Chapter 2 Dynamics of Ownership Transformation: Privatization of Small and Medium Scale Enterprises

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シリーズタイトル(英)	IDE Spot Survey
シリーズ番号	25
journal or publication title	Beyond Market Socialism Privatization of State-owned and Collective Enterprises in China
page range	[9]-25
year	2003
URL	http://hdl.handle.net/2344/00010298

Chapter 2

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Introduction

Privatization in China took off with the transformation of ownership at small and medium stated-owned and collective enterprises under the jurisdiction of local governments. With political constraints over privatization of small and medium enterprises eased substantially in the latter half of the 1990s, privatization movements driven by local governments moved into high gear extensively. It is expected that privatization of small and medium enterprises will largely be completed in the not so distant future.

The progress in privatization is bringing with it changes in the form of privatization. In the early years of privatization, the transformation of state-owned and collective enterprises into employee-owned enterprises with egalitarian distribution of ownership accounted for a majority of privatization cases. In recent years, however, control of capital by management and buyouts by private-sector enterprises are becoming the prevalent forms of privatization.

In this chapter, the progress in privatization of urban small and medium state-owned and collective enterprises is analyzed mainly on the basis of field studies conducted in 1999-2001. Small and medium state-owned and collective enterprises accounted for only about 20% of China's mining and manufacturing sector as of 1995, keeping the immediate impact of their privatization small relative to that of village and township enterprises. With the waves of privatization surging to hit enterprises with larger scale, however, the dynamics of ownership transformation seen in privatization of small and medium state-owned and collective enterprises has started to influence privatization of middle-scale or larger state-owned and collective enterprises. The analysis of privatization of small and medium state-owned and collective enterprises is of great significance in finding a clue to the future course of privatization of large enterprises.[1]

2.1 Accelerating Privatization of Small and Medium Scale Enterprises

2.1.1 Backdrop of Privatization: Rising Competitive Pressure

(1) Overview of Small and Medium State-Owned and Collective Enterprises

In Chinese industrial statistics, the sizes of enterprises are classified into large, medium and small, based on the size of production capacity or fixed assets by industry sector.[2] The average number of employees at small state-owned enterprises is a little less than 180, roughly corresponds to the conventional norms of small and medium enterprises in many other countries. Medium enterprises cover a broad spectrum of enterprises in size, with medium enterprises with a relatively small size actually being little more than small enterprises.

By form of ownership, a majority of state-owned enterprises which come under the jurisdiction of county or district governments as well as urban collective enterprises are small enterprises, or medium enterprises with a relatively small size. Here we assume for convinience that all the three forms of small state-owned enterprises, state-owned enterprises under the jurisdiction of county and district governments, and urban collective enterprises fall under the category of small and medium state-owned and collective enterprises, Profile of these enterprises at the time of the third industrial census of 1995 is given

Table 1 Summary Statistics of State-owned and Urban Collective Enterprises (Based on the Third Industrial Census in 1995)

	Enterprises	Employee (10 thousands)	Assets (100 million RMB)	Average Number of Employees	Average Assets (10 thousand RMB)	Profit on asset (%)
Total	754,864	10,170	87,200	135	1,155	2.57
State-owned enterprises	87,905	4,465	50,042	508	5,693	1.33
· Small state-owned enterprises	72,237	1,277	8,126	177	1,125	-0.48
· State-owned enterprises under the jurisdiction of county and district government	50,123	1,129	7,702	225	1,537	0.82
Collective enterprises	536,901	4,332	19,100	81	356	4.39
· Urban collective enterprises	158,385	1,592	7,196	100	454	0.79

Note: 1) The figures for the total do not include village enterprises, private enterprises, joint enterprises and individual enterprises of which annual sales are below one million RMB. State-owned enterprises without independent accounting unit status are also excluded.
2) Small state-owned enterprises and state-owned enterprises under the jurisdiction of county and district governments overlap to a great extent. A great majority of state-owned enterprises under the jurisdiction of county and district governments fall into the category of small enterprises.
3) The figures for urban collective enterprises are calculated by deducting figures for village and township enterprises and rural joint enterprises from figures for collective enterprises.

