The Reform of State-Owned Enterprises in China: The Groundwork for Privatization Needs to Be Laid Urgently

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Introduction

China's reforms of its state-owned enterprises have so far failed to resolve some of their fundamental problems, such as their lack of corporate governance (itself the result of the "absence of a real owner"). The government has been aware of this and has, since the late 1990s and in accordance with its policy for "Strategic Realignment of the State-Owned Economy," sought to reduce the role of the state-owned economy (e.g., to areas such as providing public goods and services) through privatization, while leaving competitive areas of the economy to the private sector.

If privatization is to proceed smoothly, the ability of the country's securities markets to act as intermediaries needs to be improved as they are a key element of the privatization process. With some 70% of the shares of listed companies still owned by the state in the form of non-tradable shares, it has been difficult to establish corporate governance and protect the minority interests of private shareholders. These problems will remain until all the shares still owned by the state are eventually released onto the market.

The rapid growth of the non-public-owned sector has made it easier to reform the state-owned enterprises. In particular, private companies have absorbed some of the state-owned enterprises' surplus labor and participated in the privatization process by acquiring or merging with state-owned enterprises.

More needs to be done to improve the governance of those enterprises that are still owned by the state. The establishment of the State-owned Assets Supervision and Administration Commission (SASAC) has enabled the government to concentrate the responsibility for managing state assets in the hands of one body, while the balance of power between the central government and local governments has shifted, and government intervention in business has been curbed. However, SASAC has been criticized for being reluctant to privatize companies under its control.

I. The Limits of Reforms That Fail to Challenge the Dominance of Public Ownership

1. "Decentralization"

Reform of China's state-owned enterprises began in 1978 with a series of measures to delegate authority to companies. Through this process of "decentralization," the government hoped that both managers and workers would work harder. After a trial phase when companies were granted greater managerial autonomy and allowed to retain part of their profits, the government introduced a contract responsibility system in the mid-1980s in order to separate ownership and management as well as government and corporate functions.

In 1987, the contract responsibility system was introduced in most state-owned enterprises. Under this system, companies agreed to a number of conditions (e.g., paying a pre-determined amount to the government as profits and in taxes each year) in exchange for the right to operate their businesses independently of their supervisory agencies for 3-5 years. Provided they fulfilled these obligations, companies were allowed, for example, to distribute part of their retained earnings as bonuses to their employees or to increase their capital investment.

Then, in 1992, legislation ("Regulations on Transforming the Management Mechanism of State-Owned Industrial Enterprises") was passed in order to ensure the "separation of government and corporate functions" in accordance with the State-Owned Enterprises Law of China, which had come into force in 1988. This legislation gave companies 14 rights of control (e.g., the right to decide how much to invest in production facilities, how much to charge for their products and how much to pay their employees as well as how to use their retained earnings) in order to enable them to manage their businesses in a market economy.

Although the greater incentives and managerial autonomy of "decentralization" and the other early reforms boosted the productivity of state-owned enterprises, they also made it more difficult for outsiders to monitor the enterprises and their employees. This led to widespread abuses, such as cuts in dividend payments to the state and the expropriation of state assets.

This problem of insider control was compounded by the fact that loss-making companies could expect to be bailed out by either the state or the banks (the "soft budget constraint"). The resulting moral hazard led to the assets of the state-owned enterprises being "privatized" while their liabilities were "nationalized."

2. The creation of a "modern enterprise system"

In order to solve this problem, the 14th National Congress of the Communist Party of China, which met in October 1992, decided that China should try to establish its own brand of socialism based on market principles. This theme was further pursued at the Third Plenary Session of the Fourteenth Central Committee of the Communist Party of China in 1993, and the creation of a modern enterprise system was made the principal goal of reforming the country's state-owned enterprises. The key elements of such a system were held to be (1) a clear separation of ownership (by the state) and management (by the enterprises themselves), (2) a clear delineation of the rights and responsibilities of the owners (e.g., the right to a share of the profits) and the managers (e.g., the responsibility for profits and losses), (3) a commitment by the government not to intervene in a company's production operations or the way it was managed, and (4) a "scientific" system of organization and control. In order to achieve this (especially in the case of large companies), a system of shareholding was to be introduced, and companies were to be obliged to set up a board of directors and a board of supervisors, and to hold general meetings of their shareholders.

