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SOE reform 3

## Corporatisation, not privatisation

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Over the past decade, corporatisation has been the central mechanism of state-owned enterprise (SOE) reform. While state ownership remains, the organisational form of the traditional SOE – an enterprise without shares administratively subordinate to a government ministry or other agency – is being replaced by that of one of the three corporate forms allowed under the Company Law (limited liability company, state-owned limited liability company or shareholding limited company). Many of these shareholding companies have been listed on domestic or foreign stock exchanges. Some commentators have seen this process as a kind of creeping privatisation; in fact, the clear goal is to reinforce the state's grip on key economic sectors.

*Corporatised for control*

The basic dilemma in Chinese corporate governance is that the state wants to maintain full or controlling ownership in enterprises in several major sectors, and it wants these enterprises to be run along commercial lines in the service of wealth maximisation. Unfortunately these two goals are fundamentally incompatible. If the state's goal were really to maximise its financial returns, it would choose to sell or hold depending on which strategy offered the best financial return, rather than foreclosing the option of sale from the outset.

In reality, of course, the state insists on controlling enterprises precisely because it has aims other than wealth maximisation: for example, maintenance of urban employment levels, direct control over sensitive industries, or politically-motivated job placement. These goals create several problems in enterprise administration. First, many of the state's goals are not easily measured and there is no obvious way of balancing them one against the other. Second, there is a conflict of interest between the state as controlling shareholder and other shareholders. In using its control for purposes other than value maximisation, the state exploits minority shareholders who have no other way to benefit from their investment.

*Mixed motives*

### Corporatisation versus privatisation

The corporatisation policy has many aims. These include:

- The raising of equity capital for SOEs following conversion to the corporate form;
- The expansion of state control in some sectors through leverage; and
- The improvement of the management of state assets through the implementation of a new organisational form.

Privatisation may be an occasional side-effect of this process but it is scarcely a major goal. As recently as June 13, Li Rongrong, head of the newly-formed State Assets

Supervision and Administration Commission (SASAC), reiterated the state's commitment to retaining ownership control over key enterprises in several sectors: national security-related industries, natural monopolies, sectors providing important goods and services to the public, and pillar industries and high technology.\*

If corporate governance reform and the Company Law are not about privatisation, neither are they about facilitating business activity in general. They are driven by the policy of restructuring of SOEs. The need of non-state actors for a convenient environment in which to conduct business occupies a very low priority in the minds of state policymakers, and the Company Law is thus clearly concerned more with regulating and suppressing than with fostering and nurturing.

*The urge to control*

This concern arises from the deep-rooted official suspicion of accumulations of wealth not controlled by the state or its officials, coupled with the suspicion of any organised activity not firmly under state leadership. A government that bans unauthorised fishing clubs and associations for the study of antique furniture and paper-cutting\*\* is unlikely to welcome the unbridled blossoming of organisations whose purpose is to make real money.

**Leverage as power**

An explicit goal of enterprise reform is the *magnification* of the scope of direct state control through leverage; this concept is enshrined in a key Communist Party decision document from 1999.\* Previously, the state was the sole owner of a traditional SOE and exercised full control over it. Corporatisation allows non-state investors to contribute funds to the enterprise without sharing in control. The state maintains the same level of control it had before, but now over a larger pool of assets. Thus, the apparent dilution of state ownership through the sale of shares in listed companies, which leads some observers to assume the inevitability of eventual privatisation, is in fact a mechanism for *expanding* the state's economic empire.

Take, for example, the China Telecom group of companies. China Telecom Corporation Limited (CTCL) is a shareholding limited company with shares listed on the New York and Hong Kong stock exchanges. Almost 80 percent of its stock, however, is owned by China Telecom Group Company, a traditional SOE with no shares that is directly owned by the Chinese government, while less than 12 percent of the equity was sold to the public. By creating a controlled subsidiary in the form of a shareholding company and selling a small proportion of its shares to the public, the parent SOE actually *increased* the value of assets under state control.

*In China, it's still  
all the state's*

A more extreme example can be seen in the recent boast of a former senior policymaker that, with an equity stake of a mere 6 percent, the state controls the 94 percent of "social capital" in the Guangzhou Light Industrial Group and the enterprise should therefore be classified as "state-controlled."\*\*\*

\*"Heli buju tiaozheng jiegou, fazhan zhuangda guoyou jingji – fang guowuyuan guoyou zichan jian-du guanli weiyuanhui zhuren Li Rongrong" (Rationally lay out structural adjustment, develop a great state-owned economy: a visit with the chairman of the State Council's State Asset Supervision and Management Commission, Li Rongrong), *Jingji Ribao* (Economic Daily), June 13, 2003.

\*\*Under an order published in the Ministry of Civil Affairs Bulletin, No. 41, June 6, 2003, available at <http://www.mca.gov.cn/news/shtuan41.html>

### The wrong medicine

But in addition to magnifying state control, corporatisation is also supposed to make traditional SOEs more efficient. Theoretically, corporatisation achieves this improved efficiency by eliminating three major problems in traditional SOE management:

- The bureaucratic interference arising from the state being both the owner and the manager of the enterprise;
- The confusion arising from multiple state agencies having overlapping authority over the enterprise;
- The lack of accountability caused by the absence of a clear single or dominant owner to whom managers must report.

