BRIEFING NOTE

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Will privatisation in China work?

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Summary

- China is in a favourable position to effect a successful programme of state asset sales. Extensive trade liberalisation and price liberalisation have enhanced competition in the domestic market. Company law, as well as a framework for M&A activity, has been developed. A large number of wealthy domestic private buyers are now in the market for state assets. The government is relatively unified both in terms of policy formulation and implementation. Institutional investors have grown up. The difficulties of registration of private businesses have been greatly eased since the late 1990s. All these factors mean that privatisation on a large scale should work much better in China than it did in the former Soviet bloc.

- However, as it moves ahead with a privatisation programme, the government should carefully consider its methods of sale, particularly for its larger firms. The stock market 'three-step approach' for large firms is too slow and too inefficient. Sale of control rights should take place at the earliest possible point for any enterprises marked for sale. For those companies that are making a public offering, a private sale of a strategic stake could be combined with a public share issue. This way ownership is transferred and a new owner created and the problems of 'one-third privatisation' avoided.

- The share issue route takes considerable time and demands high levels of disclosure and pre-sale restructuring, both of which are often not necessary. A good alternative would be open auctions. These would ensure that the value of the assets was properly assessed and, properly governed, would salve the government's fear of asset stripping. They would be preferable to tender offers and one-to-one deals, the predominant forms of sales in large enterprises so far.

This briefing note is based on a longer working paper also available on the Chatham House website (www.riia.org). A future briefing note will look at the government's institutions for managing its own shares.

Introduction

Can China learn its lessons and organise privatisation better than the countries of the former Soviet bloc (FSB) did? The government of the People's Republic of China owned some Rmb14.8trn ($1.8trn) in assets at year end 2002 and is in the midst of a huge programme of enterprise restructuring. There is still much debate within policy circles about whether privatisation (already an acceptable policy for small-sized SOEs) is suitable for the larger state firms. In recent weeks, statements by central government officials have suggested that it is. Thus, determining how best to organise these sales is crucial.

Privatisation in the FSB has attracted much criticism. Four critiques are made. First, the policy was 'imposed' from outside by officials from the IMF and World Bank who believed that a sell-off had to be pursued rapidly. Second, some critics claim that privatisation did nothing to promote growth and everything to destroy jobs. Third, privatisation stimulated, rather than constrained, corruption, with insiders and government officials rigging sales for their own benefit. Fourth, privatisation should have waited for institutions and the rule of law to take root.

Many of these criticisms are misplaced. Many do not consider the (worse) alternatives to privatisation or the political or institutional settings in which decision makers had to operate. An earlier Briefing Note (*Privatisation in the former Soviet Bloc: Any lessons for China?*) tacked the lessons of privatisation policy in the FSB and provided a fuller critique. The FSB experience, however, did raise important questions about method which the Chinese authorities will no doubt take note of.

This Briefing Note considers the condition of the Chinese economy in 2003 and asks whether it provides better starting conditions than FSB countries provided in the early 1990s. The answer is clearly yes. This suggests that China could have a much more succesful privatisation programme, in terms of both efficiency improvements at the firms that are sold and in terms of fairness and popular support. The Briefing Note then considers current sale methods and suggests some possible alternatives.

Initial conditions for privatisation in China

Many of the structural reforms introduced in China's economy have improved the operating environment for all enterprises, both state and privately-owned. These encourage state firms to perform better, but also provide a framework in which newly-privatised firms are also likely to do well.

- **Entry barriers to market have fallen.** One of the most important drivers of growth in China's economy has been the emergence of a strong indigenous private sector. Most sectors of the market have opened, or are opening up to private investment, while the difficulties of registration of private businesses have been greatly eased since the late 1990s.

- **Extensive trade liberalisation has allowed competition from imports.** In the domestic market and tariff and non-tariff protections have also been dismantled. This has resulted in increased competition in the domestic market.

- **Extensive price liberalisation has taken place.** Apart from utilities, basic foodstuffs and bank credit, prices are now set by the market. This has had two important effects. First, it has forced state firms to buy and sell factors at market prices, thus constraining their ability to generate rents via exploiting the twin-track economy. Second, assets from privatised firms can mostly be valued on a market basis and transferred on a more rational basis.

- **Foreign investment has been promoted.** Although FDI has been encouraged into green-field investments, mostly joint ventures (JVs), investors have gained valuable experience of buying out and taking over plant and operations from their JV partners. A legal framework for foreign investors has developed too, facilitating the emergence of a M&A regime.

