Master Thesis

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Chinese-style Privatization: From Political Taboo to Incrementalist Reform

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Introduction

Beginning in 1978, China’s industrial revolution has progressed for several decades. There are generally two phases of China’s industrial reform: first during the 1980s, China did not privatize significant numbers of state-owned firms; secondly after the mid-1990s, China launched the second wave of industrial reforms, featuring privatization and corporatization. Especially in the realm of State Owned Enterprises (SOEs) reform, after 1997’s 15th Congress of the Communist Party, the “mainstream” of SOEs reform was “grasping the large, and letting the small go”, namely to reorganize large SOEs to become even larger and more competitive groups, and to privatize middle and small SOEs at the time. Yet what caused the large scale privatization? Has it improved SOEs performance, and what are its negative impacts? What is the future of the policy? All remains very complicated. As Megginson and Netter (2001) point out:

One of the more complex issues in this area involves the interrelated questions of when to privatize, whether to privatize rapidly or slowly, what order to follow in privatizing firms (sequencing), whether to sell a SOE at once or in stages (staging), whether to restructure a SOE prior to sale (or to just restructure
the SOE), . . . . , the complexity of the issue has limited the empirical work in this area. (p. 341)\(^1\)

In this paper, I’ll focus on the analysis of privatization of small and medium sized SOEs. The following sections will be organized as: section 2 will discuss problems prior to privatization and its process; section 3 will examine why China’s privatization took the form it did; section 4 will evaluate the policy and the following section will point out the reason why it is insufficient or ineffective; the last section will offer some feasible policy recommendations.

**Pre-privatization Problems and the Reform Process**

*Problems*

With its double-digit economic growth for several decades, China has been well known for its economic reforms, especially in the state-owned enterprises. Between 1978 and 1993 the share of SOEs in the Chinese economy was dominant, and township village enterprises (TVEs) produced over 40 percent of China’s exports and employed more than 40 per cent of nation’s industrial workers. (Bowles and Dong 1999) By 1993, growth of the non-state sector had transformed China’s economy without closing any state-owned enterprises.\(^2\) However, after 1993 the profit per capita of TVEs and urban SOEs began falling and eventually China witnessed the large-scale privatization of SOEs. “By early 1993 it had become evident that

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\(^2\) See Cao, Yuanzheng, Qian, Yingyi, and Weingast Barry R., “From Federalism, Chinese Style to Privatization, Chinese Style”, *The European Bank for Reconstruction and Development*, 1999, pp. 104. This paper also classified the ownership structure of Chinese firms in 1993: state-owned enterprises (SOEs), collective enterprises (urban collectives and rural collectives; The latter are also known as TVEs), and private enterprises (including foreign firms). The latter two together are referred to as “non-state-ownership” while the first two together are referred to as “public–ownership of firms”.

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the lack of fundamental SOE reforms had seriously undermined China’s development.”

Figure 1 shows some key performance indicators including total profits. We can observe that in the early and middle 90s, although the sales revenue increased steadily, the total profits of SOEs staggered. Several problems emerging at this time can explain the privatization.

Figure 1: Performance indicators of China’s state owned & holding enterprises, 1993-2009, RMB million

Source: CEIC

In urban areas, for SOEs, the problem of surplus labor was a huge concern for central authorities. For some firms in old industrial centers developed on the traditional Soviet model, and some firms that lost their advantage after the entry of non-state firms, surplus employment was more acute than asset problems. In addition, in 1994 there were about 300,000 SOEs (including 100,000 in industry) with about 75 million state employees

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3 Ibid., pp. 104
Among all these SOEs approximately half were loss-making and had continued to consume a great portion of bank credit and other resources. At this time China was facing thorny problems in state enterprises.

At the rural level, Qian (2000) offered one insightful explanation. Qian divides the period between 1978 and 1999 into two stages: 1978-93 and 1994-1999. During the first stage, both state and market institution were imperfect and existing institution offered TVEs and private enterprises (PEs) both advantages and disadvantages. By using community government assistance, TVEs were thought to have better access to bank loans, and easier access to SOE technology and inputs that were in short supply. Also, in order to achieve community objectives, local governments (LGs) often induced both TVEs and PEs to adopt output targets or labor hiring goals that could potentially push the enterprises away from profit-maximizing production practices. However, by 1994, the state sector was no longer the major source of national industrial output and the official Communist Party line was to embrace a market system with private ownership and further develop market-supporting institutions based on the rule of law and incorporation of international best practices being established.5 Thus TVEs lost their comparative advantage in the first stage, and the banking reform in mid 1990s offered banks incentives to allocate financial resources to more productive uses. Under a more profit-driven and market-oriented economic environment, TVEs began to be less profitable and were regarded as financial burdens by local governments. Other works including Fang and Smith (2008) demonstrated that although TVEs hold institutional