However, the introduction of a system of shareholding has not in itself ensured effective corporate governance of state-owned enterprises, and many problems (e.g., insider control and the mixing of government and corporate functions) have remained unresolved.

The first of these problems arises from the fact that the state has remained the largest shareholder of state-owned enterprises even since the transition to the shareholding system. The government has continued to intervene in the operations of these enterprises in order to ensure that they fulfill their obligations to the state. However, these obligations may contradict an owner's principal aim of profit maximization. Indeed, their obligation to comply with government policy has remained as onerous as ever, and the umbilical cord between government and enterprise remains uncut.

The second problem is the lack of an effective system of corporate governance. Under China's Company Law, a company's board of directors is responsible for appointing and supervising the company's managers as well as for assessing their performance and deciding how they should be rewarded or penalized. In spite of this responsibility, however, the state's large shareholding in state-owned enterprises means that they continue to be subject to strong pressures from both the Communist Party and government officials. In addition, the same person tends to act as both chairman of the board of directors and chief executive officer. With the board of directors under the control of corporate insiders, it cannot perform its supervisory duties properly.

These problems are also partly caused by the inefficiency of the country's securities markets. In a properly functioning securities market, the shares of a poorly performing company would decline in value and the company would become a target for takeover. As the managers would be replaced in the event of a takeover, they need to do their best for the company to ensure that this does not happen. In the case of China's securities markets, however, the risk of a listed company being taken over is virtually zero because tradable shares account for only a small proportion of the total number of shares issued, the vast majority of which are (non-tradable) state shares.

In addition, there is no market for managerial talent (i.e., a competitive market for human resources). Companies are therefore unable to find replacements for managers they might want to dismiss and are unable to appoint and dismiss managers in accordance with market principles.

II. Privatization Gathers Momentum

1. Privatization as a remedy for the absence of a real owner

As we have seen, China's state-owned enterprises have remained beset by the problems of the mixing of government and corporate functions and the lack of a proper system of corporate governance even since the establishment of a "modern enterprise system." It will be difficult to resolve these contradictions without embarking on a program of privatization.

The reason why privatization may provide a solution is that, by definition, state-owned enterprises cannot be separate from government. Since managers of state-owned enterprises are public officials, they are motivated by administrative rather than market incentives. In other words, a company that is expected to be independent of the government must have very different objectives from the government and therefore has no reason to be owned by the state in the first place. However, it would be an infringement of the government's rights to demand that it should not be involved in the operation of the companies it owns. Therefore, any separation of government and corporate functions can only be achieved by means of privatization.

When it comes to the provision of public goods and services, however, the appropriate approach is to improve government supervision of the state-owned enterprises involved in order to ensure that they meet their targets—not to make them independent of government. In the case of all other companies, the government should renounce its rights of ownership and control by privatizing them so that the separation of government and corporate functions can be fully achieved.

State ownership also makes it difficult to establish an effective system of corporate governance. In terms of agency theory, the problem lies in the conflict of interests and the asymmetry of information that exist between managers (the agents) and owners (the principals).

Managers have different objectives from owners. While any profits belong to the owners, it is the managers who are supposed to work hard to earn those profits. Therefore, unless a system of corporate governance works properly, the managers are likely to pursue their own interests rather than the owners' profits.

In addition, the existence of an asymmetry of information makes it difficult to monitor managers. Managers are well aware of what they are capable of doing and how much effort they have made on the owners' behalf. However, this information is hardly available to the government, which is supposed to be the owner of these enterprises. Managers therefore are tempted to manipulate information for their own interests.

Even in developed capitalist economies there is a risk that the separation of ownership and management may lead managers to infringe the rights of owners. In the case of China's state-owned enterprises, however, this problem is especially acute—as the expression "absence of a real owner" indicates. China's 1.3 billion citizens are in no position to exercise effective control over the country's state-owned enterprises, of which they are supposed to be the ultimate owners. Although each of them owns part of each of China's several hundred thousand state-owned enterprises, they have neither the ability nor any incentive to monitor them. And even if they wanted to, they would not even be able to attend their shareholder meetings. That is why they have no alternative but to let government agencies act on their behalf. However, maximization of profit is only one of many objectives the government has for managing state-owned assets; others include job creation and social stability. Furthermore, the officials appointed by the government to carry out its policies are likely to put their own interests before those of the state or their fellow citizens.