Source: Disanci quanguo gongye pucha bangongshi (ed.), *Zhonghua Renmin Gongheguo 1995 nian Disanci Quanguo Gongye Pucha Ziliao Huibia* Zhongguo tongji chubanshe (Statistical abstract of the third industrial census of the People's Republic of China), 1996.

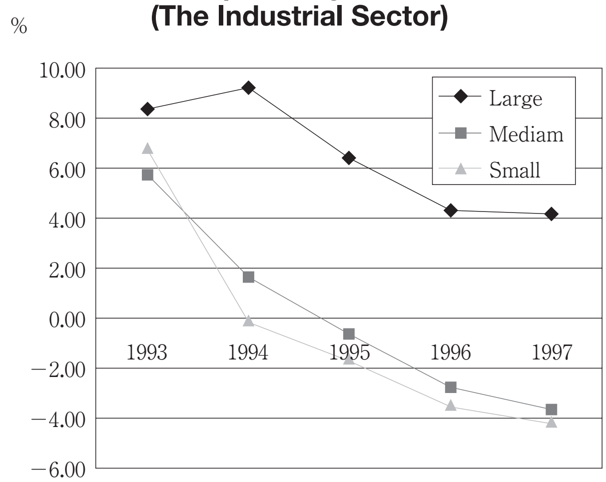
in Table 1. For each of the three forms, the profit rate is substantially lower than the average for the entire mining and manufacturing sector or the average for state-owned and collective enterprises.

(2) Deterioration of Business amid Mounting Competitive Pressure

Privatization of small and medium state-owned and collective enterprises was initially triggered by the deterioration of business as the inefficiency of management made them unable to compete with village and township enterprises or private-sector enterprises amid mounting competitive pressure.

Since the mid-1980s, competitive pressure intensified with the increased entry by village and township enterprises and others mainly into labor-intensive industries with relatively low barriers to entry. This dealt a heavy blow to less competitive small state-owned enterprises and urban collective enterprises, and their profit rate began to slide. After a temporary recovery due to the economic boom in 1992-1993, the profit rate at state-owned enterprises declined further during the 1990s. In particular, small enterprises suffered a pronounced deterioration (Figure 1).[3] In 1994 onward, small state-owned enterprises as a whole slipped into the position of net loss, where their combined losses exceeded combined profits. The profit rate for medium enterprises is slightly higher than that for small enterprises, but the downtrend of their profit is still quite similar.

Figure 1 Return on Sales of State-owned Enterprises by Size (The Industrial Sector)



Note: Return on Sales = Pre-tax profit/Sales.
Source: *China Statistical Yearbook*, various issues.

2.1.2 Start and Full-Blown Progress of Privatization

(1) Start of Voluntary Privatization

Privatization of small and medium state-owned and collective enterprises started as voluntary steps by local governments.[4] With Deng Xiaoping's "Southern Tour Lectures" of 1992 and the establishment of the socialist market economy policy at the third Plenum of the 14th Central Committee of the Communist Party of China (CPC) in 1993 as the trigger, county and city governments in such provinces as Sichuan, Shandong and Guangdong embarked on privatization of enterprises under their jurisdiction.

The party leadership effectively permitted privatization of small and medium enterprises with the decision at third Plenum of the 14th Central Committee of the CPC, but did not set out concrete guidelines for the scope of enterprises subject to privatization or specific methods of privatization. Ideological resistance to privatization was far from removed, and pushing ahead with the sale of state-owned and collective enterprises still involved great political risks.