4 Ibid., pp 111
5 Ibid.,

advantages, they were less financially efficient than PEs. Over time, the institutional advantages initially held by TVEs deteriorated.6

Process

Due to huge problems remaining in China’s SOEs, privatization, as one of the policy baskets provided by the central government to improve SOE performance, has become very significant in China since the end of the 1990s.7 Privatization mainly concerns assets and ownership changes. One milestone was the adoption of the Company Law in 1994, which provided a uniform legal framework into which different ownership forms fit. “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) Under the framework of Company Law, the “corporatizing” SOEs attained an official position in China’s legal system, which meant the policy-makers allowed diversified ownership, and any ownership form could operate.

Then in September 1997, the 15th Congress of China’s Communist Party began to initiate a series of SOEs reform, namely “grasping the large and letting the small go”, starting the privatizing of small and medium sized SOEs while private capital was also permitted to penetrate into “pillar” and “basic” industries in the form of private equity participation in large SOEs.8 The reform was planned to be operated in three levels9: privatization of small

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7 Shu Y. Ma (2008) argues that the de facto privatization has already been underway since the mid-1980s, under the name of “shareholding system reform”.
SOEs in county level; mass lay-off of SOE workers at the city level; and mergers, groupings/conglomerations, corporatizations, and initial public offerings (IPO) of some large SOEs which often involve the central government. In particular, for privatization, “letting the small go” offered local government much greater authority to restructure their own firms and, in particular, to privatize or close down some of them.

According to Ma (2008), China’s SOEs privatization was implemented in three phases: first, during 1997 to 2001 there was an “implicit privatization”, when a three-year target was set to eliminate the deficits of most large and medium-sized SOEs through “strategic restructuring”, and the stock market was expected “to serve the function of relieving SOEs’ difficult conditions.” This was followed by a wave of “reduction of holding of state-owned shares” (RHSOS, or guoyougu jianchi) through backdoor listing (i.e., SOEs used state shares to purchase inactive listed companies). Then from 2001 to 2002, it was called the “pension-driven privatization”, which finally failed because the two conflicted programs - RHSOS and social security reform - were linked together. Then a “deadlock” appeared from 2003 to 2004, when a high powered central agency State-owned Assets Supervision and Administration Committee (SASAC) was established to prevent depletion of state assets. The tension between SASAC and China Securities Regulatory Commission which was more concerned about the interest of share investors resulted in a deadlock during 2003 to 2004. Since 2005 a breakthrough occurred when the “share conversion” reform pilot program was launched, whose purpose is to solve the “division” between “equities” (gu) and “rights”

Summer 1999, pp. 51-87
9 Cao, Yuanzheng, Qian, Yingyi, and Weingast Barry R., “From Federalism, Chinese Style to Privatization, Chinese Style”, The European Bank for Reconstruction and Development, 1999, pp. 104-105
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The pilot program was completed within four months after its introduction, and in early September 2005 the “share conversion” reform was officially launched nationwide. By late April 2006, a year after the introduction of the pilot program, 868 listed companies accounting for about 70% of total market capitalization had already completed conversion of non-tradable shares into tradable shares, or were in the process of doing so. 10

Why Privatization Took Place?

“Chinese-style” privatization

On a macro level, as mentioned above, the Chinese privatization was characterized as a gradual and selective policy, or a 2R policy (retain government control of large enterprises that operate in the strategic sectors and retreat from small and medium-sized enterprises that operate in highly competitive markets)11, compared to the big-bang mass privatization adopted by Eastern Europe and Former Soviet Union countries: retain government control of large enterprises that operate in the strategic sectors and retreat from small and medium sized enterprises that operate in highly competitive markets.12

On a micro level, as to the choice of privatization strategy in China, insider privatization prevailed, and outsiders could hardly gain access to buying state enterprises.13 Two policy

11 Eg. Green & Liu, 2005
precedents were crucial in setting off the current wave of privatization. The first was the development in the mid-1990s of a transitional ownership form, originally for TVEs, called joint-stock cooperatives. The second precedent was established when the well-known Chinese computer company Lianxiang converted to a corporation. In this case, the founding managerial team was clearly responsible for the success of the company, which they had created from scratch. (Naughton 2005) Thereafter a majority of small and medium sized public enterprises were sold to their former managers and workers. According to surveys in some provinces, three forms of ownership account for more than half of all privatization: sales to private domestic or foreign investors or firms (chushou); incorporation into a limited liability or joint stock company (gongsizhi); and stock co-operatives where most parts of shares are sold to employees. Stock co-operatives accounted for about 35 percent of all privatization, sales to private investors to 11 percent, and corporatization for 8 percent.

