve

\textsuperscript{2} There has been a growing literature that examines the relationship between corporate governance and firm performance in China’s share issue privatization. For example, Sun and Tong (2003) show that the composition of state-owned shares affects firm performance. Fan and Wong (2007) find that CEOs who are former or current government officials are associated with less professionalized boards and worse firm performance. These studies, however, do not explain the underlying mechanism for how weak corporate governance worsens the performance of China’s privatized firms.

\textsuperscript{3} The only work based on nationwide data is that by Su and Jefferson (2006). However, they did not have direct information about privatization. They inferred that privatization had occurred by changes in the legal registrations of the firms.
efficiency (Barberis et al., 1996). It is important to point out that there are some key differences between the institutional environments at the time of mass privatization in other transitional economies and that in China. At the time of mass privatization, the countries in Eastern Europe had not established product markets, labor markets, or financial markets. Private ownership was an unfamiliar phenomenon. Under this situation, managers or private owners may not have had sustained interest in running their firms, nor did they have a clear exit strategy. In contrast, when the delayed privatization in China occurred, market institutions had been developed and, equally importantly, the private sector had already become a big part of the economy. Moreover, the capital market had developed enough to provide the new owners an exit strategy to capitalize fully on their efficiency gains.

V. Conclusion

Privatization in China has greatly changed the landscape of the state-owned firms. In particular, it has created concentrated private ownership and large shareholders essentially control major decision making in their firms. While the control rights of the state have been greatly reduced, its policy support is still important to firm growth. Moreover, the state’s influence remains important in a significant portion of China’s firms, which potentially hinders efficiency improvement.

After privatization, soft budget constraints were substantially hardened and incentives have been enhanced through equity incentives either through compensation or through ownership. China’s privatized firms are moving towards greater levels of professionalization, by hiring professional managers, introducing international accounting standards, and establishing boards of directors.
Privatized firms became more efficient and more profitable based on various measures. Such efficiency gains appear to be most significant among firms in which incentives are better aligned. Specific mechanisms of improved post-privatization performance are considered in a contemporaneous paper (Gan, Guo, and Xu, 2008b).

China’s privatization experience provides several insights into privatization designs in general. First, the Chinese experience highlights the importance of the incentives of large shareholders. Only when the large shareholders’ incentives are in place will firms undertake fundamental restructuring measures to enhance efficiency. Second, the Chinese experience suggests that postponing privatization to create stable market institutions increases the effectiveness of privatization. In particular, privatized firms can benefit from established product and labor markets for expansion and managerial tenant. They can also benefit from better developed financial institutions to obtain external financing. Legal institutions protect the property rights of the owners of privatized firms and provide them with incentives to grow their firms (Johnson, McMillan, and Woodruff, 2002). Finally, new private owners can use the capital market as an exit strategy to capitalize on efficiency gains.
References:


Table 1. Methods of Privatization and Firm Financials Prior to Privatization

This table presents the methods of China's privatization and summary statistics of financial variables prior to privatization. Profits are defined as earnings before interest, tax, and depreciation. Significance levels are all based on two-tailed tests of differences between MBOs / Selling to Outsiders and the overall sample. Significance at the 1%, 5%, and 10% levels is indicated by ***, **, and *, respectively.

### Panel A: Methods of Privatization

<table>
<thead>
<tr>
<th>Method</th>
<th># of firms</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Explicit Ownership Change:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MBO</td>
<td>338</td>
<td>47%</td>
</tr>
<tr>
<td>Selling to Outsiders</td>
<td>157</td>
<td>22%</td>
</tr>
<tr>
<td><strong>Without Explicit Ownership Change:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Listed</td>
<td>8</td>
<td>1%</td>
</tr>
<tr>
<td>JointVenture</td>
<td>11</td>
<td>2%</td>
</tr>
<tr>
<td>Lease</td>
<td>56</td>
<td>8%</td>
</tr>
<tr>
<td>Employee Holding</td>
<td>70</td>
<td>10%</td>
</tr>
<tr>
<td>Others</td>
<td>77</td>
<td>11%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>717</td>
<td>100%</td>
</tr>
</tbody>
</table>

### Panel B: Financial Variables by Privatization Methods

<table>
<thead>
<tr>
<th></th>
<th>Privatized SOEs</th>
<th>MBOs</th>
<th>Selling to Outsiders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset (in thousands)</td>
<td>260,428</td>
<td>117,114***</td>
<td>119,705***</td>
</tr>
<tr>
<td></td>
<td>(54,685)</td>
<td>(44,237***)</td>
<td>(39,437***)</td>
</tr>
<tr>
<td>Sales (in thousands)</td>
<td>155,596</td>
<td>77,595***</td>
<td>71,728**</td>
</tr>
<tr>
<td></td>
<td>(24,662)</td>
<td>(22,121***)</td>
<td>(20,240**)**</td>
</tr>
<tr>
<td>Leverage</td>
<td>0.143</td>
<td>0.132**</td>
<td>0.118***</td>
</tr>
<tr>
<td></td>
<td>(0.072)</td>
<td>(0.069***)</td>
<td>(0.048***)**</td>
</tr>
<tr>
<td>Profit/Assets</td>
<td>0.054</td>
<td>0.047**</td>
<td>0.073***</td>
</tr>
<tr>
<td></td>
<td>(0.039)</td>
<td>(0.036)</td>
<td>(0.047***)**</td>
</tr>
<tr>
<td>Profit/#Employee</td>
<td>10.883</td>
<td>7.901***</td>
<td>12.988***</td>
</tr>
<tr>
<td></td>
<td>(5.230)</td>
<td>(4.449***)</td>
<td>(6.445***)**</td>
</tr>
</tbody>
</table>
Table 2. Ownerships, Incentives, and Professionalization
This table presents basic facts of China's privatization and summary statistics of financial variables used in the empirical analysis. Profits are defined as earnings before interest, tax, and depreciation.

**Panel A. Ownership of Privitized Firms**

<table>
<thead>
<tr>
<th>Ownership by the Largest Shareholder</th>
<th>Mean</th>
<th>MBO</th>
<th>Selling to Outsiders</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Median</td>
<td>(30%)</td>
<td>(70%)</td>
<td>(100%)</td>
<td>(51%)</td>
</tr>
<tr>
<td>Ownership by the Second and Third Largest Shareholder</td>
<td>Mean</td>
<td>27%</td>
<td>20%</td>
<td>30%</td>
<td>26%</td>
</tr>
<tr>
<td></td>
<td>Median</td>
<td>(22%)</td>
<td>(15%)</td>
<td>(30%)</td>
<td>(20%)</td>
</tr>
</tbody>
</table>

**Panel B. Incentives and Professionalization**

<table>
<thead>
<tr>
<th></th>
<th>Performance Based Compensation</th>
<th>Change of Core Management Team</th>
<th>International Accounting &amp; Independent Auditing</th>
<th>Establishing Board of Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>MBO</td>
<td>8%</td>
<td>64%</td>
<td>11%</td>
<td>84%</td>
</tr>
<tr>
<td>Selling to Outsiders</td>
<td>15%</td>
<td>61%</td>
<td>7%</td>
<td>67%</td>
</tr>
<tr>
<td>Other</td>
<td>2%</td>
<td>60%</td>
<td>5%</td>
<td>71%</td>
</tr>
<tr>
<td>Whole Sample</td>
<td>7%</td>
<td>62%</td>
<td>8%</td>
<td>76%</td>
</tr>
</tbody>
</table>