However, there were pressing circumstances on the part of local governments that set about privatization. In the case of Yibin Country in Sichuan Province, one of the first local governments that started the privatization process, over 70% of a total of 66 state-owned enterprises under the jurisdiction of the country authorities were operating in the red as of 1991, with their combined losses amounting to 40 million RMB a year to exceed the country's total annual revenue.[5] The deterioration of profits at state-owned enterprises, the biggest source of tax revenue then, was nothing short of the "fatal blow" to the county's finances. There was the high frequency of protest actions by workers in ailing public enterprises for substantial delays in salary payments, but the county government simply lacked financial means to bail out these enterprises. Amid these circumstances, the Yibin County government launched into the sale and privatization of state-owned enterprises from around 1990, without obtaining the official authorization of Yibin City, its superior administrative unit. Local governments that started privatization in the first half of the 1990s were confronted with more or less similar circumstances.

(2) From the Wait-and-See to Approval and Promotion

At first, provincial governments and the central government took a wait-and-see attitude toward voluntary privatization measures by local governments. With the growing recognition of the favorable results of privatization later, provincial governments eventually authorized privatization and expanded the scope of enterprises subject to privatization. In Sichuan Province, for example, the first Provincial Conference on the Reform of Small and Medium State-owned Enterprises in Sichuan was held in 1994, where the decision was made to push for reform of state-owned enterprises under county governments on the model of Yibin County. The second conference in 1995 adopted the policy to complete the reform in three years by 1997.

The party leadership virtually authorized the local government-led privatization of small and medium enterprises through the "Grasp the large and liberalize the small (*Zhua da fang xiao*)" policy in 1995-1996 and the speech by General Secretary Jiang Zemin at the 15th Party Congress in 1997. The third Plenum of the 15th Central Committee of the CPC in 1999 reaffirmed this policy, and emphasized the need to facilitate the exit of state capital from ordinary industries and the concentration on strategic areas. With the political constraints all but removed, movements toward privatization of small and medium enterprises have since accelerated further. From late 1999 through 2000, major cities such as Beijing, Shanghai and Nanjing adopted plans for or decided on the promotion of the exit of government capital (meaning privatization) from small and medium enterprises. In 2001, some provincial governments, including Sichuan and Jilin, announced comprehensive programs for the consolidation of state-owned enterprises by means mainly of privatization and liquidation.[6]

(3) Progress in Privatization

There has been no systematic data made publicly available on the progress in privatization in China, but decrease in the number of state-owned enterprises in official statistics provide a clue. The number of state-owned enterprises in the mining and manufacturing sector declined rapidly from 1995 after peaking in the first half of the 1990s (Table 2).[7] The decline in the number of enterprises due to mergers or bankruptcies in the sector is estimated to have reached 1,000 to 2,000 each year. Given this estimate, the downtrend of the number of enterprises shown in Table2 can be interpreted as largely indicating the progress in privatization.

From 1997, when the 15th Party Congress was held, to 1998, the number of state-owned enterprises decreased by more than 20,000.[8] While the pace of decrease in the number of state-owned enterprises slowed from 1998 to 1999, the number of state-owned enterprises fell close to half of the peak level by 2001.

Table 2 The Number of State-owned Enterprises in the Industrial Sector

	State-owned enterprises (Total)		
		Wholly state-owned (*Guoyou duzi*)	State-capital-controlled (*Guojia konggu*)
1993	n.a.	80,586	n.a.
1994	87,084	79,731	7,353
1995	n.a.	87,905	n.a.
1996	n.a.	86,982	n.a.
1997	84,397	74,388	10,009
1998	64,737	n.a.	n.a.
1999	61,301	50,651	10,650
2000	53,489	42,426	11,063
2001	46,767	34,530	12,237

Note: "State-capital-controlled" enterprises include wholly state-owned private limited companies (*Guoyou duzi gongsi*).
Source: *China Statistical Yearbook* and *Zhongguo Gongye Jingji Tongji Nianjian*, various years.

The pace of decline in the number of state-owned enterprises greatly varies by region. Provincial statistics show that the number of state-owned enterprises dropped over 60% in Sichuan and other inland provinces from 1995 through 2001, while the number of state-owned enterprises displayed little change in major cities in the coastal region, including Tianjin.