Since state ownership is at the root of all these problems, the only way to ensure effective corporate governance of state-owned enterprises is to privatize them.

2. The "Strategic Realignment of the State-Owned Economy" as the first step towards privatizing big state-owned enterprises

As we have already seen, until the mid-1990s the reforms to China's state-owned enterprises were directed mainly towards granting companies greater managerial autonomy within the framework of state ownership. However, in the mid-1990s the government launched the idea of privatizing smaller businesses ("keeping the large and releasing the small"). This was followed by the policy of "Strategic Realignment of the State-Owned Economy," announced at the 15th National Congress of the Communist Party of China in October 1997. This marked a major change of direction in government policy on state-owned enterprises in that, with the exception of a small number of key industries, the state was to withdraw from ownership, regardless of company size. The aim of this policy was not so much to reform state-owned enterprises as to reduce their role in the economy. Although the word "privatization" was not used, that was what the government was, to all intents and purposes, advocating.

In September 1999, at the Fourth Plenary Session of the Fifteenth Central Committee of the Communist Party of China, a decision ("The Decision of the Central Committee of the Communist Party of China on Major Issues Concerning the Reform and Development of State-Owned Enterprises") was adopted which fleshed out the policy of "Strategic Realignment of the State-Owned Economy." According to this decision, China had to complete this strategic realignment by 2010 and decide which sectors of the reshaped economy its state-owned enterprises should try to enter and which they should exit. With the exception of a few key sectors, the state was to reduce its activity or withdraw altogether from competitive industries. The final outcome of this would be that the state-owned enterprises that remained would play essentially the same role as their counterparts in countries with market economies.

With the exception of the following four areas, where the state was to continue to play a leading role, state-owned enterprises were to be privatized, regardless of their size.

The first category was "industries that are crucial to national security." This included arms production and other defense-related industries, coinage and strategic reserves (e.g., of food and energy).

The second category was "industries that are natural monopolies or oligopolies." This included postal services, telecommunications, electric power, the railways and air transport. China's accession to the World Trade Organization meant that both foreign and private-sector Chinese companies would have to be allowed to enter some of these industries (e.g., telecommunications) and that they could not remain the preserve of state-owned enterprises. However, the government believed that some projects involving the development of natural resources would require either such large investment or have such a long payback period that it could not count on either foreign or private-sector companies.

The third category was "industries that supply public goods and services." The government took the view that, although private-sector companies should be allowed to provide such goods and services, it could not count on them to provide the necessary quantity and would therefore have to maintain a presence of its own. Examples mentioned included water and gas supplies and public transport, ports, airports, irrigation facilities and major forest reserve projects.

The fourth category was "pillar industries and backbone enterprises in high and new technology sectors." Examples mentioned were the oil, steel and automobile industries and some advanced sectors of the electronics industry.

As with reforms in other areas, the approach to privatizing the country's state-owned enterprises has been a gradualist one, with the government reducing its stake step by step. The first step has been to pluralize the ownership of state-owned enterprises. This process involves extending ownership, which was originally limited to the state, to (1) foreign investors, (2) private-sector Chinese investors, (3) legal persons and (4) both managers and employees. In recent years foreign investors have even been encouraged to merge with or acquire state-owned enterprises as part of the "Strategic Realignment of the State-Owned Economy," albeit within certain limits. The privatization process has also been opened up to private-sector companies, while cross-ownership by state-owned enterprises has also become commonplace.

At the Third Plenary Session of the 16th Central Committee in October 2003 a resolution ("Decision on Issues Regarding the Improvement of the Socialist Market Economic System") was adopted to remove some of the obstacles to privatization that still existed. The "shareholding" (or "joint stock") system was to replace state ownership as the mainstay of public ownership. This was to be a mixed form of ownership, involving the state, collectives, and the non-state sector. Moreover, even when the state was involved, it was no longer considered necessary in certain circumstances for it to have an absolute majority of the shares so long as it exercised effective control as the largest shareholder.