- **Hard budget constraints are increasingly common.** There is anecdotal evidence that the state-owned banks are increasingly evaluating loan applications on a commercial basis and that fewer loans are being extended to SOEs. Bank officers are now personally responsible for their lending decisions.

Moreover, a number of other developments in China's economy will facilitate best practice in the privatisation process itself. Again, briefly,

- **A large number of wealthy domestic private buyers are now in the market for state assets.** They have the requisite financial resources, and assets with which to raise additional capital, to buy SOEs and their assets. The state should therefore be able to raise more revenues from asset sales than did countries in the FSB, and those buying them will more likely have experience operating them.

- **The government is relatively unified both in terms of policy formulation and implementation.** The absence of an institutionalised political opposition – should mean that any enterprise reform plan will not meet with institutionalised opposition. Local governments in China, with responsibility for their own budgets, are unlikely to block the privatisation process – indeed they are likely to promote it.

- **A basic framework needed to facilitate secondary sales has been developed.** A stock market has been established, a provisional M&A framework has been introduced, and a (albeit still fragile) bankruptcy regime is also emerging. All these, since they facilitate, the selling of privatised assets, will reduce pressure on policy makers to get the initial sale method right.

- **There are firm level incentives for privatisation.** Revenues from asset sales in the former Soviet bloc went predominantly to the government budget. In contrast, in China proceeds from the sales of assets go to the enterprise itself and those from the sales of share sales accrue to the entities (usually state-controlled firms or agencies of the local government) that sell them. This creates incentives for sales for officials at the local level.

However, reforms introduced during the 1980-90s have also undermined the prospects of China organising successful privatisation programme. There are a number of reasons:

- **Firm insiders have been empowered.** China resembles Poland and Russia in this regard. Previous reforms have extended considerable autonomy to firm managers, (in contrast to places like the Czech Republic where the state was firmly in control when privatisation began). This has likely increased resistance to sales of control to outsiders.

- **Private entrepreneurs have gained sufficient influence to skew sales methods to their advantage.** Leveraging their political and financial influence, private buyers will likely lobby for assets to be sold via direct sales at below their market value. Officials will be vulnerable to bribes.

- **Continued resistance to market-based asset valuation methods for state assets.** Official book values are still used as a price floor for asset sales. However, book values frequently over-state the actual value of state firms. Using an unrealistic price floor creates disincentives for buyers (and incentives for sellers to offer informal sweeteners). Movement to more market-based valuation methods is prevented by fear of asset-stripping by connected parties.

On balance, however, the starting conditions are positive – much more so than in most of the FSB. The next part of the Briefing Note outlines the privatisation experience thus far of China's SOEs. This can be divided into two main types: small and medium-sized firms, and large-sized ones. Broadly speaking, by the end of 2000 one third of SOEs had been reformed, one third were being restructured and one third had yet to reform. As reforms have progressed there has been a gradual radicalisation of policy, moving in the 1990s to a creeping recognition of the role of private capital and the utility of privatisation.

Small and medium-sized SOEs

The sale of SMEs has occurred quickly and easily, and has raised few political problems. The bulk have been sold to insiders. Reforms began in Shunde in Guangdong and Zhucheng in Shandong with small and medium-sized SOEs. According to a SETC survey cited by Stoyan Tenev and Zhang Chunlin by the end of 2000, 81% of the 63,490 small SOEs in existence nationally at year end 1996 had been sold, mostly through EBO/MBOs.[1] The employees usually became the dominant shareholders, with managers typically taking a 20-30% stake.

These firms generally failed to experience an improvement in performance. Tenev and Zhang identify four main problems.

- **Dispersed shareholdings create free-rider problems since shares are distributed among hundreds, sometimes thousands, of employees.** No one shareholder has the incentive to expend resources to actively monitor performance and to enforce measures which would be to the long-term benefit of the firm. In contrast, firms are run for the short-term benefits of employees: minimum post-sale restructuring takes place and employee-shareholders tend to push for profits to be distributed rather than invested.

- **Administrative interference tends to continue.** Local government officials often retain their right to appoint managers, to set salaries and to intervene in conflicts within the firm.

- **New corporate governance structures are undermined by old ones.** In many firms, there is conflict between the 'three new committees' (the shareholders meeting, the board of directors and the board of supervisors) with the three 'old ones' (the party committee, the workers' congress and the trade union).