Secondly, as Qian and Weingast argued, the liquidity and wealth constraints of potential buyers were less of a problem in China, while these problems were major concerns in the design of privatization programs in Eastern Europe and Russia and are partially responsible for the free distribution of shares. Chinese people have accumulated significant amount of private savings in a form of bank deposit since the commencement of reform, and most SOEs debt-asset ratios are very high to the extent that net wealth of these firms is very small relative to assets, sometimes even close to zero. Thus in many cases, the employees can afford to buy these firms with their own savings.

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15 Cao, Yuanzheng, Qian, Yingyi, and Weingast Barry R., “From Federalism, Chinese Style to Privatization, Chinese Style”, *The European Bank for Reconstruction and Development*, 1999, pp. 110
Thirdly, there are apparent difference between urban SOE privatization and rural TVE privatization. Generally speaking, the privatization in urban SOEs tended to be more gradual and involved a more limited transfer of property rights to private investors than what happened in rural TVEs. Besides, as Dong, Putterman and Unel argued, the privatization of SOEs exhibited selection bias as the worse performing enterprises were the principal targets of reforms; while in contrast, pre-reform performance did not play a role in determining the TVEs selection for privatization.16

Motives

In general, what are the factors leading to the Chinese style of “grasping the large, letting go of the small”? The major reason is the different level of central and local SOE development over the 20 years since the start of the reform. After 20 years of reform, the central government’ earlier policies were increasingly focused on energy, natural resources, and a few economic sectors of substantial scale. These sectors are often protected by high entry barriers, and they remained profitable. Thus the central government was willing to keep controll of these “above-scale” enterprises. On the contrary, in the 1990s those enterprises run by local government were much smaller in scale than central ones, and were much more exposed to competitive pressures and much less profitable. As a result, the local government had incentives to get rid of loss-making enterprises due to the fact that most of small and medium sized SOEs were losing money in early 1990s. More specifically, as Qian and

16 See Dong, Xiao-yuan, Putterman, Louis, and Unel, Bulent, “Privatization and Firm Performance: A Comparison between Rural and Urban Enterprises in China”, *Journal of Comparative Economics*, 34 2006. However, some other scholars pointed out that those SOEs with mediocre performance are most likely chosen for privatization.
Weingast argued, harder budget constraints of local government and increased competition from the non-state sector have made it increasingly costly to maintain these inefficient enterprises.\textsuperscript{17}

Besides, political compromise among local officials, managers and workers of SOEs might be responsible for the prevalence of stock co-operative ownership. Jin Zeng (2010) conducted a case study in privatization in Shanghai, Shenyang, and Xiamen, and explained that the prevalence of insider privatization results from the political compromises among district officials, managers and workers of public enterprises when the local officials perceive the regulatory environment to be relatively lax or when these actors intentionally circumvent the regulatory constraints.\textsuperscript{18}

Moreover, some scholars express a “political-benefits” view to explain the motives of privatization, arguing that “to assess the constraints on and possibilities for privatization, one must have a clear picture of . . . the gains and losses that will be sustained by the constituent elements of dominant political coalitions”\textsuperscript{19} With its application to China, Liu, Sun and Woo (2006) argued that incentives for sale have been created by the increasingly hardened budget constraints faced by local officials, intensified market competition, the likely improved post-privatization performance, and the magnitude of the private benefits from which local

\textsuperscript{17} Cao, Yuanzheng, Qian, Yingyi, and Weingast Barry R., “From Federalism, Chinese Style to Privatization, Chinese Style”, \textit{The European Bank for Reconstruction and Development}, 1999, pp. 121
\textsuperscript{18} Zeng, Jin, “Political Compromises: The Privatization of Small and Medium Sized Public Enterprises in China”, \textit{Journal of Chinese Political Science/Association of Chinese Political Studies}, 2010
\textsuperscript{19} Bienen and Waterbury 1989, p618
leaders can expect to derive after privatization. Some of these benefits may include the existence of localities’ private control as well as political interests in post-privatized companies.