III. The Need to Reform China's Securities Markets

1. China's securities markets symbolize the contradictions between socialism and the market economy

If privatization of China's big state-owned enterprises is to be successful, further reform of the country's securities markets will be needed. In Western market economies privatization usually involves a three-step process: corporatization of state-owned companies, listing their shares on a stock exchange, and gradually reducing the state's shareholding. It is now more than 10 years since China's first stock exchanges were established: in Shanghai in 1990 and in Shenzhen in 1991. However, a series of scandals involving listed companies has destroyed investors' trust in the country's securities markets. As a result, share prices have gone nowhere and the securities markets have failed to perform the role expected of them in the privatization of the country's state-owned enterprises even though the economy has continued to grow rapidly.

Shares in listed Chinese companies are divided into different classes according to who owns them: state shares, legal person shares and public investor (or individual) shares. State shares are the shares owned by government departments or government agencies. Since most of China's shareholding (or joint stock) companies were originally state-owned enterprises, the state tends to have a large shareholding in them. Legal person shares are shares owned by companies or incorporated public organizations. State shares and legal person shares currently account for roughly 70% of the shares in listed Chinese companies. Public investor (or individual) shares, on the other hand, are tradable shares purchased by Chinese individuals or organizations using their own money. State shares and legal person shares are non-tradable, and the only shares in Chinese companies that Chinese investors can trade on the Shanghai and Shenzhen stock exchanges are public investor shares.

This distinction between tradable and non-tradable shares has existed ever since the two stock exchanges were established. At that time, China was largely a planned and state-owned economy, and it was inevitable that the majority of shares issued were supposed to remain in the hands of the state. However, this has had a deleterious effect on the development of the country's securities markets and led to the abuse of the rights of small (individual) shareholders by major (state) shareholders with a negative knock-on effect on share prices.

One of these abuses is the high level at which many listed Chinese companies set the price of their rights issues. The effect of these issues is to dilute the value of tradable shares and boost the net asset value of non-tradable shares. Therefore, once a company is listed, the holders of its non-tradable shares tend to be much more interested in any new share issues than the company's development. Nor are the funds raised by such issues always used for investment proper. As a result, many companies have seen their earnings decline sharply since they were listed or are even making a loss, and this has had a deleterious effect on the development of the country's securities markets.

Another of these abuses is the way in which large shareholders use their absolute control of listed companies to manipulate their accounts by carrying out transactions with affiliated companies. These shareholders usually control a large number of affiliated companies and can manipulate their accounts to carry out transactions among them to their own advantage.

Another example is the way in which large shareholders abuse their position to spread misinformation about companies. In the case of some listed companies, the deception has occurred right from the start, with the window dressing taking place before the shares have even been listed. There have been numerous cases where large shareholders have pushed up share prices in order to attract minority shareholders and then quietly disposed of their holdings at a huge profit.

2. Disposing of the state's shares

With non-tradable (state and legal person) shares accounting for such a large proportion and tradable (private investor) shares accounting for such a small proportion of the outstanding shares in state-owned enterprises, it is difficult for China's securities markets to develop properly. At some stage the government will have no alternative but to sell its shares in these companies to the private sector if the process of economic reform is to continue. Such a move would achieve four things. First, by making state-owned assets more liquid, it would provide an effective channel for the government to withdraw from certain sectors in the process of realigning the state-owned economy. Second, by eliminating the distinction between state, legal person and tradable shares, it would help China's securities markets to develop in a more disciplined and healthy manner. Third, by pluralizing and eventually privatizing the ownership of large and medium-sized state-owned enterprises, it would help to create a more effective system of corporate governance. Finally, the proceeds of these sales could be used to put the Social Security Fund on a sounder financial footing.

