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**Property Rights
and State-Owned Enterprise Reform in China**

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Summary

The fact that the state is the sole or majority owner of enterprises has become the main barrier to the establishment of clear and enforceable property rights in China. As a result of this system, private individuals have been benefiting from gains, while losses are borne by society as a whole. To change state-owned enterprises (SOEs) into truly limited liability modern corporations would require either privatization or at least a mixed state-private ownership structure with the state holding non-majority shares. The fifteenth Chinese Communist Party Congress has just endorsed the much-needed SOE ownership reforms, which will provide the institutional foundation and building blocks upon which China can establish a competitive modern corporate sector in the twenty-first century.

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China's path-breaking change in policies towards SOE ownership reform

In 1978 China adopted a unique approach to its transition from plan to market: reform without privatization. Until very recently China scholars and observers have assumed that reforms of state-owned enterprise (SOE) ownership were out of the question and hence should not be seriously discussed or even mentioned at all. Even the World Bank, which has been pushing privatization all over the world, has been extremely cautious about discussing ownership reforms in China until recently¹.

The silence on the subject of SOE ownership reform in China was officially broken by the fifteenth Chinese Communist Party Congress, which ended yesterday. In a path-breaking policy change, the Party is now endorsing the selling of all small and medium-sized SOEs to their employees and other private investors. Selling large SOEs to private investors through public listing, foreign joint ventures, and other channels is also officially allowed, provided that the state still keeps control over shares of those reformed SOEs in strategically important sectors. The Party will not necessarily require the state to retain control over the majority of such enterprises, however.

This paper examines the profound implications of the proposed ownership reform in China. It focuses on the necessity and usefulness of the mixed state-private ownership structure with the state as non-majority owner for clarifying and enforcing property rights of reformed SOEs.

How property rights are clarified and enforced in market economies

Clear property rights are essential in order for efficient and voluntary exchange and production activities to take place in market economies. Clear property rights mean not only well-delineated ownership titles and the rights and obligations associated with them but also *effective enforcement* of these rights and obligations.

When the equity value of a private corporation falls to zero or below, the corporation becomes insolvent, and the equity owners lose all their investment but incur no more liabilities. This is the limited liabilities feature of the modern corporation. When it is insolvent, a corporation's gross asset value is smaller than its gross liability value. The resulting asset deficit is a loss that has to be shared by stakeholders of the corporation, including banks, bond holders, suppliers, customers, and employees. The insolvency triggers a legal process of bankruptcy that determines how the loss will be shared among all the

¹ In August 1997 the World Bank published its country study, *China's Management of Enterprise Assets: The State As Shareholder*. I participated in this study as a consultant for the World Bank. As far as I know, this is the only published World Bank study that closely examines the issue of unclear, fragmented, and unenforceable property rights at the Chinese SOEs and recommends ownership reforms that would turn the state into a non-majority shareholder. Some of the analysis in this paper is drawn from this study as well as from other work, such as Xiao (1997), Sheng and Xiao (1996), and Broadman and Xiao (1997).

stakeholders. The shareholders and stakeholders, who suffer the legally delineated losses, then have to reduce their expenditures in response to their reduced income and wealth.

Since any attempt by shareholders or stakeholders to escape their legally delineated liabilities violates other shareholders or stakeholders' property rights, they have a strong incentive to monitor each other. They may create specific private contractual arrangements to guard their property rights if these arrangements are cheaper than resorting to an independent legal system for protection would be. The private and legal means for delineating, enforcing, and absorbing losses and liabilities discussed here have made property rights clear and enforceable in market economies.

China's experiences contradict Marx and show that capital many not bring surplus value but rather causes losses and liabilities as a result of unclear and unenforceable property rights under state ownership

Property rights over SOEs in China are unclear and unenforceable precisely because the institutional facilities for delineation, enforcement, and absorption of SOE losses and liabilities could not be established as long as the state was the sole or majority owner of enterprises, as will be argued in detail below. Because property rights have been unclear and unenforceable, private individuals have been benefiting from gains, while losses are borne by society as a whole. The state, as the sole or majority owner of SOEs, is obligated to assume basically unlimited liability. This is a new phenomenon that developed during the period of partial reform and that is contradictory to the Surplus Value Theory of Marx, with which all Chinese have been indoctrinated from the time they were very young.