Last but not least, from the view of fiscal budget, Qian and Roland (1998), Cao (1999) and Li (2000) pointed out that the tighter budget for local government was one of the most crucial drives behind privatization. First, the fiscal and monetary recentralization in the 1990s contributed to the significant hardening of budget constraints on local governments, which means that they now have to assume the primary responsibility for local economies, in correspondence with their control of independent revenue sources granted by the 1980s decentralization. Second, the intensification of cross-regional competition in product markets is the driving force behind local governments privatizing their enterprises to supply more incentives to managers and to improve the enterprises’ competitiveness, which in turn increases their fiscal revenue.

The resurgence of state-sector

After several years of encouragement of private sector development, the percentage of state-owned enterprises in industrial production has fallen from approximately 80% at the beginning of the reform, to about 30% in 2008. However, one heat debated topic on China’s SOE reform in the past decade is whether or not the state sector was re-emphasized by the central authority, while the private sector was stifled. This new trend is labeled as “the state

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advances and the private sector retreats” (guojin mintui).

As stated in previous sections, at the beginning of the SOE reform, not only did those large SOEs in key industries got privatized but they were even restructured as “national champions”. These key industries include: 1) industries related to national securities; 2) natural resources which the state monopolies; 3) industries that produce public goods and social welfare. In 2003, the establishment of the State-owned Assets Supervision and Administration Committee (SASAC) brought a turning point to the falling state sector. This agency’s task is “to revitalize the SOEs and to reorganize them from money-losing into profitable firms, through restructuring and consolidation.”21 Li Rongrong, the chairman of SASAC declared that “country’s seven major industries, including electricity and grid, petroleum and petrochemical, telecommunications, coal, civil aviation, and maritime, should be exclusively owned by the state, while excluding any domestic private entities.”22

Meanwhile, China’s plan of massive investment in infrastructure and the global financial crisis offered another great opportunity to the state-sector in the way that the crisis had a greater impact on China’s private sector as most of private enterprises are dependent on export, while large SOEs focus on the domestic market. Moreover, in November 2008 the central government announced a 4 trillion RMB expansion plan on domestic demand, focusing on investment in infrastructure such as railways, roads, and airports, which are mostly monopolized by state-owned enterprises. In early 2009, a stimulus plan (USD 540

22 Ibid.,
billion) for 10 key industries also benefited SOEs by encouraging mergers and acquisitions (M&A) led by large SOEs to foster large and strong companies.

There are examples in various sectors which SOEs benefit from. In the real estate sector, some state-owned real estate developers have tight relationship with local government, whose public finance rely on selling lands to a very large extent. This close tie raises broad concerns and media often criticized state-owned developers as “land king” who are pushing up the housing prices in major cities such as Beijing and Shanghai. In 2009 state-owned developers purchased 60% of the 10 most expensive plots which were on sale. Many winning bidders have close ties with the government. For example, a property company as a subsidiary of the state-owned Sinochem Group bought a plot in Beijing for nearly 4 billion RMB, making it the most expensive plot across the country. Another plot in Beijing’s outskirts was sold for 3 billion RMB to the Greenland Group, owned by the Shanghai municipal government.23

In the steel industry, in September 2009 the state-owned Shangdong Iron and Steel Group Co. Ltd., which lost money for a long time, acquired the private Rizhao Iron and Steel Co. Ltd.. The latter is one of the countries’ largest private steel companies. This deal in turn created the second largest steel company in China. In Shanghai the Baoshan Steel Group, a famous SOE, acquired the private Ninbo Steel Company.24 In the oil industry, the China Petroleum (CNPC) acquired most of the non-state oil companies in Heilongjiang Province.25

24 “Asia: Nationalisation rides again; China's state-owned enterprises”, The Economist, London: Nov 14, 2009, Vol. 393, Iss. 8657; pg. 52
25 Jialin Zhang, “The Advance of China’s State Sector: Some Implications for the China’s Economy”,
In addition, in July 2009 the China National Cereals Group (COFCO) invested in and purchased 20% share of the private Mengniu Dairy Company, the country’s leading dairy producer. This is the largest-ever deal in the Chinese food industry, and COFCO has become the largest shareholder of Mengniu. COFCO business goes far beyond food and beverages, to include residential and commercial real estate. In Shanxi, the provincial government ordered a reorganization of the coal industry. The share of private capital in that industry is not supposed to exceed 30 percent. Many private coal mining factories are complaining about this round of nationalization.  

Policy Evaluation

In this section I’ll evaluate the policy of privatization by analyzing the pros and cons brought by the implementation of the policy to SOE performance, economic efficiency, and social stability. In particular, the impacts of “state advances” discussed in the previous section will also be covered.