2.2 Current Status of Privatization of Small and Medium Scale Enterprises

2.2.1 Modes and Characteristics of Privatization

(1) Various Modes of Corporate System Reform

In China, various modes of the restructuring of the corporate system, including privatization, are generically called "institutional reforms (*Gaizhi*)." The institutional reforms include reforms in the form of leasing and contracting that do not involve ownership changes.

During the incipient phase of privatization in the first half of the 1990s, conversion into joint stock cooperatives owned by employees was the dominant mode of privatization in the true sense of the word that entailed ownership changes. But joint stock cooperative as a mode of company have one crucial flaw: if lacks well-developed legal grounds. Since the latter half of the 1990s when privatization moved into high gear, private limited companies increasingly replaced joint stock cooperatives as the principal mode of conversion into enterprises owned by employees. Buyouts by private enterprises or individual business men have been increasing in recent years,[9] though they still account for only a minority of the total number of privatization cases.

(2) Current State of Privatization

The Institute of Developing Economies (IDE) visited 15 privatized enterprises in Sichuan Province in 1999 to survey the progress of privatization of small and medium state-owned and collective enterprises. Later, from 1999 through 2001, the author also visited 11 privatized enterprises (including those with plans for privatization) in Chongqing of Sichuan Province, Zhenjiang of Jiangsu Province

Table 3 Overview of Privatized Enterprises Visited

No.	Name	Place	Number of Employees upon Privatization	Form Taken after the Privatization	Time of Privatization	Methods of Privatization	Changes in Financial Performance
1	Fengyang Lapping Co.	Yibin	138	State-owned	1992	MEBO (Relatively concentrated)	−⇒++
2	Chengzhong Construction Co.	Yibin	9	State-owned	1993	MEBO (Equal -> concentrated)	++⇒++
3	Yueliang Food Co.	Dachuan	207	State-owned	1994	MEBO (Relatively concentrated -> concentrated)	−⇒++
4	Weili Chemical Co.	Yibin	512	State-owned	1995	MEBO (Equal)	−⇒+
5	Lansen Dailiy Chemical Co.	Dachuan	280	State-owned	1995	MEBO (Concentrated) + State capital (55%. Further divestiture expected.)	−⇒+
6	Saiqi Construction Machinery Factory	Hangzhou	about 30	Collective	1995	Acquisition by three incumbent managers	++⇒++
7	Hooley Group Co.	Hangzhou	about 2,000	Collective	1995	MEBO (Equal -> concentrated to managers and core employees since 1998)	++⇒++
8	Shenghe Pharmaceuticals Co.	Qionglai	347	State-owned	1996	Acquisition by a private company and several individuals	−−⇒++
9	Yibin Electrics Co	Yibin	700	State-owned	1996	MEBO (Equal)	−⇒+
10	Huayang Manufacturing Co.	Dachuan	550	Collective	1996	MEBO (Equal) + collective share	−⇒+
11	Lida Fiber Co.	Zhenjiang	about 100	State-owned	1996	MEBO (Equal) + investment by some companies -> concentrated to managers in 1999	++⇒++
12	Hongji Timber Co.	Xindu	about 400	Nominally collective	1996	MEBO (Concentrated)	++⇒++
13	Sanxin Electronics Co.	Chongqing	about 7 to 8	Nominally collective	1996	MEBO (Concentrated to the virtual founder and core employees)	++⇒++
14	Meihao Food Co.	Dachuan	about 400	State-owned	1997	Acquisition by a private company in the form of joint venture	−−⇒++
15	Nanyang Electric Factory	Shanghai	46	State-owned	1998	MEBO (Relatively concentrated -> concentrated)	++⇒++
16	Jiangjin Snacks Co.	Jiangjin	360	State-owned	1998	MEBO (Relatively concentrated)	−⇒−
17	Jiangjin Brewery Co.	Jiangjin	290	State-owned	1998	MEBO (Relatively concentrated)	++⇒++
18	Lanjian Beer Co.	Xindu	1,300	State-owned	1998	Acquisition by a private company and employees. Employee shares relatively concentrated.	−⇒++
19	Xindalu Radiator Co.	Chengdu	about 700	State-owned	1998	MEBO (Concentrated)	−⇒+
20	Changzheng Machine Tool Co., Ltd.	Chengdu	2,300	Listed (state-capital-controlled)	1998	Acquisition by a private company	−−⇒++
21	Suzhou Experiment Machinery Co.	Suzhou	about 900	State-owned	1998	Acquisition by the incumbent manager and a private company	−−⇒−
22	Changming Machinery Co.	Yibin	460	State-owned	1998	Bankrupt -> Acquired by a private businessman	−−⇒++
23	Dachuan Ruichang Ceramics Co.	Dachuan	270	State-owned	1998	Leasing contract by a private company	−−⇒++
24	Wenjun Tea Co.	Qionglai	230	State-owned	1998	Bankrupt -> MEBO (Relatively concentrated)	−−⇒+
25	Hangzhou No.2 Textile Machinery Factory	Hangzhou	130	State-owned	2001	MBO (Concentrated) [Planned]	−
26	Danyang Textile Factory	Zhenjiang	1,100	State-owned	2001	MBO [Planned]	++