The government has started to explore ways to dispose of its shares in China's listed companies. At the end of 1999 and with the approval of the Ministry of Finance, the China Securities Regulatory Commission (CSRC) selected 10 companies as pilot cases. However, only two of them actually offered non-tradable shares to private investors. Holders of private investor shares in these companies were offered the right to buy these shares in proportion to the number of tradable shares they already owned. As the prices of these shares were set too high, private investors complained that their interests were harmed. A second attempt began on 12 June 2001. The method this time was to require firms to sell state-owned shares (equivalent to 10% of the proceeds from IPOs or additional share issues) at market price. One of the conditions was that the proceeds from the sales should go to the Social Security Fund. However, the Chinese stock market declined by 40% during the following six months as investors worried about an increase in supply, and most had their fingers badly burnt. Finally, on 22 October 2001, the Commission threw in the towel and called a halt to any more sales of state-owned shares.

In November 2001, in view of the negative reaction to both attempts, the Commission invited suggestions from the public on how it should go about disposing of state-owned shares and received more than 4,000 suggestions. The following are the six main suggestions:

(1) holders of private investor shares of these companies should be offered the right to buy these shares in proportion to the number of tradable shares they already owned (as in 1999);

(2) ownership of state-owned enterprises should be restructured (by converting non-tradable shares to tradable shares at a certain discount rate, or by splitting tradable shares at a certain ratio and then allowing state-owned shares to be traded in the market);

(3) an alternative market should be established to trade state and legal person shares;

(4) non-tradable shares of various companies should be pooled together and repackaged into an exchange-traded fund (ETF) which would be allowed to be traded freely in the market;

(5) state-owned shares should be converted to corporate bonds or preference shares;

(6) state-owned shares should be transferred to the Social Security Fund.

Of these, the first option seems to be the most likely. Holders of tradable shares would like the offering price to be set at the net asset value per share (i.e., the book price). They argue that, since the value of state-owned shares has risen on at least two occasions as a result of asset valuations and issue premiums, their holders would make a tidy profit even if they sold them at net asset value per share. That is why the holders of tradable shares believe that state-owned shares should be offered either at or below that level. However, net asset value per share does not necessarily reflect a company's profitability; the more profitable a company, the more likely net asset value per share is to be an undervaluation of its shares.

Holders of non-tradable shares, on the other hand, would like state-owned shares to be offered at their market price. They argue that the state cannot afford the loss in the value of its assets that would otherwise result. While the principle of equal treatment does argue in favor of pricing state-owned shares at their market value (as one could otherwise claim that the legal rights of the state were not being safeguarded), the secondary market price of the tradable shares has been formed on the assumption that the state-owned shares would not be offered for sale. If they were, the market price would be much lower. The fact that on both occasions when the government offered state-owned shares at the secondary market price share prices suffered a sharp correction supports this view. The main reason tradable shares trade at a premium is that there was a tacit understanding when they were issued that state and legal person shares would not be offered for sale. Even if one adheres to the principle of fair treatment for all, holders of state-owned shares should be required to compensate holders of tradable shares one way or another if they are to be granted the (new) right to trade their shares on the secondary market.

IV. The Development of Private Companies as a Prerequisite for the Reform of State-Owned Enterprises

1. From toleration to active encouragement of privatization

During the era of the planned economy, private property was viewed as the root of all evil. But, under the leadership of Deng Xiaoping beginning in the late 1970s, the government put forward a plan to develop private companies in order to adapt to the demands of people pursuing personal wealth. These policies have done much to foster innovation and hard work among the people, and have become a driving force behind China's economic growth.

Since the introduction of market-oriented reforms, the attitude of the government towards private companies has changed from one of toleration to active encouragement. The Chinese Constitution as amended in 1988 included the following paragraph: "The state permits the private sector of the economy to exist and develop within the limits prescribed by law. The private sector of the economy is a complement to the socialist public-owned economy. The state protects the lawful rights and interests of the private sector of the economy, and exercises guidance, supervision and control over it." This is stated even more clearly in President Jiang Zemin's report to the 15th National Congress of the Communist Party of China, which met in 1997: "The non-public-owned sector is an important part of the socialist market economy in China. We encourage and guide the continuous and healthy development of such non-public-owned sectors of the economy as individually owned and privately owned businesses."…"The development of the economic system with public ownership playing a dominant role and diverse forms of ownership developing side by side is a basic characteristic of the socialist economic system at the preliminary stage." This was incorporated in the Constitution without any changes when it was amended again in March 1999, and the status of the non-public-owned sector was raised from that of a "complement" to an "important part" of China's socialist market economy.