- **Selection bias**. There is evidence that it is the better firms which tend to undergo an EBO/MBO, while the worse performers remain state owned.

The collective action problems associated with dispersed ownership can only be solved by the concentration of ownership control in one or two shareholders and the balancing of their powers with the effective oversight of other shareholders. In 1997 a second wave of reforms took place in Zhucheng and Shunde in which management was allowed to buy larger stakes in EBO-ed firms. Another method for facilitating concentration of ownership would be auctions where the shares of employees can be consolidated into blocks and sold.

In hindsight, auctions or sales of blocks to outsiders (with a minority stake sold to insiders) would have probably worked better in terms of post-sale performance than buy-outs, although both would have been difficult to organise without the backing of insiders. Moreover, since many of these firms already enjoyed considerable autonomy from the government via reforms introduced in the 1980s, outside buyers would have struggled to assume de facto control of these firms.

[1] Tenev, S. and Zhang Chunlin, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets,* Washington, DC: World Bank & IFC, 2002, pp. 27-28.

Large- and medium-sized SOEs

Since the early 1990s, the strategy for China's large SOEs has involved incorporation into shareholding companies, the creation of state-controlled enterprise groups and sales of minority stakes in some firms to outsiders. Few sales of controlling stakes have been made to outside investors. State-controlled firms therefore include SOEs and shareholding firms in which government-controlled entities have a controlling stake.

As time has revealed the drawbacks of this strategy and the government's socialist ideology has further weakened, privatisation has become an increasingly acceptable option for an increasing number of state firms.

The central government has experimented with two (unsuccessful) schemes to sell off state shares in listed firms, for instance. Local state-controlled shareholders of listed firms have been actively selling their stakes of non-tradable shares to private investors. As a result of these two developments, it seems that many in government are happy to allow most listed firms to go private. The provinces retained control of the vast majority of state-controlled firms, some 150,000 often through their local asset management bureaux. Provinces are gearing up to sell increasingly large swathes of local industry. In recent months, Shenzhen, Shandong, Hunan and Jiangsu provinces have all announced plans to sell large minority stakes in infrastructure, utility and manufacturing firms.

However, the creation of the SAMC in March 2003 signalled that there are limits to the government's use of the policy, at least for the moment. In March 2003, 196 huge enterprise groups run from the central government level were placed under the ownership of the State-owned Assets Supervision and Administration Commission of the State Council (*Guowuyuan Guoyou Zichan Jiandu Guanli Weiyuanhui*, hereafter SASAC).

Although the stock market hosts only a small sub-population of the state's firms it is worth considering in-detail the privatisation process that many listed firms have undergone – and which awaits many others apparently. A three-step process has emerged: incorporation, a public issue of a minority stake followed sometime later perhaps by a private sale of a controlling stake to a private firm. Many of the best performing state firms have incorporates and issued shares.

However, only a small number of firms have so far completed the three-step process – perhaps only 200. Because of the limited places allocated, tens of thousands of firms have completed the first stage but not the second or third; others the first two steps and not yet the final step of actual privatisation. The significance of the three-step process is that, by default more than by design, it is considered the 'right way' to privatise the best of China's state firms. The three-step approach has a number of advantages:

- **Restructuring takes place before the sale**. In mass privatisation restructuring occurs after ownership had been transferred, while at China's listed SOEs it is carried out beforehand. This ensures that the firms' assets and liabilities are clarified and any non-profit making activities can be separated from the firm.

- **It raises revenues for the firms and the state.** The public, as well as institutional investors, is asked to pay for the initial equity stakes (in firms that were, in theory of course, already owned by the public) rather than being allocated free shares as in a voucher scheme. Revenues can thus be raised for the restructuring firm. In the third stage, the sale of the LP shares, revenues are raised for the state representatives who sell their stakes.

- **Ownership can be spread widely, relatively cheaply.** The people can gain an ownership stake in domestic industry through the IPO, something that should create popular support for the privatisation process. At the same time, ideological sensitivities are smoothed by the gradual nature of the transfer of ownership.

- **Prices are set (more or less) competitively.** Since restrictions on the prices of IPO shares have been relaxed since 2000, the prices of IPOs are set by the issuing firm and the underwriter in expectation of market demand (although the Ministry of Finance insists that the per share net asset value is still used as a price floor).

