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Reforming the governance structure of China's state-owned enterprises

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SUMMARY

Over the last 20 years, China's state-owned enterprises have been the subject of significant reform. As discussed in this article, they were previously state-run work units within the centralized governmental hierarchy, but in recent years they have been transformed in such a way as to have a recognized legal personality. Provision has also been made for them to be reconstituted as modern corporate entities under the Company Law (which came into effect in 1994) and to become an integral component of an appropriately organized system of state asset management. Progress has been slow in this regard, but some positive developments have occurred and, in late 1997, the door was officially opened for some of them to be partially or even fully divested. © 1998 John Wiley & Sons, Ltd.

INTRODUCTION

At the start of market-oriented reforms in 1978, state-owned enterprises and urban collectively owned enterprises were basically the only two categories of enterprises in the People's Republic of China (PRC). The state-owned enterprises produced 77.6% of the industrial output and the urban collective enterprises produced the rest. By 1996, after almost 20 years of reforms, the share of state-owned enterprises in the total industrial output had fallen sharply to 28.5% owing to the emergence of various non-state enterprises such as foreign-invested firms and rural township and village enterprises. Specifically, the share of industrial output among the non-state enterprises in 1996 was 39.4% for urban and rural collective enterprises, 15.5% for individually owned enterprises, and 16.5% for other types of enterprises including foreign-invested, privately owned and joint-stock enterprises.

One of the key factors responsible for the poor performance of the state-owned enterprises has been their governance structure. This article addresses this problem and considers the main reforms which have been introduced in recent years.

LEGAL FRAMEWORK FOR ENTERPRISES

China did not have any unified legislation covering all types of enterprises with different ownership until 1993. The Company Law was passed by the National

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People's Congress on 29 December 1993 and came into effect on 1 July 1994. This law is based on similar laws in mature market economies, with modifications to fit special Chinese circumstances such as in the area of wholly state-owned enterprises. However, since the law was put into effect, relatively few enterprises have actually been organized or reorganized in accordance with its provisions. Instead, most enterprises of different ownership have continued to operate under separate laws and regulations which were enacted during 1978–1993 and still remain in effect.

The foreign-invested enterprises are subject to a special set of enterprise laws designed specifically for the needs of foreign investors. These include:

- the PRC Law on Sino–Foreign Equity Joint Ventures (introduced in 1979);
- the PRC Law on Wholly Foreign Owned Enterprises (introduced in 1986); and
- the PRC Law on Sino–Foreign Contractual Joint Ventures (introduced in 1988).

In addition to these enterprise laws, China has also used the designation of special economic zones, along with special tax and tariff treatments as well as many other central and regional special regulations and policies, to create a market-friendly institutional environment for foreign-invested enterprises.

The institutional environment for domestic non-state enterprises has also been different from that for the state-owned enterprises. Among the non-state enterprises, the rural township and village enterprises have expanded most rapidly in recent years. To support these enterprises, the Law on Township Enterprises was introduced in 1996. The urban collectively owned enterprises are still governed by a regulation issued by the State Council in 1991.

In recent years, especially since 1996, many small and medium-sized state-owned enterprises have been transformed into shareholding co-operative enterprises under the various privatization experiments, where employees are the major shareholders and decision making is on the basis of one-employee–one-vote rather than one-share–one-vote. There are ongoing debates among policy makers and scholars as to whether separate national laws and regulations should be established for these shareholding co-operative enterprises. Currently, they are governed by regulations set by local governments.

Most of China's state-owned enterprises (SOEs) are still governed by the PRC Law on Industrial Enterprises Owned Wholly by the People (hereafter the SOE Enterprise Law) which was introduced in 1988. Although these enterprises have been encouraged to reorganize under the recently introduced Company Law, relatively few of them have actually done so.

STATE-OWNED ENTERPRISE REFORM

Before the market-oriented reforms began in the late 1970s, SOEs were simply part of the Chinese government hierarchy. The whole industrial sector in the nation resembled a big factory with individual enterprises existing as workshops at different locations and in different sectors. In fact, the enterprises were usually called state-run work units. The managers of these work units were responsible to their superiors at various levels of the government hierarchy. They held ranks which were similar to government officials and which varied with the size and importance of their enterprises. The rank of managers would determine their salaries, benefits and other privileges.

Government officials allocated resources across work units, regions and sectors administratively using a central plan as their main instrument for guidance. Under this system, profits and losses could be allocated and shared across units, regions and sectors. Overall, the system was effective in mobilizing resources but not efficient in generating profits (Xiao, 1997a).

Since the late 1970s, the reform of the governance of SOEs has been a two-stage process. The government realized that something had to be done about the problem of extensive bureaucratic intervention as well as the lack of material incentives under the hierarchical work unit system.