Note: 1) Cities other than Shanghai, Chongqing (including Jiangjin), Hangzhou (Zhejiang Province), Suzhou, Zhenjiang (Jiangsu Province belong to Sichuan Province.

2) Notations in the colum of changes in financial performance read as follows.

−−=Fairly bad. −=Relatively bad. +=Relatively good. ++=Very good.

Source: Based on field surveys conducted by the authors (1999 to 2001).

and some other cities. These samples of privatized enterprises presumably represent the overall trend of privatization of small and medium state-owned and collective enterprises.[10] On the basis of these field surveys, the status of privatization in China is examined below (Privatization modes of the samples are outlined in Table 3). The survey samples include nine mid-size (with the work force in excess of 500) enterprises and five collective enterprises.

Privatization by Employee Ownership

Privatization through the conversion into employee ownership is the most widely seen mode of privatization for small and medium enterprises. This mode of privatization accounted for about two-thirds (17 enterprises) of the survey samples. Among enterprises that became privatized by 1996, the majority of them (11 out of 13 enterprises) opted for the ownership by employees. The privatization through the conversion into employee ownership is officially regarded as a form of collective ownership, i.e., workers' ownership, thus presenting few ideological problems and minimizing resistance by employees. Thus, in the early years of privatization of small and medium enterprises, the administrative authorities actively encouraged these enterprises to shift into employee-owned enterprises, while the central government, at least at first, also gave the blessing to the conversion to employee ownership. For almost all of the enterprises surveyed which had been turned into employees' ownership, the conversion was made by adopting the corporate form of private limited company (*youxian zeren gongsi*).[11]

There are roughly two methods of turning enterprises into employee-owned: one is for the relatively equitable distribution of equity among all employees and the other is for the concentrated allocation of equity to managers and management staff. Yibin City(including Yibin County) of Sichuan Province, which was one of the first to start the privatization drive, pursued an egalitarian approach to employee ownership, which limited the gap in equity ratios to a maximum of a few times in order to mitigate employees' antipathy toward privatization.[12] Typical examples of this approach include Weili Chemical Engineering (fully equal distribution of shares at the initial state of privatization) and Yibin Electric Machinery (the equity share of managers limited to three times the combined share of ordinary employees). At Weili Chemical Engineering and Fenghuang Packaging Materials, corporate managers at first tried to gain dominant share in equity upon privatization, but failed to do so due to the resistance by employees. The above-described approach seems to have been adopted by many local governments up to some point, and the central government was also of the position, until around the 1997 guidelines, that the excessive disparity of equity shares was "undesirable."

However, Dachuan City, which followed Yibin City to embark on privatization, took an approach that from the beginning provided managers and management with a greater equity shares. At Yibin Food, the first case of privatization in Dachuan, members of the board of directors (*dongshihui*) alone own a combined 20% of capital. In later cases of privatization, the egalitarian approach for employee ownership, adopted for Weili Chemical Engineering and Yeibin Electric Machinery in Yibin City, was rarely seen, with a majority of privatization cases involving the distribution of equity shares tilted toward managers and management.