Furthermore, President Jiang Zemin's report to the 16th National Congress of the Communist Party of China in November 2002 emphasized the following: "In line with the requirements of releasing and developing the productive forces, we must uphold and improve the basic economic system, with public ownership playing a dominant role and diverse forms of ownership developing side by side."…"All sectors of the economy can very well display their respective advantages in market competition and stimulate one another for common development."…"First, it is necessary to consolidate and develop unswervingly the public-owned sector of the economy."…"Secondly, it is necessary to encourage, support and guide the development of the non-public-owned sectors of the economy."

As a major step in this direction, the Constitution was amended in 2004 to abolish discrimination against the non-public-owned sector and, in particular, to improve the social standing of entrepreneurs and private companies. Whereas the previous version of the Constitution stated that "the state guides, supervises, and manages the individual economy and the private economy," the 2004 version amended this to "the state encourages, supports, and guides the development of non-public-owned sector of the economy." Private entrepreneurs have come to be recognized as the "builders of the socialist cause" and prejudice against them should be removed. In view of the discrimination (e.g., in terms of borrowing, taxation and imports/exports) to which the non-public-owned sector had previously been subject, the amendments should contribute significantly to the sector's development. In addition, the amendments enhanced the provisions for protecting private property: "The lawful private property of citizens is not to be violated. The state protects the right of citizens to own and inherit private property according to the provisions of the law. The state may, in the public interest and in accordance with the provisions of the law, requisition or expropriate for its use the private property of citizens and shall pay compensation."

In January 2005 Premier Wen Jiabao convened a meeting of the State Council's standing committee in which "Some Opinions Regarding the State Council's Encouragement and Support of the Development of the Non-Public-Owned Economy" were discussed. The view was presented that "Not only does encouraging, supporting and guiding the development of the non-public-owned economy help promote the economic prosperity in urban and rural areas and increase fiscal revenue, it is also beneficial in creating new jobs, bettering the lives of the people, improving the economic structure and accelerating economic growth. It also has important strategic significance in realizing an all-round well-off society and in pushing forward the process of socialist modernization." At the same time, the latest "opinions" recognize the need to "provide the non-public-owned economy with an environment of competing on an equal footing; a system based on the rule of law; and a policy and market environment and policy measures that encourage, support and guide the development of the non-public-owned economy." Needless to say, the non-public-owned economy here refers mainly to the private-sector economy, which has seen rapid growth. Since private companies have faced discrimination in various areas, it is significant that the government has made clear its intention to grant them "national treatment," as well.

As the government's policies towards private companies have changed, China's corporate sector has itself undergone a transformation since the introduction of market-opening policies in the late 1970s. Until then, the sector was dominated by state-owned enterprises (known at that time as "state-run" enterprises); but now the picture is a much more varied one with joint ventures between publicly and privately owned companies, Chinese and foreign companies and even wholly private-owned and wholly foreign-owned companies. Most of these businesses are doing better than traditional state-owned enterprises. Whereas the latter have inherited the inefficiency dating from the days of the planned economy, the former are able to operate largely according to market principles. Similarly, whereas in the days of the planned economy state-owned enterprises (known at that time as state-run enterprises) accounted for the bulk of industrial production, nowadays the figure is less than 30% as a result of the expansion of the non-state-sector (especially private companies) and the privatization of many state-owned enterprises.

2. The role of the private sector in privatization

The growth of private companies provides a favorable environment for state-owned enterprise reform, including privatization.

The development of private companies has created new jobs for the surplus labor of state-owned enterprises. The private sector was nonexistent during the planned economy era, but it has expanded rapidly since the shift to market-opening reforms and especially since Deng Xiaoping's famous speech during his tour of south China in early 1992. In that year, only 8.38 million people were employed in the private sector in urban areas; as of 2003 the figure had risen to 49.22 million (Figure 1). Of this number, 25.45 million people are employed at privately owned enterprises with eight or more employees, while 23.77 million work at companies run by individuals—those with fewer than eight workers. (In China, privately owned enterprises and individually owned enterprises are together called private companies, or the private- sector economy.) Meanwhile, in rural areas, the number of workers in the private sector more than doubled from 18.62 million in 1992 to 40.14 million in 2003. (Of these, 17.54 million people worked at privately owned enterprises and 22.6 million worked at individually run businesses.) By contrast, the number of employees at state-owned enterprises stood at 68.76 million in 2003, down considerably from its peak of 112.61 million in 1995. Thus, the growth of private companies has been absorbing workers affected by restructuring at state-owned enterprises and the surplus workforce of rural areas. In fact, in 2003 alone the private sector created 7.83 million new jobs: 6.54 million in urban areas and 1.29 million in rural areas. When we also consider the fact that many state-owned enterprises and township and village enterprises are bringing in private capital, the private sector's contributions are probably much greater than these figures suggest.