Pros

In general, for urban SOEs, ownership structure has been changed drastically. After more than 30 years of economic reform and 15 years of privatization, the ownership form of China has been transformed to the extent that, at the beginning of the century, the private sector already accounted for more than 40% of output and employment of national industry.

www.ChinaUSFriendship.com, August 1, 2010
26 “Asia: Nationalisation rides again; China's state-owned enterprises”, The Economists, London: Nov 14, 2009. Vol. 393, Iss. 8657; pg. 52
Privatization along with the revised ownership structure will have positive influences on several aspects.

Figure 2: State-owned and state-holding industrial enterprises 1998-2007

![Graph showing state-owned and state-holding industrial enterprises 1998-2007](source: China Statistical Yearbook)

Figure 3: Percentage of SOE in all Industry output 1993-2003

Conventional wisdom reveals that privatized enterprises will have better performance and become more efficient. Alchian (1977), in a paper argues that behavior under public ownership is different from that under private ownership “not because the objectives sought by organizations under each form are different, but, instead, even with the same explicit organizational goals, the cost-rewards system impinging on the employees and the ‘owners’ of the organizations are different.” He proposed the following theorem, “Under public ownership the cost of any decision or choice are less fully thrust upon the selectors than under private property.”

After reviewing previous literature on the impacts of privatization on firm performance, I believe it is evident that privatization had positive impacts on firms’ performance (see Figure 1), but controlling selection bias and endogeneity in the reforming process is important. Using a survey of 736 firms drawn from five cities and seven sectors for 1996 to 2001, Yusuf et al. (2005) shows the conventional results that foreign ownership, reformed SOEs, and non-SOE ownership all enhance productivity. However, when the authors use fixed effects to control for potential endogeneity and selection bias, they find that the impact of restructuring is not robust. Although they find no strong statistical evidence that restructuring has led to productivity gains, their survey provides evidence of upgrading following restructuring, including the introduction of new production technologies. However, since technology acquisition requires an established absorptive capacity, this finding is also consistent with the proposition that the most efficient firms are those selected for reform and, hence, controlling

for selectivity bias is crucial.

Song and Yao (2004) use a survey of enterprise data covering 683 firms in 11 cities over the period from 1995 to 2001. They find that state control and private control lead to higher profitability than state ownership but find little impact of these restructurings on unit cost and productivity. Like the previous authors, they find that introducing fixed effects reduces the statistical significance of the relevant estimates. According to Bai, Lu and Tao (2009)’s empirical research, the privatization of SOEs was found to have positive impact on sales and hence led to higher labor productivity. At the same time, there was a gain in firm profitability contributed to mostly by the reduction of managerial expenses to sales. These suggest that it is inefficient to keep state-owned enterprises while as a way of maintaining social stability, and necessary to establish an efficient and independent social welfare system.

Cons

Apart from positive effects it brought to SOEs performance and efficiency, privatization will also lead to some negative effects on social stability. Privatization has aroused some discontent among workers. One irony is that privatization, schemed and controlled by the Communist Party to better reform the economy, got resisted and discontent among workers in a traditional “communist” way. Feng Chen’s work demonstrated that with an aggressive implementation of privatization schemes, labor struggles have emerged in which companies are increasingly permeated by “class consciousness”. Workers’ previous experiences with

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socialism shape the way they comprehend privatization. In many cases, privatization often triggered organized resistance as workers perceived a legitimate target to oppose and a contestable interest to defend, and felt it politically defensible to reject capitalism in the name of protecting state property.  

Another irony has something to do with the state-enterprise relationship: the original purpose of SOEs privatization was to make local government get rid of less-profitable SOEs, but in many cases the local government has *de facto* dominated the process of the reform, and will continue to retain control over the SOE. Hu (2000) mentioned that the mode by which an SOE is transformed has thus far been dictated by the local government involved: the government selects the strategy and timing of the reform pursued for each SOE and even chooses merger partners as well as those who will be able to buy stocks in or purchase the SOE at stake. When SOEs merge, the resulting new enterprises are still state-owned operations. In joint-stock companies, the state tends to hold a majority of shares. In other cases, the state may lease out all of or some SOE assets. Thus in this sense, the privatization has not been well implemented since the state continues to hold significant influence in local level enterprises. Consequently, the remaining state’s leverage on the local enterprises will influence the policy-making and strategy-selection of companies according to political interest rather than market-oriented factors. In sum, the privatization reform was incomplete.