At most of employee-owned enterprises, pre-privatization management teams have been retained, with few rather exceptional cases involving the major shakeup of management.

Buyout by Private Enterprises

Most of privatization cases through the buyout by private enterprises occurred after 1996. The fact that the political climate surrounding private enterprises turned favorable at the time is believed to have contributed to the realization of privatization through the buyout.

In the cases of Shenghe Pharmaceuticals, Meihao Food and Suzhou Testing Equipment, all of which were insolvent or in near-insolvency at the time of privatization, the private-sector buyers did not wait for the completion of bankruptcy procedures before the acquisition, an irrational action on the face of it (For Meihao Food, the acquired enterprise and Hope Group, the buyer, set up a joint venture). This can be explained principally by the potential value the buyers saw in the enterprises being purchased as well as policy measurers accorded to the buyers by local governments to alleviate their financial burdens.

In the case of Shenghe Pharmaceuticals, the private-sector acquirer, Yihe Co., whose principal business was the distribution of pharmaceuticals products, wanted to expand into production operations but opted for the acquisition of an existing drug maker because of the regulation at that time that did not allow a pure private entity to go into drug manufacturing. In the case of Meihao Food, the purchaser, Hope Group, wanted to enter the local market by taking over management assets of the enterprise being acquired. In either case, local governments shouldered 30% to 60% of debts owed by the enterprises acquired to reduce the burdens on the purchasing companies. In the case of Suzhou Testing Equipment, the buyer was attracted by the potential value Suzhou Testing Equipment offered in terms of technology and facilities as a long-established testing equipment maker as well as its cooperative business ties with a major Japanese manufacturer. The local government reduced the buyer's burden by lowering the valuation of assets being acquired.

Bankruptcy procedures

Local governments tended to avoid bankruptcy proceedings for struggling small and medium enterprises because of big problems associated with the treatment of workers at bankrupt enterprises. The survey samples include only two bankruptcy cases, Changming Machinery and Wenjun Tea. Both of them were in extremely bad shape, with actual business operations shut down, at the time of privatization.

Even when state-owned enterprises are effectively insolvent, there are instances where they do not become subject to bankruptcy proceedings because of the unwillingness to do so on the part of creditor financial institutions. In the case of tile maker Dachuan Ruichang Ceramics, the former state-owned entity had problems in terms of both the location of operations and technology it had from the beginning, and became insolvent before the launch of normal operations. The method of relief adopted was to lease its assets to Ruichang Co., a private enterprise, while the state-owned entity continued to exist. The local government still wants to dispose of the state-owned enterprise through bankruptcy proceedings, but it has yet to obtain the consent of creditor banks. In China, courts are under the influence of local authorities, and bankruptcy proceedings are often found to go against creditors. Therefore, branches of state-owned banks that manage loans to insolvent enterprises are more often than not loath to bankruptcy proceedings that force them to realize latent losses.

Recently, however, government authorities have become more proactive in pursuing the bankruptcy of insolvent public enterprises as part of the disposal of nonperforming loans held by state-owned banks. In Hangzhou, which began privatization in earnest in 1998, the municipal authorities resorted to bankruptcy proceedings for 30 (17.5%) of a total of 171 state-owned mining and manufacturing enterprises under the local government's jurisdiction by October 2001. Still, the constraints blocking bankruptcy proceedings remain in force. In Hangzhou, the government is still unable to take bankruptcy proceedings for 24 insolvent enterprises because of the reluctance of creditor banks and other reasons.[13] Given the extent of the deterioration of management conditions at many small and medium state-owned and collective enterprises, however, the number of enterprises to be subjected to bankruptcy proceedings is highly likely to increase going forward.

Local Government Measures for Promoting Privatization

Privatization of ailing small and medium state-owned and collective enterprises entails enormous difficulties. In order to help reduce the financial burdens on employees or outside companies interested in the acquisition of these enterprises, local governments are offering a variety of preferential measures to encourage the privatization process.

