The Huge Debate over Privatization and MBOs in China
– Can the Drain on State-owned Assets Be Justified?

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Recently Professor Lang Xianping of the Chinese University of Hong Kong has sharply criticized the eroding of state-owned assets in China's privatization process by the managers of many listed firms through such means as management buyouts (MBOs). He has triggered a huge debate over whether privatization is the right policy and, if so, how to proceed with it. The arguments made by the "neo-leftists," who support Professor Lang from the viewpoint of "fairness," and the "neo-liberals," who disagree with him from the viewpoint of "efficiency," differ sharply. Ironically, in China, which calls itself a socialist country, the government's thinking is closer to that of the neo-liberals (who are known as "mainstream" economists) than that of the neo-leftists (who are known as "non-mainstream" economists).

The arguments of Professor Lang and the non-mainstream economists

Professor Lang views financial maneuvers such as MBOs and efforts to raise capital through listing as manipulation and plundering of state-owned assets by management (see appendix for a discussion of the problems of MBOs in China). He argues that managers have only been entrusted with the firm's management by the state, and that obtaining shares, which are a symbol of a company's ownership, at lower prices than ordinary investors is tantamount to embezzlement.

While the drain on state assets that accompanies privatization has been regarded as problematic for a long time, Lang provides new food for thought by showing the huge loss of state-owned assets based on accounting and other data from such well-known companies as Haier, TCL and Greencool Technology. The defamation suit filed in a Hong Kong court by Gu Chujun, chairman of Greencool (listed as an H-share on the Hong Kong Stock Exchange), against Lang has added fuel to this controversy.

In addition, Professor Lang staunchly opposes the privatization of state-owned enterprises for the following reasons. First, the larger the company, the more active the role the government should play in its management; large companies should not be left in private hands. Also, the idea that state-owned enterprises are less efficient than private firms is, he contends, a myth. In fact, many state-owned companies are recording high returns. The notion that privatization is the only way to implement corporate reforms is simply an erroneous belief harbored by some economists, and is not based on theory or evidence. Furthermore, the problem of the "absence of owner" often cited when state-owned enterprises are discussed does not actually exist; the real problem lies in the lack of supervision over management.

Lang believes that even in state-owned enterprises, professional managers should be hired from the market and that they should be rewarded or punished according to their performance in managing the firm based on clear rules stipulated by appropriate laws. At the same time, he argues that priority should be given to protecting the interests of smaller investors. Amid floundering stock prices, the ideas of Lang — who has been nicknamed "Supervisor Lang" for his zeal in looking into stock market irregularities — are widely supported by small investors. Given the lack of a solid legal framework for the restructuring of state-owned assets, Lang also calls for a ban on ownership reforms at state-owned enterprises, especially the privatization of assets through MBOs, in order to prevent the drain on such assets. His views are supported by many non-mainstream or "neo-leftist" economists.

Counterarguments by mainstream economists

In response to the arguments presented by the neo-leftists, mainstream economic scholars, who support a smaller role for the state (and thus privatization), offer a number of rebuttals. Among them are the arguments of Professor Zhang Weiying of Peking University, and Zhao Xiao, head of the Macroeconomic Strategy Division of the State-owned Assets Supervision and Administration Commission's Economic Research Center.

The first argument is that while it is true that there is a drain on state-owned assets in particular instances, viewed as a whole, it is rather the state-owned enterprises that have used their monopolistic position to erode private capital. Thus in addition to charging high fees for public utilities, they can list shares and raise capital on the stock market at prices much higher than their net asset values.

Second, the drain on state-owned assets helps accelerate the transition from the old economic system to a new one by weakening the opposition to reforms by vested interests. Thus, one must tolerate a certain degree of asset drain as a cost of the transition. As can be seen from the experience of Japan since the Meiji Restoration, and the transition of the former Soviet Union and Eastern Europe from socialism to capitalism, a drain on state-owned assets cannot be avoided when establishing a new economic order.

Third, the opportunity cost of not moving forward with privatization is enormous. If these enterprises remain state-owned, there is no chance for their efficiency to improve and they will become a burden on the state, which will have to make up for their losses. Giving shares to managers through such means as MBOs provides them with an incentive to improve corporate performance, thereby reducing the government's fiscal burden.

Fourth, delaying the reform of state-owned enterprises not only hurts efficiency but is also unfair because the monopolistic power and preferential treatments such as obtaining cheap loans traditionally enjoyed by state-owned firms translate into discriminations against private firms.

In sum, the ongoing reforms are not a process of dividing up state-owned assets but a process of creating wealth that is a win-win situation for both the government and the private sector. From the standpoint of income redistribution, selling state assets through MBOs may be problematic, but from the viewpoint of wealth creation it is very efficient. The drain on state assets may lead to social inequity, but when we consider that both inequity and inefficiency may prevail if the economic transition were to slacken, reforms such as privatization should be accelerated rather than suspended. In addition, mainstream economists warn that raising objections to the siphoning off of state-owned assets to entrepreneurs could lead to a deceleration in ownership reforms and worsen the investment environment. They argue that the entrepreneurs who have made great contributions to China's economic development should be more respected and appreciated.