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The impact of privatization on employment is more complex. Privatization is not only a political economic issue, but also related to social policy, since one important aspect of privatization is mass lay-off of employees from traditional SOEs. According to Rawski (2002), there were approximately 6 million out of 44 million industrial workers in the industrial state sector, by the end of the century.\(^{31}\) Based on Ministry of Labor and Social Security (MOLSS), there are 21 million workers that were laid off during 1994 between 2005. (Table 1) How to ensure social stability when large amounts of workers lost their positions from prior “iron rice bowl” remained to be critical for the central government, since social stability turned out to be the priority of CCP after the Tiananmen Event in 1989. Local government adopted a series of policies to assist laid-off workers reemployed. When SOEs were sold, buyers were required to sign a contract arranging for the redeployment of employees. Government funds, such as the state asset exit fund and the SOE bankruptcy provisional fund, were established to finance compensation and re-deploy workers.\(^{32}\) In some cases, the government would pay extra subsides to cover the redeployment of employees. In addition, tax holidays were offered to former SOE employees starting their own business who hired laid-off workers.\(^ {33}\)

Some scholars argue that privatization and mass laid-off workers brought social unrest, as the central government’s re-employment policy was not efficient enough. Solinger (2002) pointed out that the non-state sectors generally have more work for rural migrants or the highly-educated than for the laid-off; the Re-employment Project is full of pitfalls; and

\(^{31}\) Rawski, 2002  
\(^{33}\) Ibid.,
immense challenges of both resource scarcity and administrative incapacity characterize the national-scale social welfare programme.\textsuperscript{34} However, it is not justifiable to say the re-employment program did not have any fruits, despite that the re-employment of laid-off workers never reached 100% though the official channel. Table 1 and 2 displays the total number of reemployment and yearly decrease of laid-off workers since 1998. The total number of reemployment from 1998 to 2005 is 19,740,000 and the number of laid-off workers decreased to 606,000 in 2004.

**Table 1: Laid-off workers 1999-2005, Unit: 10,000 person**

<table>
<thead>
<tr>
<th>year</th>
<th>Registered Laid-off workers</th>
<th>No. of increase</th>
<th>No. of Reemployment</th>
</tr>
</thead>
<tbody>
<tr>
<td>balance as in 1998</td>
<td>691.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>594.8</td>
<td>562.2</td>
<td>610</td>
</tr>
<tr>
<td>1999</td>
<td>652.5</td>
<td>618.6</td>
<td>491</td>
</tr>
<tr>
<td>2000</td>
<td>657.2</td>
<td>445.5</td>
<td>361</td>
</tr>
<tr>
<td>2001</td>
<td>515.4</td>
<td>234.3</td>
<td>227</td>
</tr>
<tr>
<td>2002</td>
<td>409.9</td>
<td>162.1</td>
<td>120</td>
</tr>
<tr>
<td>2003</td>
<td>260.2</td>
<td>103</td>
<td>85</td>
</tr>
<tr>
<td>2004</td>
<td>153</td>
<td>34.3</td>
<td>47</td>
</tr>
<tr>
<td>2005</td>
<td>60.6</td>
<td>14.8</td>
<td>34</td>
</tr>
<tr>
<td>1998-2005</td>
<td><strong>2174.8</strong></td>
<td></td>
<td><strong>1974</strong></td>
</tr>
</tbody>
</table>

*Source: China Statistical Yearbook 2006*

**Table 2: Yearly decrease of laid-off workers 1999-2005 through Reemployment**

*Unit: 10,000 person*

<table>
<thead>
<tr>
<th>year</th>
<th>No. of decrease</th>
<th>No. of reemployment</th>
<th>% of reemployment in all decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>balance as in 1998</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>659.3</td>
<td>610</td>
<td>93%</td>
</tr>
<tr>
<td>1999</td>
<td>557.7</td>
<td>491</td>
<td>88%</td>
</tr>
<tr>
<td>2000</td>
<td>440.8</td>
<td>361</td>
<td>82%</td>
</tr>
</tbody>
</table>

\textsuperscript{34} Solinger, Dorothy J., “Labor Market Reform and the Plight of the Laid-off Proletariat”, *The China Quarterly*, 2002
<table>
<thead>
<tr>
<th>Year</th>
<th>Workers</th>
<th>Unemployed</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>376.2</td>
<td>227</td>
<td>60%</td>
</tr>
<tr>
<td>2002</td>
<td>267.6</td>
<td>120</td>
<td>45%</td>
</tr>
<tr>
<td>2003</td>
<td>249.0</td>
<td>85</td>
<td>34%</td>
</tr>
<tr>
<td>2004</td>
<td>141.5</td>
<td>47</td>
<td>33%</td>
</tr>
<tr>
<td>2005</td>
<td>107.2</td>
<td>34</td>
<td>32%</td>
</tr>
</tbody>
</table>