Stage I: SOEs as legal persons

The first stage of reform saw the transition, during 1978–1993, from the work unit system to a system governed by the SOE Enterprise Law. The key governance reform during this stage was to separate SOEs from the government by introducing the concept of each enterprise being a legal person with its own rights and obligations and carrying responsibility for its own profits and losses. In this regard, the relations between the government and individual enterprises are now largely determined by responsibility contracts which are signed by representatives of various government agencies and the director of the enterprise representing the enterprise as a distinct legal entity. The contracts emphasize material incentives through various links between performance and pay for managers and workers, but they overlook the problem of moral hazard whereby managers and workers could achieve a small personal gain at a large cost to the enterprise or to the economy (Broadman and Xiao, 1997).

In the Chinese context, the idea of an enterprise being recognized as a legal person was introduced for the first time in the General Principles of Civil Law in 1986. The Regulation on the Registration of Enterprise Legal Persons and the SOE Enterprise Law were subsequently introduced in 1988. Under the SOE Enterprise Law, the enterprise director (rather than a board of management or board of directors) is designated as the representative of the legal person. This arrangement is designed to facilitate the separation between the rights and responsibilities of the government as the owner of an enterprise and the rights and obligations of the enterprise in its own legal capacity. SOEs as legal persons now have the right to enter into contractual relations with asset owners, employees, banks, suppliers, customers and other legal entities. This is a significant step away from the hierarchical work unit system in which the owner of an enterprise's assets, the state and its hierarchies, and the enterprise as an organization were not clearly separated in any legal sense.

The separation which is now provided for has considerable legal significance, but it has not been very effective in reducing the extensive administrative intervention of supervisory departments in the work of SOEs. In particular, in the SOE Enterprise Law, it is specified that the director of the enterprise, who represents the enterprise in its legal capacity, should be either appointed by the supervisory department or elected by the congress of employees with the approval of the supervisory department. This makes it very easy for the supervisory department to exercise control over an enterprise.

With the aim of reducing administrative interventions, the State Council issued the Regulation on Transforming the Management Mechanism of the Industrial

Enterprises Owned by the Whole People in 1992. This regulation gives 16 autonomous management rights to SOEs as legal persons. It requires (again) that the enterprises be responsible for their own profits and losses; it specifies the conditions for property rights transactions applied to the enterprises; and it delineates further the legal responsibilities of the enterprises and the supervisory departments.

Stage II: the Company Law and state asset management

The second stage of reform has involved the transition from the system governed by the SOE Enterprise Law to a modern corporate system governed by the Company Law. During this stage, which started in 1993 and is still continuing, the key governance reform is to establish the state as one of the shareholders of SOEs, possibly with mixed state–private ownership. In particular, the government is expected to play only the role of a shareholder with the objective of maintaining and increasing the value of state-owned assets. The focus of the governance reform is to establish a modern corporate system of state asset management. However, to date, the implementation of the Company Law has not been very successful. Fewer than 80 of the 100 SOEs selected nationwide to experiment with the company system have chosen to register as wholly state-owned limited liability companies.

One consequence of the autonomous rights arrangement referred to above was that the taking of state assets in SOEs, often by the management, became a serious problem in the early 1990s. To control this kind of asset stripping, the State Council issued in 1994 the Regulation on Monitoring and Management of State Property. This regulation states clearly that the role of the government in social and economic management should be separated from the function of the government as the owner of state property. The regulation, together with the Company Law and SOE Enterprise Law, lays the regulatory foundation for state asset management in China.

The current system of state asset management consists of three tiers of legal and organizational structures which correspond to the roles of the ultimate owner of the state's assets, its various acting owners, and the SOEs actually using the assets. The system attempts to ensure unified ownership of state assets while allowing for the decentralized management of these assets by SOEs structured as modern corporate entities (World Bank, 1997).

The first tier comprises the ultimate owners of state assets. According to current laws, regulations and practices, the whole people of China ultimately own all state assets and only the State Council can represent the whole people in exercising any residual rights of this ownership. In particular, local governments, line ministries, supervisory departments and SOEs themselves are not the ultimate owners of the state's assets. However, in accordance with the State Council's Regulation on Monitoring and Management of State Property, the overall management of state assets is based on a structure consisting of the central and local governments and involving specially constituted state asset management bureaux and commissions.

The second tier comprises the acting owners of the state's assets. It is understood that the state asset management bureaux and commissions at different levels of government do not perform a detailed managerial role. Hence group companies and holding companies are necessary to play the role of acting owners of the state's assets on their behalf and ultimately on behalf of the people.