- **The IPO process is relatively transparent and fair.** Through the IPO auction system everyone with a share account has an equal chance of securing a stake in the issuing firm, while the IPO process should facilitate higher standards of disclosure than, say, a tender sale.

- **The sale of controlling stakes in the third stage does not have a destabilising effect on the share market since these shares remain non-tradable.** In contrast to attempts to sell off state shares (by selling them into the secondary market and thus making them tradable), this method does not increase the total sum of tradable shares and thus does not seem to affect the price of tradable shares.

However, the disadvantages of the privatisation three-step are equally clear.

- **Actual control of the enterprise does not change and property rights continue to be unclear after incorporation.** Despite the formal breaking of links between government and firm, administrative influence in the running of the firm remains. Party committees continue to operate in most listed companies, while local government officials continue to wield influence through their indirect shareholdings.

- **Pre-sale restructuring often fails to resolve the problems of unpaid liabilities, excess staff and inefficient production.** The lack of real control transfer means that debts are fudged, excessive staff are retained and productive efficiency is not improved. Sale of control earlier on would ensure that restructuring is thorough.

- **There is a clear bottleneck at the second step since only some 100 enterprises a year can issue shares publicly.** This is partly because of the enormous amount of work that goes into each restructuring, but is mainly due to the apparent limited public demand for equities in former SOEs. The long wait likely reduces incentives for enterprise restructuring ‘upstream’.

- **Foreign involvement in the privatisation has been limited at the second and third stages.** Foreign investors have so far been excluded from both the IPO (for all A-share companies) and LP share markets, though the QFII regime and M&A rules both rolled out in late 2002 now allow them to participate in both. Allowing them further access would allow some of the most productive owners to assume control of firms.

- **The third-step lacks transparency.** It also tends to be subject to administrative interference and is subject to few rules or central government oversight. There is much potential for corruption.

- **Forcing private companies to list via a back door buy-out acts like a tax on access to capital.** Since private companies are still largely prevented from making a listing in their own right, they are in effect forced to take-over a defunct listed former SOE. This entails numerous costs, not least the cost of the controlling stake, as well as subjecting them to the risk of becoming liable to the debts of the shell.

Concluding remarks

China is in a favourable position to effect a successful programme of state asset sales. Extensive trade liberalisation and price liberalisation have enhanced competition in the domestic market. Company law, as well as a framework for merger and acquisition (M&A) activity, has been developed. A large number of wealthy domestic private buyers are now in the market for state assets. The government is relatively unified both in terms of policy formulation and implementation. Institutional investors have grown up. The difficulties of registration of private businesses have been greatly eased since the late 1990s. All these factors mean that privatisation on a large scale should work much better in China than it did in the FSB.

However, as it moves ahead with a privatisation programme, the government should carefully consider its methods of sale, particularly for its larger firms. The stock market three-step approach for large firm restructuring is slow and inefficient. Sale of control rights should take place at the earliest possible stage for any enterprises marked for sale. For those companies that are making a public offering, a private sale of a strategic stake could be combined with a public share issue. This way ownership is transferred and a new owner created and the problems of one-third privatisation avoided. Earlier entry of foreign investors should be encouraged, (the subject of a future Briefing Note).

The share issue route takes considerable time and demands high levels of disclosure and pre-sale restructuring, which are often not necessary. A good alternative would be open auctions. They would ensure that the value of the assets was properly assessed and salve the government's fear of asset stripping. They would be much more preferable than tender offers or one-to-one deals which have been the predominant forms of sales in large enterprises so far. More bankruptcies, although of course politically difficult, followed by a sale of the assets, should also be encouraged where possible.

The lack of an explicit privatisation 'plan' is also a problem. Due to ideological sensitivities, the government still refuses to recognise the fact that its industrial reforms are promoting privatisation in many areas. This means that regulation of the sales is sub-optimal: there are no national-level guidelines for sales and no privatisation ministry with an explicit mandate to oversee sales.

In November 2003, Li Rongrong, the head of the SASAC predicted that provincial governments were on the brink of a massive sell-off. Large enterprises at the central level will also be sold. If true, then the government has a good opportunity to organise such sales both efficiently and fairly.

This briefing note is based on a longer working paper also available on the RIIA website. The working paper tackles some of the lessons learned from former Soviet bloc and provides a full list of the sources used in this note.

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