*Source: China Statistical Yearbook 2006*

**Figure 4: Percentage of SOE workers in all employment 1994 - 2007**

Yet although surplus labor remains to be a severe problem for both pre-privatized SOEs and post-privatized SOEs, some other quantitative research surprisingly indicate that China’s privatization did not bring a huge shock in rural areas. In rural TVEs sector, Junichi Ito (2006) pointed out that unlike the privatization of SOEs in urban areas, the ownership reform of SOEs in rural China did not generate massive unemployment.\(^{35}\) In urban areas, Bai believed that privatization in China had little impact on the change of employment: while shrinking of the labor force before privatization was observed and could have also taken place even before

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the sample period, there was no evidence for an accelerated layoff of surplus labor after the privatization. Bai also pointed out that even some privatized SOEs were forced to limit their numbers of laid-off workers, due to the huge political pressure of the central government to maintain social stability in some of deals as parts of privatization. This suggests that privatization was harmonious, consistent with multitask theory that delaying the privatization of state-owned enterprises as a second-best way of absorbing surplus labor force, and maintaining social stability, a public good for the rest of the economy. (Bai 2000)36

Impacts of the resurging state sector

The increasing monopolies in many key industries and the resurging of the state sector are raising many concerns, as it may indicate a turning point in China’s market-oriented transition. First of all, “state advances” hampers the development of millions of small private enterprises. The history of China’s private sector has been relatively short compared to other mature markets. It is facing lots of barriers since the Opening up and Reform era, including barriers in access to capital (especially from national banks), lack of human capital, and lack of competiveness confronting with SOEs which are under the umbrella of central authorities. The “state advances” in the past decade even deteriorate the situation, especially during the financial crisis when numerous private companies suffered from huge damages. Due to the close tie with the government, the shareholder of SOEs, state-owned firms introduce lobbying activities which will increase the entry barrier for the market, in turn damaging the principle of competition in the market economy.

Secondly, the state monopolies also impacted the living standards of Chinese people. One example is the increasing state power in the real estate sector. As discussed before, the purchasing of large tracts of lands by state-owned real estate developers is a critical factor in driving the housing prices up. Others argue that a stronger state sector only benefits a small group of people. “Despite making vast profits by taking advantage of their monopoly positions, state-owned enterprises pay relatively little in the way of dividends to the government, their shareholder. Ultimately, it is not the general public, but only executives and employees of these enterprises who reap the benefits by receiving high salaries and bonuses.”

Why Insufficient or Ineffective?

Managerial Abuse

In many aspects, as mentioned above, the SOEs reform and privatization are slow and ineffective. What are the factors leading to the insufficiency and ineffectiveness? The first explanation involves corporate governance. There are basically two types of corporate governance system, namely the market based and the control based. The China case is very distinctive: as a result of the weakness of both control-based and market-based system of managerial oversight, Chinese state firm managers have been extraordinarily independent, resulting in the abuse of managerial power in some cases. Naughton (2005) mentioned that although the penalties for corruption are severe, the overall institutional environment makes

corruption relatively difficult to detect and punish unless it is particularly overt. Some specific examples include: selling public resources for a price slightly under the true market price to a related party; setting up a subsidiary, staffed by family members, that receives preference from the public enterprise in a range of business activities.

Multitask Theory

In transition economies like China, SOEs not only have the economic function of production, but also are in charge of providing social welfare and maintaining employment, due to the lack of independent and effective social welfare net. Thus the central government is not willing to implement complete SOEs reform. Bai (2000) utilized the “multitask theory” to explain why in almost all the transition economies, the reforms of SOEs have been slow and SOEs continue to have poor financial performance. At the beginning of the reform, independent agencies specializing in providing a social safety net are missing because before transition SOEs are majorly responsible for taking over this important task. Since building a social safety net is very complicated, it is almost impossible to establish such an efficient system immediately even if the funding is adequate. Consequently, during transition, the government selects to slow down the pace of privatization in order to keep a certain number of SOEs to maintain social stability. Applying this theory to China’s incomplete transformation of ownership structure, we believe that the coexistence of SOEs and non-SOEs in China is “a second-best arrangement that helps maintain social stability and thus

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protects the business environment of all firms."\textsuperscript{40}

**Policy Recommendations**

*Corporate governance matters*

Privatization deals with assets and ownership, while corporatization deals with corporate governance. To increasingly improve the performance of SOEs, it is not adequate to merely transform its ownership structure, but also necessary to introduce mechanisms to make firms operate better. Corporatization is definitely the solution, which can minimize the potential conflict of interest between those with control and those with income rights. According to OECD report, corporate governance refers to the set of mechanisms that induce individuals with de facto control over assets to make decisions that maximize the value of the company to the owners.\textsuperscript{41} In retrospect, China actually has already adopted a series of policies of corporatization to improve corporate governance, particularly after the mid of 1990s.