Due 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 the 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 economic theory 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 unlikely. Unfortunately, that unlikely possibility became a reality in China under the state ownership of enterprises during the period of partial reforms.

As a result of China's past "reform without privatization" approach, private individuals have been benefiting from gains, while losses are borne by society

Instead of implementing fundamental reforms of ownership and property rights, the Chinese government adopted a Contract Responsibility System (CRS) for SOE reform in 1978. The CRS emphasizes material incentives through various

links between performance and pay for managers and workers but overlooks the problems of moral hazard, whereby managers and workers could achieve a small personal gain at a large cost to the enterprise or to the economy.

When the economy is booming and enterprises are making profits, managers, workers, and the government all share in the gains. Any increased cost due to moral hazard could easily be hidden under their balance sheets during the boom, when it is easy to access state bank loans. However, when state banks start to tighten credit to reduce inflation, the cost of moral hazard at SOEs shows up as enterprise losses, bad loans at state banks, inter-firm debts, layoffs, and political instability.

The fact that private individuals are benefiting from gains while society bears losses has become a key problem for the state sector troika of state enterprises, state banks, and the state budget in China. China's SOEs have taken about two-thirds of capital, investment, bank credit, and urban employment but now produce only about one-third of industrial output value. The asset deficit in the state sector troika 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 to 30 percent of the GDP. The non-performing loans in the state banks are as high as 30 to 40 percent of total loans. The central government revenues as a share of the GDP fell from 30.9 percent in 1978 to 12.4 percent in 1995.

No one would be able and willing to bear the brunt of SOEs losses except the state as their sole or majority owner

No individual officials, managers, or workers would be able or willing to assume the responsibility for the loss of asset value at SOEs. The government could fire and even financially punish managers and workers. However, that would not assist in the recovery of the accumulated stock of losses, since none of the individual managers and workers owns any significant private property that could be used as a hostage or a collateral for the right to use and manage the state-owned assets under the Responsibility Contract. In most cases, the punishment would not be credible and would be difficult to implement. Even if it were credible and possible to implement, it is difficult to imagine that it would be severe enough to offset the private gains the managers and workers can derive from mismanaging the state's assets. The state, with its ownership of enterprise assets, is the only party that would be able and willing to assume the accumulated stock of losses and liabilities.

Unlike private owners, the state can print and borrow money to handle the unlimited losses of SOEs before it is overthrown politically

Unlike private owners, whose capacity to assume losses and liabilities is limited by the amount of assets they own, the state's capacity to do the same is not limited by the amount of state-owned assets. The state itself is not subject to bankruptcy unless it is overthrown politically. Its ability to assume unlimited

liability before it is overthrown politically greatly weakens its incentive to monitor the managers and workers at SOEs and state-owned banks.

In addition, the state as a sole or majority owner of SOEs is fundamentally different from private small shareholders with diffusely held shares. To be sure, private small shareholders have much weaker incentives to monitor managers than do private large shareholders with concentrated shares, but the small shareholders assume the full cost of their failure to monitor with their limited share value. The state, when it is absent or ineffective at monitoring managers, assumes the losses and liabilities not with its limited share value but with its power and willingness to tax, to print money, to borrow domestically and externally, and to sell the resources it owns. The taking of losses and liabilities by the state does not usually lead to a direct reduction of expenditures in the state sector. The society as a whole often has to bear indirectly the immediate losses and liabilities incurred by the SOEs as well as the additional costs of inflation, of an inefficient financial system, and of other system-wide inefficiencies caused by the SOE losses. Only the privileged few benefit from the accumulation of assets.

It is impossible to effectively separate the government from enterprises when the state is their sole or majority owner

One of the key problems with wholly or majority state-owned enterprises in China is the difficulty in identifying their real owners. Their nominal owners are the people of China as a whole, who are legally represented by the State Council. The acting owners who actually make decisions on the use of SOE assets are somewhere in the government hierarchy. As a result, decision-making by these acting owners is likely to be constrained by government bureaucracy. Property rights over the SOE assets are likely to be fragmented and intentionally distributed among various government departments to ensure adequate checks and balances. Also, the real objective of the acting owners may not be to maximize profits and asset value. Moreover, as part of the government hierarchy, the acting owners are likely to impose obligations on enterprises and on their stakeholders. When it is impossible to separate the acting owners from the government, it is not possible to achieve truly limited liabilities for wholly or majority state-owned enterprises. When the acting owners are part of the government hierarchy, the managers appointed by them will also be part of the government. Other stakeholders in the SOEs, such as workers, suppliers, banks, and customers, will also see SOEs and their managers as part of the government.

