China’s emergence as a global economic player has been accompanied by a major internal transformation described in a new World Bank/IFC publication.** Over the past decade, the economy has made the transition from complete reliance on state-owned and collective enterprise to a mixed economy where private enterprise plays a leading role. This is an ongoing process, during which the economy will remain structurally a very diverse one. While some Chinese companies are in the vanguard of globalisation, many are struggling with old legacies of planning. Thus, in these times of optimism and dynamism, increased attention must be given to solving the problems of the state-owned sector.

A key response is gaizhi, a Chinese term meaning ‘transforming the system’, which has become a major phenomenon in most parts of the country; in many cases it has involved full privatisation. Unlike the mass privatisation programs that have occurred in Eastern Europe and the former Soviet Union since the late 1980s, gaizhi programs in China have been gradual and low profile. However, the significance of the Chinese reforms should not be underestimated. In many ways they have been as far-reaching as, and generally more economically productive than, those in Eastern Europe and the former Soviet Union.

Gaizhi has taken a variety of forms. The more radical forms involve the transfer of state assets to private owners. A properly managed transfer of assets from the state to private owners is a crucial part of the gaizhi process, with strong implications for preventing losses of state assets and maintaining social stability. An effective and transparent asset valuation system needs to be built to achieve fair and smooth transfers of state assets.

The restructuring of state-owned enterprises (SOEs) often requires a reduction of redundant workers. A large number of SOE employees have already lost their jobs as result of restructuring programs. To deal with this employment issue, the Chinese government has established a social security system consisting of pensions, medical insurance, unemployment insurance, and a social relief system, which together guarantee a minimum standard of living for urban residents. The government intends to expand the social security system further and to increase the share of the budget spent on social security.

Survey results show that gaizhi firms discharged more workers in the year when gaizhi was implemented than non-gaizhi firms, but they were able to afford to retain more workers in subsequent years. Therefore, it is possible that gaizhi and privatisation create a ‘win-win’ result for both employment and wages growth in the long run.

Market reforms have resulted in a significant degree of insider control, as SOE managers have gradually acquired considerable discretion over the use of state assets. Expanding managerial autonomy was a necessary complement to market reforms, as managers needed the flexibility to respond to market signals. However, this has exacerbated agency problems by enlarging the discrepancy between managerial control and the ownership structure. The agency costs of this increased autonomy have manifested themselves in various incentives for managers to maintain or acquire private benefits of control through on-the-job consumption and other rents related to investment and business expansion. Survey results show that outside investors in controlling positions are more likely to use, and rely on, the new mechanisms of corporate control to provide effective checks and balances on managerial discretion, and to offer attractive incentives to senior managers.

The merits of gaizhi should ultimately be judged on how well the restructured firms perform. While improving enterprise performance was not the only goal of gaizhi, the experiment would have failed if efficiency does not improve. Survey results show that privatisation has brought considerable efficiency gains to the enterprise sector. It has a significant positive impact on firm profitability, although a weak or insignificant impact on unit cost and labour productivity. Outside ownership, irrespective of whether private or state, has a strong and significant impact on performance, though this impact tends to be concentrated in the early years of reform.

Although important, the efficiency aspects of the gaizhi process most likely will not determine the future of enterprise reform in China. Recently, fairness and distribution issues related to gaizhi have been attracting most public attention. The government and the general public are concerned that gaizhi has been accompanied by erosion of state assets, corruption, and ‘inglorious’ enrichment by private individuals. Ongoing public debate in China puts the main issues surrounding the future of privatisation in the country into sharp focus.
What are the implications of this debate for the future course of China’s ownership transformation? The main findings from this study do not imply a halt of China’s ownership reforms. But they do imply the need for regulations and stronger regulatory capacity. A notable feature of desirable regulations is that they establish stricter standards and a higher level of scrutiny when state assets are transferred to non-state entities. Specifically, regulations need to clarify the methods that can be used to reform SOEs, such as reorganisation, mergers, leasing contract operations, joint ventures, transfer of state assets, and the joint-stock and joint-stock cooperatives systems.

Regulations also need to specify the procedures to be followed, including preparation of restructuring plans, appointment of auditors and appraisers, the determining of the price valuation of state assets, method of payment, and the need to protect the interests of creditors and employees. They must also require that the state property rights of non-listed enterprises be transferred on the property rights exchange without regard to the region, industry, investment, or affiliation of the enterprise. In addition, transfers must be made publicly and competitively by auctioning, public bidding, agreed transfer, or other means that are stipulated in state laws and regulations.

The new regulations should devote special attention to management buy-outs (MBOs). They should address conflict of interest issues by prohibiting the managers who are buying the state-owned assets of their own firms from participating in key decisions on any property transfer, such as financial auditing, the terminating audit, asset and capital verification, assets evaluation, and the setting of the base price of property.

The debates also imply the need for a competitive environment in which ownership structures evolve so that different interests provide checks and balances on each other and prevent concentration of economic and political power. A critical aspect of such a competitive environment is the ability of outside investors to inject capital and energy into enterprises. Given the limited role that private outside investors have played in the ownership reform process so far, the conclusion is that China needs more — not less — outside private ownership at this stage.

However, impediments exist on both the demand and supply side of the process. Investors have difficulty finding independent and reliable financial information about companies. Publicly available records on many aspects of a company’s business are often either unavailable or unreliable. Corporate accounting is also frequently lax, especially by foreign standards. The existence of different classes of shares presents a major obstacle to the development of China’s equity market as it creates conflicts between different shareholders, particularly between the holders of legal person shares and the holders of tradable shares. This complicates the corporate governance of Chinese listed companies.

While private enterprises are becoming more active in acquiring and restructuring SOEs, they still account for a small share of all gaizhi cases. Government policy is to expand the role of the private sector, both domestic and foreign, in the process of ownership transformation. This will require sustained efforts from both the government and the private sector to improve the business environment for private economic activities and to move China’s private enterprise towards global best practice. China is making substantial progress in improving official attitudes towards the private sector, which will significantly facilitate the process of its ownership transformation.

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(Endnotes)**


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