

# Shareholding System Reform in China

Privatizing by Groping for Stones



Shu-Yun Ma

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Shu-Yun Ma

*Professor, The Chinese University of Hong Kong*

**Edward Elgar**

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# 1. Introduction

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Throughout human history, private and public ownerships have been coexisting over time and across societies, giving rise to different forms of economic systems. Capitalism emerged on the basis of private ownership. But the Great Depression and the devastation of the two world wars called for massive government intervention, resulting in large-scale nationalization in post-war Britain. The pendulum began to swing back in the 1980s, when Margaret Thatcher's conservative government launched a series of privatization programmes (Megginson and Netter, 2003). This was followed by a worldwide wave of transfers of assets from the state to private hands. According to World Bank statistics, from 1989 to 2007 governments in the world received about US\$733 billion through privatization (Table 1.1). This book is about the case of China in this process.

Initially, most of the privatization activities took place in developed OECD countries (OECD, 2001, p. 43). This was followed by post-communist transition economies in Eastern Europe and Central Asia, which emerged as a major group of participants in the worldwide privatization trend. During the 1990s, proceeds from privatizations in these countries accounted for about 20 per cent of world total. In comparison, China's share during this period was only about 7 per cent. However, China began to pick up in the early 2000s, and has since emerged as one of the largest privatizing countries. From 2000 to 2007, China alone accounted for over 38 per cent of the world's proceeds from privatizations (Table 1.1).

The above seems to suggest that privatization is an economic prescription based on intensive researches by experts and scholars, exported from developed countries first to post-communist transition economies in Eastern Europe and Central Asia, and subsequently to China as a result of proven powerfulness of privatization as an impetus of economic growth. This, however, is an illusion. The fact is that economic theorists have never reached any consensus about the desirability of privatization. Both private and public ownerships are found to have theoretical advantages and disadvantages, and there are many trade-offs between the two kinds of ownership. That is to say, even at pure theoretical level, privatization has not been proved as a panacea (Roland, 2008).

Table 1.1 Proceeds from privatization<sup>a</sup>

	Transition economies in E. Europe and C. Asia <sup>b</sup>			China		World Total		
	US\$ billion	Annual change (%)	Share in world total (%)	US\$ billion	Annual change (%)	Share in world total (%)	US\$ billion	Annual change (%)
1989	0.47	N.A.	13	N.A.	N.A.	N.A.	3.63	N.A.
1990	0.83	76	7	N.A.	N.A.	N.A.	12.66	249
1991	1.97	139	8	0.01	N.A.	0	23.86	88
1992	2.85	44	11	1.26	11 479	5	26.18	10
1993	3.78	33	16	2.85	126	12	23.66	-10
1994	3.95	4	18	2.23	-22	10	21.71	-8
1995	9.41	138	43	0.65	-71	3	21.90	1
1996	5.45	-42	21	0.92	42	4	25.36	16
1997	16.79	208	25	9.12	893	14	66.57	162
1998	7.79	-54	16	0.61	-93	1	50.16	-25
1999	11.17	43	26	2.95	382	7	42.35	-16
2000	9.65	-14	25	10.28	249	26	39.04	-8
2001	7.07	-27	43	0.96	-91	6	16.31	-58
2002	9.59	36	62	1.60	67	10	15.56	-5
2003	7.02	-27	36	6.07	279	31	19.61	26
2004	13.71	95	41	4.12	-32	12	33.58	71
2005	15.63	14	29	14.09	242	27	53.06	58

2006	27.43	75	26	50.36	257	48	104.88	98
2007	36.60	33	28	71.54	42	54	132.64	26
1990–1999	63.99	N.A.	20	20.60	N.A.	7	314.41	N.A.
2000–2007	126.70	N.A.	31	159.02	N.A.	38	414.68	N.A.
1989–2007	191.14	N.A.	26	179.60	N.A.	25	732.69	N.A.

*Notes:*

<sup>a</sup> Proceeds from privatization are defined as 'all monetary receipts to the government resulting from transactions involving partial and full divestitures, concessions, and releases. Thus, only those transactions that generated revenue for the government from privatization or private sector participation in an existing state-owned enterprise and other government assets are included.'