"Fairness" vs. "efficiency"

In this debate, some scholars accept parts of the arguments of both the neo-liberalists and the neo-leftists. For example, Wu Jinglian, who is highly respected for his great contributions to the theory of the "socialist market economy" and its implementation through policy-making, acknowledges that there are some illegal practices such as corruption present within the reform process. However, he disputes Lang's view that all state-owned enterprises are wonderful and all private firms are evil. In addition, Zhang Wenkui, deputy director of the Enterprise Economic Research Institute of the State Council's Development Research Center, argues that the drain on state-owned assets is not the result of ownership reforms but the lack of transparency in the transactions themselves and the absence of a competitive framework. Thus rather than suspending privatization, its implementation process should be improved.

In the first place, we need to distinguish between state-owned firms such as Haier and TCL operating in competitive industries that have recently come under fire, and monopolistic state-owned enterprises such as China Telecommunications and State Grid Corp. Most state-owned enterprises in competitive industries have failed; the only exceptions have been those that, as in Haier's case, are blessed with brilliant managers like Zhang Ruimin. Therefore, when implementing ownership reform, it is only natural to give these managers a majority of the shares. At first glance, this may seem to be a drain on state assets, but in fact it is merely a ratification of the rights of the people who created this wealth, and does not run counter to fairness. By contrast, in the case of state-owned enterprises in monopolistic sectors, corporate performance is unrelated to managerial effort, so there is no need to give managers shares on preferential terms when carrying out ownership reforms.

As we can see, this argument does not stop at the pros and cons of privatization and how it ought to be implemented, but also focuses on the trade-off between "fairness" and "efficiency." Under Deng Xiaoping's slogan of "allowing some to get rich before others," China's economic reforms have so far placed priority on "efficiency" rather than "fairness." If efficiency were the only benchmark in the latest debate, the arguments of the neo-liberals might be sound. However, as the non-mainstream economists point out, privatization without a proper legal system is leading to "the capitalization of power," and is one reason for the polarization of income and wealth in China. To ensure fairness in privatization, we need to find ways to spread its benefits widely among the people, while taking into consideration the contributions made by individual entrepreneurs.

Appendix: MBOs have become a hotbed of corruption

Management buyouts are transactions in which the management of a company gains ownership by purchasing its outstanding shares from the parent firm or its owners with his or her own money. It is often used as an effective means of reorganizing a firm's operations or to fend off hostile takeover bids. Hired managers usually do not have the necessary funds for an MBO, so in many cases they join hands with investment companies affiliated with financial institutions or investment funds that have amassed capital from investors, who put up the necessary money.

MBOs have, in recent years, become a common means to privatize state-owned enterprises in China. However, MBOs in China, which still lacks a proper legal framework to regulate these transactions, have a number of "Chinese characteristics" that set them apart from those of other countries (Li Zhenghua, "Watch Out for the Misfortunes that Come with MBO Variations," *Chinese Economic Weekly*, June 28, 2004, in Chinese).

First, in most MBOs of listed state-owned enterprises in China, the shares are not purchased from the market. The managers exploit a structural flaw of the Chinese stock market — where shares both in and out of circulation coexist — to "buy in" rather than buy out. Because of the large gap between the price of outstanding shares and that of shares not in circulation, managers damage the interests of the vast majority of shareholders by gaining control of a firm at rock-bottom, insider prices through a negotiated transfer of non-circulated shares, rather than an open purchase of outstanding shares.

In addition, as the "B" (buy) in MBO signifies, managers should purchase shares based on their fair market values. However, in the Chinese state-owned enterprise MBO game, managers do not have sufficient (or often any) funds for their purchases, but conspire with bureaucrats to make deals with no money changing hands. As a result, managers reap the benefits without paying the cost or shouldering any risk. Such transactions are more of a theft than a purchase of state-owned assets conducted by the very people who are entrusted to manage them.

Moreover, in the West, MBOs are simply a form of economic activity on the part of corporate managers. But MBOs of China's state-owned enterprises have a political context. The managers of China's state-owned firms are not "hired from the market" as in the West, but are, in effect, government officials. They are given far-reaching authority without any effective mechanism to hold abuses in check. Thus, MBOs of state-owned enterprises are widely used as a means to turn political power into financial capital.

In this way, MBOs in China have come close to making corruption legal. If it were not for MBOs, managers with a huge amount of gray income would be unable to avoid allegations of corruption and would have no choice but to sit in the defendant's seat. However, thanks to MBOs, they can say that they obtained their massive wealth fair and square by legal means.