Aivazian, Ge and Qiu (2005) suggest that it is optimal for governments to carry out corporatization of SOEs before eventual privatization, and even without privatization, corporate governance reform along is a potential effective way to improve performance of SEOs.\textsuperscript{42} By corporatization, SOEs are able to enhance their efficiency by better monitoring of managers, improvements in information-sharing channels, and a reduction in governmental political intervention. In sum, corporatization and privatization are two mutual influenced


\textsuperscript{41} OECD 2004

\textsuperscript{42} Aivizian, Varouj A., Ge, Ying, and Qiu, Jiaping, “Can Corporatization improve the performance of state-owned enterprises even without privatization?”, *Journal of Corporate Finance*, 11 2005
solutions to improve SOEs performance. On one hand, corporatization enables privatization, either complete privatization or diversification of ownership by selling off minority stakes to the public or to strategic investors. On the other, corporatization can leave unsolved problems which have to be addressed by privatization.

More R&D

Another approach for deeper SOEs reform is innovation. For a long time Chinese enterprises were at the bottom of value chain due to the lack of innovative spirit. One of the legacies of central planned economy is the over capitalization of Chinese industrial enterprises. The reliance on capital-intensive industries is promoted by financial repression that provides inexpensive capital to industry. That is the reason why numerous economists are proposing a “rebalancing” Chinese economy which relies less on exports and investment. An increasing input of R&D may enhance SOEs’ performance and make it more sustainable. In fact, building the national innovation system has already been put on agenda in 2006 when the central government initiated the Middle to Long-term Plan for Sciences and Technology Development (MLP). The overreaching goal is to make China an innovation-oriented society by the year 2020 and over the long term - one of the world’s leading “innovation economies”. It emphasizes the need to develop capabilities for “indigenous” or “home-grown innovation”. This has been widely regarded as the signal for Chinese enterprises to shift from simply copying foreign advanced technologies to developing their own to replace

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43 As Alchian recognized, in some cases it is not easy or possible to impose extra corrective constraints as offsets on public agents. (p. 147)
Western technologies, and it has rose broad concern in the Western world. Through investing more on R&D, Chinese state enterprises will not only increase their efficiency and to pursue for the rest of value chain, but will also be more “outward” – investing and building branches overseas.  

Social Safety Net Building

As mentioned above, based on the arguments of multitask theory, one of the most critical reasons why most SOEs privatization is slow and incomplete is the lack of independent and effective agencies providing a social safety net other than SOEs. Thus a third approach is to build genuine social safety system. In the process of privatization which resulted in mass layoff of workers, the central government seemed not care too much about the principles of fairness and justice. “The government has never made it an official national policy and no national legislation exists to dictate the process.” Yet the installation of a genuine social security net is already under construction. The longer-range goal is to create a stand-alone social security network, comprising four separate types of insurance: for pensions, unemployment, medical care, and work injury. But obstructing the fulfillment of the state’s projections are the refusal or inability of firms to make their contributions to pools, misappropriation of funds, a lack of objective standards in issuing the funds, and problems in transferring insurance after working for many years in a given firm.

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46 However, the MLP and China’s Indigenous Innovation program also raised some concerns in the Western world. Some scholars argued that the true purpose of MLP was to use China’s own technology to replace foreigners. See James McGregor, “China’s Drive for ‘Indigenous Innovation’: A Web of Industrial Policies”, Global Regulatory Corporation Project

47 Feng, pp. 45


49 N.a., “Offering advice and suggestions,” pp. 4.
Concluding Remarks

This article has firstly explored the policy problems existing before privatization including surplus labor in SOEs, and deficiency in firm performance, then introduced the historical process of policy implementation since the mid-1990s. This article also characterizes China’s privatization as selective and gradual, insider privatization, less financial constraints, and distinction between rural and urban enterprises. One particular point need to be emphasized here is the “state advances and private retreats” in the past decade especially after the financial crisis. Many signals have indicated that the central authorities have re-emphasized the role of SOEs through a series of stimulus plan and organizational adjustment. Then it analyzes the pros and cons of this policy, especially the impacts of the advancing state.

This paper also points out that managerial abuse and lack of independent, effective social safety net are key reasons why it has been insufficient and ineffective in some aspects. The last part proposes three approaches for further SOEs reform, namely thorough corporatization, more input on innovation, and building a genuine social safety system for the whole nation.


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