<sup>b</sup> Data for 1988–99 cover the following countries: Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russian Federation, Serbia, Slovakia, Slovenia, Ukraine, and Uzbekistan. Data for 2000–2007 cover all the above countries, plus Bosnia, Georgia, Herzegovina, and Tajikistan. Moreover, pre-2000 data were collected on an 'announcement' basis, whereas data from 2000 on reflect actual flows of receipts. The two sets of data are thus not entirely compatible.

*Source:* World Bank Privatization Database (<http://rru.worldbank.org/privatization>).



Major arguments in favour of privatization include relief of the state's financial and administrative burdens; enhancement of economic efficiency and productivity; stimulation of private entrepreneurship; and reduction of the public sector, which tends to be monopolistic and bureaucratic. These arguments, however, have been challenged on the grounds that efficiency of the public sector can be improved through greater public accountability and transparency; only profitable activities are privatizable; loss of stable income of the state from profitable public sector activities; adverse impacts on public sector employees, lower-income consumers, and social welfare recipients; and finally high costs of monitoring privatized enterprises. Apart from such lack of theoretical consensus, empirical results of privatizations in both developed and developing countries are also mixed. As ideological faith in privatization declines, even advocates of privatization have to admit that for the strategy to work, sequencing and preconditions of reform are also important (Jomo, 2008; Parker and Saal, 2003).

As mentioned, since the early 2000s China has emerged as one of the largest privatizing countries in the world. However, there is no indication that China was theoretically informed to join the above worldwide privatization trend. China did engage in ideological discussion about privatization; but the debate was more about the socialist-legitimacy of privatization, rather than the liberal-economic rationale of the reform. What this book intends to argue is that China's privatization is not based on any grand blueprint; rather, it is privatization by 'groping for stones to cross the river', a well-known metaphor often attributed to Deng Xiaoping, meaning that the reform simply proceeds on a trial-and-error basis, without being guided by any theory. That is to say, though China's privatization is consistent with the above-mentioned worldwide trend, that general theoretical context does not seem to be directly relevant to the Chinese case.

As indicated in Table 1.2, immediately after the Chinese economic reform was launched in 1978, the Chinese economy began to show robust growth. However, according to World Bank statistics, Chinese privatization did not start until 1991 (Table 1.1). Some analysts thus took the Chinese case as showing that economic success could be achieved through restructuring of state enterprises, and that privatization is not necessary (Megginson and Netter, 2001, p. 338). This might be true as far as privatization in the narrow sense – divestiture of existing state enterprises – is concerned. However, if proper attention is paid also to privatization in the broad sense – which includes also development of greenfield private enterprises that is not covered in the World Bank data – the Chinese case shows that 'privatization is absolutely necessary to achieve sustained intensive growth' (Chai, 2003, p. 256).

The above notwithstanding, this book will focus on China's privatization

*Table 1.2 China's real GDP growth (%)*

1979	7.6	1994	13.1
1980	7.8	1995	10.9
1981	5.3	1996	10.0
1982	9.0	1997	9.3
1983	10.9	1998	7.8
1984	15.2	1999	7.6
1985	13.5	2000	8.4
1986	8.9	2001	8.3
1987	11.6	2002	9.1
1988	11.3	2003	10.0
1989	4.1	2004	10.1
1990	3.8	2005	10.4
1991	9.2	2006	11.7
1992	14.2	2007	13.0
1993	13.9	2008	9.0

Source: China Data Online (<http://chinadataonline.org>).

in the narrow sense. More specifically, it is about the shareholding system reform, which provides a channel for the transfer of state assets to private hands. We do not intend to examine the effect of this change; rather, our concern is how this reform has evolved, without any pre-existing plan, from a spontaneous local attempt into a nationwide reform programme. That is to say, it is about the emergence of a privatization programme through 'groping for stones to cross the river'.

This book is based on a collection of updated versions of previously published articles. Chapter 2 identifies the shareholding system reform as the Chinese way of privatization, in a political and ideological context in which the term privatization had to be avoided. Chapter 3 traces the evolution of the shareholding system reform, from the early spontaneous attempt in the early 1980s, to the official endorsement of it as the mainstream reform programme in 1997. Chapter 4 examines the role of spontaneity and state initiative in the shareholding system reform, based on three case studies in Foshan, where China's first industrial shareholding enterprise appeared. Chapter 5 analyses foreign participation in the shareholding system reform, and the role of the state in this process. Chapter 6 discusses how China's shareholding system reform has been facilitated by Hong Kong as an important venue for the listing of Chinese state enterprises. Chapter 7 traces further the evolution of the shareholding system reform from 1997 to the

completion of the reform through the ‘share conversion’ programme in 2005–2006. Finally, Chapter 8 concludes by arguing that the shareholding system reform is consistently gradualist, and the entire process can be characterized as ‘privatizing by groping for stepping stones to cross the river’.