Figure 1 The Number of People Employed in the Private Sector [1]

(Unit: million)

			1992	1995	2002	2003	Change in 2003
Private-sector economy	Urban areas	Individually owned	7.4	15.6	22.7	23.8	1.1
		Privately owned	1.0	4.9	20.0	25.5	5.5
		Total	8.4	20.5	42.7	49.2	6.5
	Rural areas	Individually owned	17.3	30.5	24.7	22.6	-2.1
		Privately owned	1.3	4.7	14.1	17.5	3.4
		Total	18.6	35.3	38.9	40.1	1.3
	Total	Individually owned	24.7	46.1	47.4	46.4	-1.1
		Privately owned	2.3	9.6	34.1	43.0	8.9
		Total	27.0	55.7	81.5	89.4	7.8
Reference	Rural areas	TVEs [2]	106.3	128.6	132.9	135.7	2.8
	Urban areas	State-owned	108.9	112.6	71.6	68.8	-2.9

Notes: 1. There are two types of private companies in China: "privately owned companies" and "individually owned companies." Privately owned companies have eight or more employees, while individually owned companies have less than eight employees.
2. "TVEs" stands for "township and village enterprises."

Source: *China Statistical Yearbook* 2004.

Also, the rapidly growing private sector is directly participating in the reform of state-owned enterprises in the following four ways. First, some private companies purchase a portion of the stock of state-owned companies as they shift to a joint-stock company. They may even hold enough shares to be able to assume a leadership role in the company's operations. Second, some private companies purchase a state-owned enterprise outright. In this case, the state-owned enterprise continues to exist as a private company. Third, a private enterprise may absorb a state-owned enterprise through merger. Fourth, the state-owned enterprises that have been operating in the red for a long time and for which rehabilitation may be impossible are liquidated through legal means so that private businesses can purchase their assets and use them more efficiently.

Meanwhile, the rise of private enterprise has led to intensified competition; the monopolistic position of state-owned enterprises is under threat and their profitability is declining, while the demonstration effect of fast-growing private businesses despite the adverse business environment they face stands in sharp contrast to the stagnation at state-owned enterprises. This is making the public more aware of the need for reform and is a key factor in keeping conservative forces at bay. The development of private enterprise has also boosted economic growth in general, and the income this has generated has helped to assuage opponents of the reforms to state-owned enterprises by compensating interest groups that have suffered as a result of these reforms.

V. Improving the Management of State-Owned Assets

1. The reforms carried out by the State-Owned Assets Supervision and Administration Commission

In addition to strengthening the role of China's stock markets in privatization, the government needs to ensure that the assets of those state-owned enterprises that remain are better managed. As the system for managing these assets was set up in the days of the planned economy, it has continued to show some of the characteristics of that period (e.g., the mixing of government and corporate functions). Despite repeated efforts to revamp the system since China started its economic reform process in the late 1970s, it had failed to match the needs of a market economy. In response, in his report to the 16th National Congress of the Communist Party of China in November 2002 President Jiang Zemin called for the setting up of a new system to manage state assets. In April 2003 this was put into effect with the establishment of the State-Owned Assets Supervision and Administration Commission (SASAC). One of more than 20 bodies affiliated to the State Council, the Commission is responsible for supervising and administering nearly RMB7 trillion of state assets. However, it is not directly involved in day-to-day operations or management; rather it helps companies to establish a modern enterprise system. The establishment of a government-backed body with clear responsibility for managing the country's state assets is expected to help remedy the much criticized "absence of a real owner" of these assets.

The new system of management centered on SASAC has carried out three major reforms to remedy the defects of the previous system.