It is impossible to turn SOEs into truly limited liability companies when the state is their sole or majority owner

Chinese policy makers have gradually come to recognize the SOEs' unlimited liabilities problem. The government has thus determined to transform SOEs into modern corporations with limited liabilities. The People's Congress passed a company law on 29 December 1993 and put it into effect on 1 July 1994. The company law is similar to laws in market economies except that it contains a

special section dealing with wholly state-owned companies. The implementation of the company law has proven difficult. For example, more than 80 of the 100 SOEs selected nationwide to experiment with the corporation system have so far chosen to register as wholly state-owned limited liabilities companies. Is it possible for wholly state-owned enterprises to become truly limited liabilities companies? Twenty years of SOE reforms in China suggests that the answer is no. In 1978, SOEs' first goal was to become responsible for their own losses and profits. That goal has not yet been reached. China's own experiences show that it is too difficult, if not impossible, to effectively separate the government from enterprises for wholly or majority state-owned enterprises.

Privatization or ownership reforms with the state as non-majority shareholder are necessary to turn SOEs into truly limited liability companies and to separate them effectively from the government

Conclusions and policy recommendations based on the above analysis are clear. China needs to privatize SOEs or at least to turn the state into a non-majority shareholder of the reformed enterprises in order to effectively separate the government from enterprises and to achieve truly limited liabilities for them. It is crucial that the majority of the owners of the reformed SOEs be profit-maximizing individuals who are investing voluntarily in the reformed enterprises.

The Chinese authorities prefer to use the term "controlling shares," which in principle could mean shareholdings of more than 50 percent but more often means shareholdings of less than 50 percent according to my own discussions with various Chinese officials. To emphasize the influence of public ownership, "state holding of controlling shares" sounds much better than does "state holding of non-majority shares" or "state holding of passive minority shares." To avoid confusion, I will use the term "majority shares" for all shareholdings of more than 50 percent and "controlling shares" only for shareholdings of less than 50 percent.

In the ownership reforms recommended here, it is fine for the state to maintain controlling but non-majority shares of reformed SOEs. In market economies, the percentage of controlling shares, e.g., the concentrated shares owners need to win votes in shareholders' meetings, could be as low as 10 percent or even 5 percent, since most minority shareholders with diversely held shares are not interested in voting at shareholders' meetings. The state could also control a large corporation with concentrated shares of much less than 50 percent. However, this would happen only when the state as a controlling shareholder is making good or at least acceptable decisions for the corporation. When the state as a controlling shareholder is making what seem to be poor decisions, private minority shareholders with diversely held shares are likely to show up to vote and to defeat the controlling but non-majority state shareholder. If private minority shareholders choose not to confront the poor decisions made by non-majority state shareholders, they expose their share value to expected risks that these decisions raise. Once the expected losses are realized, they have to reduce their consumption.

In addition to establishing the state as a non-majority shareholder, some basic rules and points for running reformed SOEs will have to change according to the internationally recognized corporate institutions as reflected in modern company laws of all nations.

- First of all, shares of reformed enterprises should be freely tradable 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 shareholders need to follow a one share-one vote rule or similar rules of democracy on capital to decide on important enterprise governance issues such as the selection of the board of directors and top managers, mergers and acquisitions, and major investment plans. This is the most important institutionalized mechanism for rational and cost-effective decision-making.
- Third, the top managers of the corporation 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 are hired only to maximize the value of the corporation, which would in the end benefit not only themselves and the mixed owners of the corporation but also other stakeholders of the corporation. This rule is particularly relevant in China because of the pervasive influence of the Party on the appointment of managers. It should be emphasized that the non-economic and even the economic objectives of the Party could be achieved much better through other political or legal channels than by distorting the time-tested basic institutions of the modern corporation system.
- Fourth, mixed state-private shareholders and stakeholders of the corporation, including minority shareholders and workers, have to realize or to be made to understand that there is a possibility that the corporation may not honor its contractual obligations and that they will have to bear the losses of their investment if the corporation becomes insolvent. This is a particularly relevant point for China, since many people are not familiar with true market economies and often base their job and investment decisions on their experiences in partially reformed or even unreformed economies.