## 2. Shareholding system reform as the Chinese way of privatization

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In the early 1990s, almost immediately following the collapse of socialist regimes in Central and Eastern Europe, privatization became one of the most important themes of post-communist transformation in this area. It is argued that restoration of a private sector is the only way through which the economies can be revitalized and political freedom guaranteed. While the necessity of the change has been widely acknowledged, there have been intense debates on what is the optimal speed and method of privatization, resulting in a mushrooming literature on the subject.<sup>1</sup>

Apparently, the issue of privatization is not as hot in China as in the former Soviet bloc countries. While privatization laws have been passed in a number of Central and East European economies, no similar legislation has been introduced in China (Chai, 1994, p. 237). Although the post-Mao reform had resulted in significant changes in China's economic system, in the early 1990s the ideological supremacy of public ownership still remained. However, as a matter of fact, as early as the mid-1980s China had already launched trial privatization measures, under the camouflage of 'shareholding economic reform'. The experiment was interrupted by political conservatism following the summer 1989 Tiananmen demonstrations. Yet the shareholding system not only survived but became so popular that a large number of Chinese state enterprises were lining up to convert into shareholding companies. This wave of reform has hastened the shrinking of the state sector in the economy. Most importantly, it represented the Chinese path to privatization.

In this chapter, we will argue that China's shareholding economic reform is tantamount to privatization, although the latter term is avoided for political and ideological reasons. The change is a continuation of a process that could be traced to the mid-1980s. Yet it does involve a radical departure from earlier reform measures, which touched mainly on issues of management and income distribution but not ownership of state enterprises. Initially, the shareholding experiment was introduced gradually and from above. After 1993, however, the process rapidly accelerated, with widespread spontaneous initiatives from below. These breakthroughs made most Western studies on China's enterprise reform of that time outdated.

## SCOPE OF DISCUSSION

Bornstein defined privatization as follows:

In the broadest sense, 'privatization' could embrace any increase in private activity, including the creation of brand new ('start-up') private enterprises, without any reduction in activity of state enterprises. A narrow, but probably most common, definition of privatization involves the transfer of ownership of state assets to private hands. (Bornstein, 1994a, p. 234)

In China, privatization in the broad sense as defined above began in the late 1970s. After almost three decades of suppression of private economic activities, the watershed Third Plenum of the Eleventh Central Committee of the Chinese Communist Party, held in December 1978, allowed farmers to produce on their small private plots. Capturing this opportunity, a number of 'youths awaiting job assignment' and 'idle people' began to establish their own new businesses. This was followed by a flow of workers from the state to the private sector, as the latter offered the possibility of higher income and greater freedom. Sources of capital for private firms also expanded, as personal savings soared and more state loans were made available to individual investors. By the end of 2006, there were about 150 000 private enterprises in China, with a total asset of 405 billion yuan (representing 14 per cent of the national total) (*ZJN*, 2007). The rapid expansion of this private sector economy, consisting mainly of new businesses, has attracted the attention of a number of Western scholars, including Ole Bruun (1993), Ross Garnaut and Ligang Song (eds) (2004), Thomas Gold (1989a, 1989b, 1990, 1991), Willy Kraus (1987, 1991), Barbara Krug (ed.) (2004), Ole Odgaard (1990, 1990/91, 1992), Susan Young (1989, 1995), and David Zweig (1988).

The focus of this book, however, is on China's privatization in the narrow sense: transfer of ownership of state assets to private hands. Unless stated otherwise, the term 'privatization' will be used with this meaning. More specifically, we will concentrate on the shareholding system as the Chinese way of privatizing state enterprises. This experiment began in the mid-1980s, several years later than the appearance of new private businesses.<sup>2</sup> The downfall of Zhao Ziyang and other reformist leaders in the wake of the 1989 political turmoil forced the shareholding experiment to adopt a low profile. After 1993 the process regained momentum. Yet not much about this reform was known in the English-speaking world for several years.