In reality, corporatisation misanalyses the problems and so delivers flawed solutions. Take item 1, the separation of ownership and control. Corporatisation is supposed to separate state ownership from state control, and thereby free managers from interference so that they can pursue efficient and profitable operations. There are two problems with this. First, even under the old system, traditional SOEs had a separation of ownership and control because the abstract "state" that owned an enterprise was distinct from the actual human beings who managed and oversaw the enterprise. Devolving more power to enterprise managers or corporatising traditional SOEs does not change this in the slightest.

*Still in the service  
of the state*

Second, the corporatising model assumes that the goal of the state owner in the new system is wealth maximisation. As we have seen, this is not so: the state has numerous goals other than wealth maximisation, which is precisely why it is so insistent on retaining direct ownership. Furthermore, reform-minded calls for government-owned enterprises to be independent of government "interference" are calls for nothing short of utter non-accountability for management. Given that the assets were contributed to the enterprise by a government agency, it seems reasonable for the agency to have some say in how the assets are used. The real issues are not separating ownership from control, or making managers non-accountable to the government-agency owners, but rather what kind of targets the agency as owner sets for managers and how it evaluates their performance. Unfortunately, it is hard to monitor effectively the implementation of possibly contradictory goals, not least when those goals are difficult or impossible to quantify.

### Private-sector perils

A wider problem is that because it was conceived mainly as an SOE restructuring device, the Company Law, instead of making it easier to organise economic activity in general, imposes a strait-jacket that constrains the development of private-sector businesses.

*Legal constraints*

Take, for example, the question of whether to make rules mandatory or to allow company organisers latitude to choose the governance rules most appropriate for their circumstances. The Company Law is clear: the rules are almost uniformly

\*"Guanyu guoyou qiye gaige he fazhan ruogan zhongda wenti de jueding" (Decision on several important questions in the reform and development of state-owned enterprises), Chinese Communist Party Central Committee document, adopted 22 September 1999.

\*\*"196 jia zhongyang qiye da zhenghe: yanchu kaishi le" (Big reorganisation of 196 central enterprises: the show has begun), *21 Shiji jingji baodao* (21st Century Economic Report), 14 July 2003.

mandatory. Why should participants in a business not be left to work out their own deal? Partly because China's ruling elites harbour a traditional mistrust for private solutions, and an almost instinctive preference for uniformity over diversity, even if it carries no particular benefits.

*The Company Law –  
designed for SOEs*

The main reason, though, is the Company Law's overwhelming orientation toward the corporatisation of traditional SOEs. The enterprise envisaged by the Company Law is not one formed by a group of private entrepreneurs; it is a corporatised traditional SOE. Thus, it is not surprising that the rules do not leave choices up to contracting parties; there *are* no contracting parties when a traditional SOE is transformed. At the same time, however, it is hard to see why, when state assets are not involved, decisions on a number of matters could not be left up to the parties involved. The state may wish to impose on its own enterprises rules about the re-investment of profits or the minimum and maximum number of directors, but why should private parties be subject to the same rules?

By the same token, continued state involvement as majority shareholder makes it virtually impossible for Chinese corporate governance law and policy to have a strong norm prohibiting exploitation of minority shareholders by dominant shareholders. Shareholders in CTCL, for example, are explicitly warned that "China Telecom Group as our controlling shareholder ... may take actions with respect to our business that may not be in our or our other shareholders' best interests."\*

**Not quite Buffett**

In short, because SOEs are transformed into companies governed by the Company Law, the Company Law (and associated principles of corporate governance) must then be twisted to suit the special circumstances of SOEs. The Company Law was supposed to embody a set of modern (read Western) corporate governance rules that would make enterprises operate more efficiently. Policymakers find, however, that they must adjust these rules to meet the needs of continued state ownership. The result is a hijacking of the entire Company Law: instead of state-sector enterprises being made more efficient by being forced to follow the rules for private-sector enterprises (the original ambition), potential private-sector enterprises are hamstrung by having to follow rules that make sense only in a state-run economy.

*Reports of privatisation  
are premature*

Reports of the privatisation of China's state sector are premature, to say the least. There is no reason to disbelieve the pronouncements of state officials and Party documents explaining the government's intention to stay involved in enterprise ownership. Nor is it plausible to suppose that the state is in it just to make money; Warren Buffett did not become rich by deciding – and publicly declaring in advance – that he would never sell his equity stake in certain businesses no matter what their performance or prospects. Whatever the merits of this from a policy perspective, it would be unobjectionable from a legal perspective had the state not made the additional decision to reorganise its enterprises under the Company Law, instead of simply admitting that state enterprises cannot function as desired under the same set of rules as private enterprises. The insistence on a unified legal regime means that the needs of one type of organisation must be subordinated to the needs of the other. Guess whose needs will prevail?

\*China Telecom Corporation Limited, Annual Report on Form 20-F, filed with the United States Securities and Exchange Commission, 20 June 2003.