The third tier consists of the SOEs which actually use and operate state assets. These enterprises (as already recorded) are constituted as independent legal persons with the capacity to enter into contractual relations with the government as well as non-government legal entities in relation to the use of the assets.

In addition to prescribing this three-tier system, the Regulation on Monitoring and Management of State Property provides for each SOE to have a board of supervisors (which is quite different from a board of directors in a modern company). The board consists of representatives from the enterprise's supervisory department, the Ministry of Finance, the State Economic and Trade Commission, and the National Bureau of State Owned Property Management, as well as other government departments, state banks, experts, managers and workers invited to sit on it by the enterprise's supervisory department. The board is responsible for monitoring the maintenance and appreciation of the value of those state assets which are being used by the enterprise. It is not expected to interfere with the enterprise's managerial autonomy. The enterprise as a legal person remains responsible for exercising the property rights over the assets on behalf of the state as owner.

The Regulation on Monitoring and Management of State Property is designed primarily to control asset stripping in SOEs, while the Regulation on Transforming the Management Mechanism of the Industrial Enterprises Owned by the Whole People seeks to increase the autonomy of SOE managers. The different objectives of the two regulations inevitably result in some contradictions and confusion; for in the name of ensuring appropriate checks and balances, various rights and responsibilities in respect of the assets used by SOEs are fragmented by being distributed among various government departments, agencies and holding companies (Xiao, 1997a).

The ultimate owner of the assets obviously retains significant rights and obligations. For example, any initiative to sell an SOE has to be approved by a state asset management bureau or commission. Similarly, other rights are able to be exercised directly by an SOE's director, including that of how the enterprise's after-tax profits or dividends will be used. Still other rights are exercised by government agencies. For example, the right to select managers is still held by the government and party personnel departments. Yet, at the same time, the obligation to honour bank debts and debts to other SOEs remains weak and blurred, since most SOEs and state banks are still regarded as being part of the state hierarchy.

If the property rights of the state as shareholder are as consolidated and integrated as they are for individual shareholders of private companies, some unwanted consequences may appear. If most of the rights are given to the acting owners, those responsible may no longer answer to the ultimate owners. On the other hand, if most of the rights are held by the ultimate owner and the acting owners are controlled tightly by the ultimate owner, the system would not be very different from a centrally planned and controlled system. Hence the consolidation and integration of the rights may not be conducive to maintaining and increasing the value of state assets.

Yet, because some of these rights have been unclear and unenforceable, private individuals have been benefiting from the existence and work of SOEs, while losses have been borne by the society as a whole. This has become a major problem for the SOEs, state banks and the state budget in China. SOEs have taken about two-thirds of the country's capital, investment, bank credit and urban employment, but they now produce only about one-third of the industrial output value. The asset deficit has led to cycles of inflation, rising national debts, rising non-performing loans and deteriorating government fiscal conditions. In 1980, China's internal and external debts were zero. Now they amount to 20–30% of GDP. The non-performing loans in the state banks are as high as 30–40% of total loans. The cental government revenues as a share of GDP fell from 30.9% in 1978 to 12.4% in 1995 (Sheng and Xiao, 1996).

The state, as the sole or majority owner of SOEs, is obliged basically to assume unlimited liability. This is a phenomenon which developed during the first stage of reform but which continues to exist. It contradicts the surplus value theory of Marx, with which all Chinese have been indoctrinated from the time they were very young. Thus, owing to the influence of Marxist economic theory and ideology, Chinese officials and Chinese people in general have usually seen capital (or property) as a means of production that is certain to generate a positive surplus value for capitalists (or capital owners). The emphasis of Marxist ideology is on redistribution of this surplus value from the capitalists to working-class people through public ownership of capital. It has never occurred to most Chinese students of Marxist political economy that the surplus value associated with capital could be negative. That would mean that workers are exploiting capitalists. Is that possible? Indeed, that negative surplus value or negative net asset value would arise in market economies is not that likely. Unfortunately, that possibility has become a reality in China with the state ownership of enterprises (Xiao, 1997b).

DIVESTMENT OF STATE-OWNED ENTERPRISES

The silence on the subject of the possible divestment of SOEs was officially broken by the 15th Chinese Communist Party Congress in September 1997. In a path-breaking policy change, the party is now endorsing the sale of all small and medium-sized SOEs to their employees and other private investors. The sale of large SOEs to private investors through public listing, foreign joint ventures and other channels is also officially allowed, provided that the state retains control over those SOEs which operate in strategically important sectors. The party will not necessarily require the state to retain a majority shareholding in such enterprises, so long as control is maintained. For ideological reasons, it is much easier for the party to endorse the state's becoming a non-majority but controlling shareholder than it is to agree to full divestment, without necessarily compromising the benefits to be gained from divestment.