## SHAREHOLDING SYSTEM REFORM: THE CHINESE WAY OF PRIVATIZATION

According to a vice-president of Bank of China, in 1986–87 some Chinese economists and World Bank consultants proposed privatization of Chinese state enterprises through an equal distribution of vouchers among the general public, a ‘shock therapy’ privatization method subsequently used by some East European countries. The suggestion was rejected in favour of a ‘minimum reform package’ without privatization, as this moderate approach was considered economically and politically less risky (Zhou, 1993).<sup>3</sup>

In the early 1990s, ‘privatization’ (*siyouhau*) was still politically taboo in China, as the term implies going capitalist and weakening state control. However, Chinese reformers have always been very clever in overcoming this kind of ideological obstacle by playing semantic games. For example, the adoption of a capitalist mode of distributing goods and services is often referred to as ‘marketization’ (*sichanghua*) or ‘commodification’ (*shangpinhua*); and the withdrawal of the state from welfare services is called ‘socialization’ (*shehuihua*) (Wong, 1994, pp. 311, 323–24). In enterprise reform, the cover for privatization is ‘shareholding economic reform’ (*gufen jingji gaige*).<sup>4</sup>

The Chinese shareholding system emerged in the mid-1980s, in response to the failure of other efforts to improve the economic efficiency of state enterprises. From 1981 to 1983, the government introduced different versions of profit contract system among state enterprises, as an attempt to translate the successful agricultural household responsibility scheme to the industrial sector. However, enterprises responded by bargaining for a larger share of profits, while leaving losses to the state. The resulting plunge in state budget revenue caused the government to substitute income taxes for remission of profits. The tax-for-profit system lasted only from 1983 to 1985, as the change simply switched the object of bargaining from profit retention ratios to tax rates. In 1986 the government decided to return to the profit contract system (Chen Youngzhong, 1991, pp. 290–92; Lee K. and Mark, 1991, p. 157; Lee K., 1993b, p. 181).

Both the profit contract system and the tax-for-profit scheme sought to improve economic efficiency by granting greater income rights to enterprises, while ownership remained in the hands of the state. Under such a property rights arrangement, the primary objective of enterprise managers and workers has been to maximize sales revenue and their say in income distribution, with little concern for cost and profit. The result was rising losses, despite growing production. As Table 2.1 shows, from 1980 to 1992 gross output of Chinese state enterprises increased by less than five times, but losses soared over tenfold.

*Table 2.1 Output and losses of Chinese state enterprise*

	1980	1992	Change
	(10 <sup>9</sup> yuan)		
Gross output value	391.6	1782.4	4.6 times
Losses	3.4	36.9	10.9 times

*Source:* ZTN, 1993, pp. 412 and 430.

It is against this background that China launched the shareholding experiment, through which enterprises and individuals are allowed to share with the state not only profits, but also ownership of enterprise assets. Again, the idea was borrowed from the rural sector. Early in 1979, the central government allowed communes and brigades to form joint-stock enterprises. In 1983 an official document stated that, in cooperative economic production, capital and labour were both legitimate bases for distributing returns. This gave rise to a number of joint-stock township and village enterprises. In April 1984, in a seminar held by the State Commission for Restructuring the Economy, a proposal was made to allow workers to invest capital in collective and small state-owned enterprises, and to receive dividends. In July that year the first shareholding company, the Beijing Tianqiao Department Store Company, was established. In October 1984, with the economic reform shifting its focus from the rural to the urban sector, the shareholding experiment was extended to medium and large state enterprises (Chen Youngzhong, 1991, pp. 316–18).

As could be expected, the shareholding system caused serious ideological, political, economic and legal debates in China.<sup>5</sup> According to advocates of the shareholding reform, the new system serves many functions. These include pooling investment funds, promoting economic integration, reducing enterprises' myopic behaviour, nurturing management professionals, increasing capital mobility, alleviating inflationary pressure, and enhancing production incentives (Chen Youngzhong, 1991, pp. 68–79). Despite these advantages, the state was very cautious about the potential challenge that the shareholding system might create for the state sector. It thus set several limits to the change. First, the state or its agents (enterprises) should hold the majority of the shares. Second, there should be no expropriation of the state assets. Third, government approval had to be obtained before conversion of state enterprises into shareholding companies. Fourth, some industries (defence, scarce metal and mineral resources, banks, foreign trade corporations and other state-controlled monopolies) were not allowed to adopt the shareholding system (Yang, 1993, pp. 194–95).