The above points are essential for establishing clear and enforceable property rights and the principle of truly limited liabilities for reformed SOEs, which are to have mixed state-private ownership with the state acting as non-majority shareholder. All the rules and points discussed here are already part of China's company law, which was promulgated in 1994 but which could not be effectively implemented without requiring the state to be the non-majority shareholder of the reformed SOEs.

Capital gains for the state are possible if it become a minority shareholder

There are many good reasons for why China will not only endorse but will also fully implement the reform discussed above that will turn the state into a non-majority shareholder. In addition to achieving truly limited liabilities, the ownership reform could in principle bring in more revenue for the government.

Suppose a large SOE is worth \$100 million on the market. The government could sell 80 percent of it and use the \$80 million in revenue to buy 20 percent shares in four private corporations of the same size. After this ownership diversification has taken place the total amount of state-owned assets is still \$100 million, but it is spread over five corporations of mixed state-private ownership. Clearly, all the five corporations are now non-state companies with 80 percent shares owned by private investors. It is hard to imagine that the five corporations would not be more profitable altogether than was the original wholly state-owned enterprise. It is most likely that the government could sit back and watch the market value of the much more diversely held state-owned portfolios rise. This capital gain is the fruits of ownership reform and could be used to finance many one-time costs of China's transition from plan to market.

Ironically, according to the above analysis, an aggressive approach that concentrates investment in wholly state-owned enterprises may end up creating unlimited liabilities for the state. On the other hand, a passive approach to limiting and diversifying state investments may increase the total market value of state-owned assets. The Chinese government should have learned this from experience. The central government invested little and passively in the sector of township and village enterprises (TVEs) but reaped huge returns in employment, taxes for central government, and profits for local governments. The Chinese government has also tasted the fruits of being a passive minority shareholder in private corporations in Hong Kong.

Ownership reform with the state as a non-majority shareholder is a practical solution given China's present ideological, political, and economic conditions

The state's transformation into a non-majority shareholder could also help to resolve dilemmas over privatization of SOEs in China. It is widely understood that privatization can make enterprises responsible for their own losses and profits, but it faces several ideological, political, and economic challenges in China:

First, the Chinese government has been tightly controlled by the Communist Party, which, because of its communist ideology, has always insisted on public ownership as a mainstay for the economy. The Party has made significant progress in modernizing its interpretation of public ownership. According to the fifteenth Party Congress, in addition to state ownership, public ownership now includes all collective ownership and the state and collective elements of the mixed state-collective-private ownership in shareholding enterprises. However, the Party also insists that it would not allow full-fledged privatization, especially

in the strategically important sectors. For ideological reasons, it is much easier to turn the state into a non-majority but controlling shareholder than it is to implement full privatization without seriously compromising the substantial benefits of privatization.

Since, as has already been shown, the ownership reform with the state as non-majority shareholder could result in maintaining or increasing the total value of state-owned assets, it is entirely consistent with China's commitment to public ownership as it was interpreted by the fifteenth Party Congress. The opening report of the Party Congress points out explicitly that public ownership as a mainstay of the economy means that the total value, quality, and influence of the assets owned collectively and by the state are dominant. 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.

Second, privatizing net assets is easy. The real difficulty is in privatizing net liabilities. No private investor would buy net liabilities from the government. But in Russia and in the Eastern European transition economies, state liabilities or government promises are on average much less valuable than are those in China, since the former governments and economies are on average much weaker than the latter. The much stronger Chinese government with its growing economy is considered far more reliable when it comes to meeting its financial obligations than are the Russian and the Eastern European governments.

Even if the Chinese government sells all its assets, the revenue they bring may not be sufficient to meet all its committed liabilities. What should the government do with a huge sum of net liabilities? The reform that turns the state into a non-majority shareholder can at least in principle regain some capital for the government, as is shown above. The capital gains could be used to pay for the net liabilities accumulated during the transitional period.

The recent stock market responses to red chip companies² in Hong Kong shows that the capital gains for government shareholders could come very quickly if the reform policies develop in the right direction given Hong Kong's advanced capital market institutions. However, whether or not the red chip companies will be able to sustain their already high share prices, which have come about largely because of market participants' high expectations for the local government reform initiatives, depends crucially on the performance of these companies in the future. It is the large-scale ownership reforms, that transform most SOEs into private firms or corporations of mixed ownership with the state as non-majority shareholder, that are likely to create reliable capital gains in the long run.