Since the partial divestment of SOEs could result in the value of state-owned assets being maintained or even increased, the party's commitment to public ownership as the mainstay of the economy is not jeopardized by divestment initiatives. The opening report of the party congress points out that public ownership means that the total value, quality and influence of the assets owned collectively and by the state should remain the dominant element of the economy. The report also points out that the decline of state ownership in some individual sectors, regions and enterprises would not affect China's socialist nature.

Given the government's need to maintain the support of a large peasant population, it is unlikely that there will be any major divestment of large SOEs by way of the sale of shares to their urban-based management and staff. Moreover, while partial or full divestment may not necessarily turn loss-making enterprises around, it will surely create unemployment in the short run as divested SOEs lay off their redundant workers. These workers will have to adjust to the competitive environment in the non-state sector. No one can help but worry about the consequences of large-scale unemployment, but this has to be put into perspective. The state sector, including SOEs, state banks and all government units in China, has been employing only about 18% of the country's total labour force over last two decades. On the other hand, the employment level of township and village enterprises (TVEs) has increased from 7% to 20% of the total labour force in China during the same period. In 1995, the state sector employed 112.6 million, which was less than the 128.6 million employed by TVEs. Clearly, most new, non-agricultural employment in China is being created by TVEs.

The real problem is that the state sector employs as much as 65% of the urban labour force. If 20% of the state sector workers are laid off, China's urban unemployment rate will go up by 13%. That makes SOE unemployment a politically sensitive issue, since the voices of urban factory workers are louder than are those of peasants in the countryside. However, to be fair, the level of urban cash and in-kind wages is much higher than are wages for rural labour. As a result, there has been a massive migration of rural workers to the cities, gradually putting pressure on young graduates and some redundant SOE employees to take jobs in the non-state sector with realistic salaries. The most urgent task facing the government is to find a cost-effective way to help elderly workers and pensioners survive the present period of rapid economic transition. In the long run, changes in the ownership of SOEs will surely bring more and better-paid employment opportunities, as is indicated by the employment performance of Chinese–foreign joint ventures (Xiao, 1997b).

For those SOEs which are targeted for divestment, it will be necessary to make some crucial changes to their structures and modes of operation. Such changes are required to bring them into line with internationally recognized corporate requirements. They extend beyond the need to create boards of directors and to curb substantially (if not remove) the powers of the existing boards of supervisors (Xiao, 1997b).

First, the shares of the enterprises should be freely tradeable so that all private shareholders are voluntary equity investors and can sell their shares if they wish. For most private minority shareholders with diversely held shares, the right to sell their shares is their most cost-effective way of protecting their investment.

Second, the mixed state–private shareholdings will need to follow a one-share–one-vote rule (or some similar rule of democracy) concerning the selection of the board of directors and top managers as well as decisions on mergers, acquisitions and major investment plans. Such a rule is an important mechanism for rational and cost-effective decision making.

Third, the top managers of the enterprises must be hired by the mixed state–private shareholders from the market through a voluntary contract rather than being transferred from the government hierarchy under the supervision of the party personnel department. They need to be hired on the basis of their capacity to maximize the value of the enterprises. This is especially significant given the pervasive influence of the party on the appointment of managers. The non-economic, as well as the economic, objectives of the party could be achieved much better through other political or legal channels than by distorting the system of corporate management.

Fourth, mixed state–private shareholders and other shareholders of the enterprises, including minority shareholders and workers, will have to realize the consequences for themselves of some enterprises not being able to honour their contractual obligations and thus possibly becoming insolvent. This, too, is significant, as many people in China are not familiar with true market economies and often base their job and investment decisions too readily on a belief in the certainty of state involvement and support.

CONCLUDING COMMENTS

The 15th party congress demonstrated that the Chinese leadership has finally responded decisively and constructively to the most significant challenge of SOE reform. The new policy which endorses a degree of divestment effectively removes the party's insistence on the full or majority state ownership of SOEs and opens the door for the state to become a non-majority shareholder. This will allow SOEs to become truly limited liability companies and to be separated from the government.

The legal reforms and changes in ownership will not alone ensure that individual enterprises perform well. The government and the public should not expect loss-making SOEs automatically to be turned around. There are simply too many reasons for an enterprise to lose money. Moreover, no country has solved the complicated problem of corporate governance involving the effective motivation and monitoring of managers by shareholders and other stakeholders. It is unreasonable to expect the Chinese government to find a solution to this problem with regard to its SOEs. Yet the adoption of the idea of an enterprise having a legal personality, along with the introduction of the Company Law and related regulations, indicates that at least some positive progress has been made towards the transformation of SOEs into modern corporate entities.

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