The political factor was influential in the fate of China's shareholding reform. In December 1986, the reformist leader Zhao Ziyang, without gaining support from the conservatives, ordered the introduction of the shareholding system in some enterprises in a number of larger cities, including Shanghai, Beijing, Wuhan, Shenyang and Chongqing (Shirk, 1993, p. 310). In October 1987, addressing delegates at the 13th Party Congress, Zhao said that, since China was still at an 'initial stage of socialism', the dominant public sector should be supplemented by other forms of ownership as well. Specifically, the shareholding system was recognized as 'a form of organizing assets of socialist enterprises', and hence the experiment 'could continue'. Distribution of dividends to shareholders, 'as long as it is legal, should be allowed' (ZBN, 1988, pp. 98–99). With such high-level support, the shareholding scheme was promoted extensively. By 1988 some 3800 enterprises had adopted the new system.<sup>6</sup>

The loss of power of Zhao Ziyang and other reformist leaders following the 1989 Tiananmen demonstrations caused a setback to the shareholding reform. A strong statement was made that 'China will not practise privatization' (BR, 4–10 September 1989, pp. 4–5). Though establishment of shareholding enterprises was not banned, the issue of shares to workers was halted. Complementary reforms were restricted to Shanghai and Shenzhen (ZGJS, pp. 11 and 65). Under this atmosphere, the number of shareholding companies had declined to 3220 by 1991 (see Table 2.2). Many Western observers thus doubted whether the experiment could survive (Bowles and White, 1992, p. 587; Lee K., 1993b, p. 192). However, the trend was reversed in 1992. After the paramount leader Deng Xiaoping called for further reform during his high-profile 'southern tour' in January that year, the shareholding experiment re-emerged in China's economic reform agenda. By the end of 1997, about 5400 shareholding companies had been established, with a total capital stock of over 220 billion yuan (ZJN, 1998, p. 718).

Table 2.2 Approximate number of shareholding companies in China (at end of year)

1988	3800
1991	3200
1992	3700
1997	5400

Note: As the data come from different sources, they may not be directly comparable.

Sources: 1988 figure from ZBN, 1989, p. 251; 1991 figure from ZGJS, 1993, p. 66; 1992 figure from ZBN, 1993, p. 239; 1997 figure from ZJN, 1998, p. 718.



China's shareholding enterprises fell under four basic models (Chen Youngzhong, 1991, pp. 165–73):

### **Model A: 'One Enterprise, Three Types of Owners'**

This model was the most common one, particularly in Sichuan and Shenyang provinces. A shareholding company under this model has three types of owners: the state, enterprise, and individual workers of the enterprise. The value of 'state shares' (*guojia gu*) is calculated from the net value of assets created by state investment. The enterprise itself is entitled to a certain amount of 'enterprise collective shares' (*qiy jiti gu*), which are equal to the net value of assets acquired through the enterprise's own retained funds. Finally, workers of the enterprise are issued 'individual workers shares' (*zhigong geren gu*). Under this model, state shares are risk-free. They are guaranteed a return that is equivalent to the 55 per cent income tax. In contrast, enterprise collective shares bear most of the risk. Their rate of return depends entirely on the financial result of the enterprise's operation. Individual worker shares receive fixed interest that is roughly the same as that which banks offer on savings deposits, plus an unguaranteed amount of dividends depending on the profits or losses made by the enterprise.

### **Model B: 'One Enterprise, Four Types of Owners'**

Many shareholding companies in Shanghai adopted this model, which consists of four types of owners: the state, the enterprise, other institutions, and individuals. Like Model A, the amounts of state shares and enterprise collective shares are determined respectively by the net value of assets created by state investment and those acquired through the enterprise's own retained funds. What is different from model A is that shares are also issued to other institutions, known as 'unit shares' (*danwei gu*), and to the general public, known as 'private individual shares' (*geren siyou gu*). Under this model, all four types of owners share equal risk. There is no guaranteed return, and dividends are distributed evenly if they are paid.

### **Model C: 'One Enterprise, Two Types of Owners'**

This model was adopted mainly by shareholding companies in Shenzhen, China's largest Special Economic Zone. A number of state enterprises here have been auctioned off to institutions and individuals. This process transfers ownership from the state and the original enterprise to the buying institutions and individuals, each holding a certain amount of 'unit' shares and private individual shares.