Third, privatization of small and medium-sized SOEs is much easier to achieve than is that of large SOEs. The Chinese leaders and many Chinese people still maintain strong patriotic feelings towards building China's own large and

² Hong Kong listed companies with controlling shares held by Chinese local governments such as Beijing and Shanghai that attempt to bring valuable assets from China to their Hong Kong companies.

modern corporations like America's IBM, Japan's Toyota, and Korea's Samsung. It has proved difficult to convince Chinese officials and managers that the large group companies in the United States, Japan, and Korea may not be the best model for China to imitate now, considering the high organizational costs and inflexibility associated with any large organization. The large Chinese group and holding companies organized through administrative means simply do not have the productivity level necessary to cover the high costs of a large organization.

It would be much better for companies to grow in an environment of clear and enforceable property rights and competitive markets. The mixed state-private ownership structure with the state as non-majority share-holder could provide a practical institutional base upon which companies can grow. Economies of scale backed by private investment are much more solid than are those administered by the government with funding from the state.

The mixed ownership structure could also accommodate some of the reasonable career development demands being made by incumbent SOE officials and managers without seriously compromising the objective of separating the government from the enterprises. On the other hand, it is difficult for China to imitate the insider privatization implemented in Russia for reasons of fairness. With a strong government keen to win the support of a large peasant population, any large-scale insider privatization of large SOEs would endanger China's political and social stability.

The Party's latest reform initiatives show clearly that the pragmatism of Deng Xiaoping has now been firmly cemented in China's economic policies. China's future economic and even political reforms are likely to be neither gradual nor radical but rather rational and practical.

How to put the expected SOE unemployment that will occur after the implementation of ownership reform into perspective?

Privatization, whether it is partial or full, may not necessarily turn loss-making enterprises around but will surely create unemployment in the short run as privatized SOEs cut their redundant workers. SOE 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 let's put this into perspective. The state sector, including SOEs, state banks, and all government units in China have been employing only about 18 percent of China's total labour force throughout last two decades. On the other hand, the employment level of township and village enterprises (TVEs) has increased from 7 percent to 20 percent of the total labor force in China during the same period. In 1995 the state sector employed 112.6 million, even 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 percent of the urban labor force. If 20 percent of the state sector workers are laid off, China's urban unemployment rate will go up by 13 percent. 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.

But, to be fair, the level of urban cash and in-kind wages is much higher than are wages for rural labor. 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, ownership reforms in SOEs will surely bring more and better-paid employment opportunities, as is indicated by the employment performance of Chinese-foreign joint ventures.

Much-needed ownership reforms proposed by the fifteenth Party Congress are not guaranteed to turn around loss-making SOEs but will form the institutional foundation and building blocks upon which China can establish a competitive modern corporate sector in the twenty-first century

The discussions presented here have shown why reforms in property rights and ownership in Chinese SOEs are necessary and could benefit the government and society. Fortunately, the fifteenth Party Congress has demonstrated that the Chinese leadership has finally responded decisively and constructively to the challenge of SOE ownership reform. The new policy 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. As has been explained, this will allow SOEs to be reformed into truly limited liabilities companies and to be separated effectively from the government.

But institutional reforms cannot ensure that individual enterprises will perform well. Most enterprises in market economies fail. The government and the public should not expect to turn loss-making SOEs around through ownership reforms. There are simply too many reasons for an enterprise to lose money. No country has solved the complicated problem of corporate governance (motivating and monitoring managers by shareholders and stakeholders). It is unreasonable to ask the Chinese government to find a solution to the corporate governance problem of its SOEs and to make reformed SOEs profitable. The government should let private investors deal with corporate governance problems.

Ownership reform should be seen as a process by which to shift the economic risks currently concentrated in the central government to the society at large so that the private sector can deal with them more efficiently. It should also be seen as a necessary step towards establishing clear and enforceable property rights. Although China still has a long way to go in making property rights as clear and enforceable as they need to be to make its economy competitive, the ownership reforms proposed at the fifteenth Party Congress will form the institutional foundation and building blocks upon which China can establish a competitive modern corporate sector in the twenty-first century. Individual firms, whether they are large or small and whether they are privately or publicly owned, may

live or die. But the Chinese economy as a whole is bound to become much more efficient once the ownership reforms proposed by the fifteenth Chinese Communist Party Congress are fully implemented.

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