First, responsibility for managing state assets has been concentrated in one body. Under the previous system, responsibility was divided among a number of government bodies. For example, responsibility for ownership of state assets lay with the Ministry of Finance; responsibility for investing in state assets lay with the State Planning Commission; responsibility for the day-to-day management of state assets lay with the State Economic and Trade Commission; and responsibility for personnel management lay with the Large-Scale Enterprise Work Commission. In addition, individual ministries (along industrial lines) were responsible for supervising individual companies' daily operations. The result was constant mutual recriminations and turf wars that made it impossible to manage state assets properly. SASAC was established in order to concentrate all these responsibilities for managing state-owned enterprises in one body, create a "state-owned assets management system …combining rights with obligations and duties, and administering assets, personnel and other affairs," and replace "management by many departments" with "management by one department." By combining the management of assets, personnel and other affairs and striking a balance between rights, obligations and duties, the new system will hopefully be able to preserve and increase the value of state assets. Moreover, should there be any problems in managing state assets (including the problem of asset stripping), the buck will now stop with SASAC; and this should help to establish an effective system of checks and balances.

Second, the new system of ownership and management of state assets has shifted the balance of power between the central government and local governments in favor of the latter. In the past, local governments had only the right to manage the assets of state-owned enterprises but no right to receive the benefits of being an owner (i.e., a share of profits). As a result, they had little incentive to improve the way in which state-owned enterprises were run. This explains why local governments showed little support for the sale of state shares in listed companies until the system was reformed. Although local governments were usually responsible for supervising listed companies, they received none of the proceeds from the sale of state shares, all of which accrued to the central government. Under the new system, the assets are owned by the state, as represented by either the central government or by some local governments, for which the benefits of ownership match the accompanying rights, obligations and responsibilities. This ensures that all parties have sufficient incentives, that ownership is clearly defined and that there is a rule-based system of corporate governance. For these reasons, state-owned assets management authorities have been established separately at both the central government and local governments at the provincial and municipal levels. While the central government retains responsibility on behalf of the state for investment in large state-owned enterprises, infrastructure and natural resources of vital importance to the economy and national security, responsibility for other state-owned assets now lies with local governments.

Third, the new system of ownership and management of state assets has limited government intervention in business. Under the old system, excessive intervention in the way state assets were managed led to low efficiency. A whole series of reforms have been carried out to deal with this problem. Until 1992, for example, companies that used state assets were called "state-run enterprises" and were subject to excessive intervention by government officials because of the emphasis placed on the fact that they were both owned and operated by the state. These companies were then renamed "state-owned enterprises" and subjected to less intervention by government officials because emphasis was placed only on the fact that they were owned by the state while less emphasis was placed on government involvement in how they were run. Following President Jiang Zemin's report to the 16th National Congress in 2002, the emphasis was shifted from reforming state-owned enterprises to managing state assets, and a new system of managing state assets was set up. Under the new system, the government is now an investor in (rather than a manager of) state assets—even if a company is wholly owned by the state. These changes from state-run to state-owned companies and then to state assets mark important steps forward. At each stage the degree of government intervention has been reduced.

2. Outstanding issues

Setting up SASAC, however, is only a first step. There are at least three other issues that need to be tackled. First, privatization needs to be used to take the strategic realignment of the state-owned economy one step further. The state needs to make a new strategic decision about which sectors and companies it should continue to control and which it should reduce in number. Second, the state needs to devise an effective mechanism for restructuring companies in financial difficulty. This would include declaring companies bankrupt and merging them with other companies. Third, the state needs to show clearly how it intends to establish or improve corporate governance.

While the establishment of SASAC has helped remedy the problem of "the absence of a real owner" that state-owned enterprises used to face, it needs to be careful not to intervene excessively in company affairs. Self-interest dictates that shareholders in private companies are deeply concerned about how those companies are run. However, there is a risk that the officials entrusted with running SASAC will, just like the managers of a company, pursue their own interests rather than those of the real owners (i.e., the Chinese people). In fact, they have already been criticized not only for being unwilling to relinquish their authority but also for having a negative attitude to privatization. The problem of "Who governs the governors?" therefore remains unresolved.