The most widely used practice is to set the selling price at a level lower than the value of assets held by an enterprise on the block calculated by asset valuation. In the case of employees' buyout, they are allowed to pay for the acquisition in installments over several years, or a deep discount of around 20% is given for a lump-sum payment in cash. Part of net assets of a privatized enterprise is often allocated to employees free of charge by recognizing their contribution to the past profits as sort of capital contributions. In the case of Jiangjin Brewery, as much as nearly 50% of its net assets was distributed to employees on a gratis basis. As a rule, these allocations are differentiated according to the length of service, and job titles.

Employees of state-owned enterprises had been customarily assured of stable employment. Even when personnel reductions were necessary, employer enterprises and local governments were required to help workers being released find other jobs. Privatization means employees of state-owned enterprises lose generous job guarantees, and this is the biggest and foremost reason why they resist privatization. In order to promote privatization, local governments sometimes offer a discount to the sales price for privatization through employee ownership as a compensation for the loss of job guarantees.

Dachuan City, that followed Yibin City in the privatization drive in Sichuan Province, obtained the provincial government's designation as an experimental area to implement its policy of deducting the standard amount of 7,000 RMB per employee as the "job remedial allowance"[14] from the sale price when state assets are sold to employees. For the privatization of Yueliang Food, the first to be privatized in Dachuan City in 1994, nearly 50% of its net assets were covered by these deductions. For Lansen Daily Chemicals, privatized in the following year, the standard deduction was raised to 12,000 RMB per employee as the enterprise's past record of relatively strong earnings was taken to mean employees' "great contribution to the state."

Sichuan Provincial Government accepted the deduction of "job remedial allowances" as the "cost associated with reform." With Dachuan City setting a precedent, many other counties in Sichuan Province began to sell off state assets at discount prices, facilitating privatization via the ownership by employees. Similar methods have now been adopted in other regions as well.

As explained earlier, when deeply troubled enterprises are sold off, local governments offer various support measures, including the assumption of debts. There have been some cases where insolvent public enterprises have been sold to outside companies for free[15]. In providing privatization support, local governments often require the continued employment of a certain percentage of employees.

One of important issues involved in privatization is the protection of claims on enterprises being privatized. The problems with newly established companies refusing to honor the liabilities of former public enterprises appear to be growing serious.[16] The Provincial government of Sichuan makes it mandatory for creditor banks to participate in the privatization process in order to preserve bank claims. There are cases where bank claims on privatized enterprises are reduced after local governments get involved in negotiations with creditor banks.

Reduction of Redundant Labor

State-owned enterprises in general have had excess personnel equivalent to some 20 to 30% of labor. Whether redundant workers can be reduced upon privatization or soon after privatization have a major bearing on the performance of privatized enterprises.

In Yibin City that went ahead with privatization through employee ownership fairly ahead of other regions, privatized enterprises have not reduced much of workforce. In the case of Yibin Electric Machinery, it wanted to cut 3% of personnel at the time of privatization. As the local government refused to authorize the reduction, the company was forced to accept the compromise that called for an annual reduction by 2%. At the time of the survey in 1999, three years after the privatization, the company was still burdened with surplus labor equivalent to as much as half the workforce.

The case of Yibin City is an extreme example, however. In other regions, even when privatization takes the form of employee ownership, it is common that workers are reduced by a certain extent at the time of privatization, followed by post-privatization reductions in stages. Xindalu Radiator in Chengdu City cut its payroll by over 20% (100-plus employees) when it was turned into the employee-owned enterprise in 1998. At Jiangjin Confectionery in Jiangjin City and Yueliang Food in Dachuan City, about 30% of the workforce was reduced in a period of three to five years after privatization.

In Sichuan Province, after the treatment of redundant labor emerged as a major issue in privatization cases in Yibin City, the provincial government in 1996 enforced a legal provision allowing part of revenue from the sale of state assets to be used for measures to cope with surplus workers. Under this provision, employees to be released became eligible for the compensation equivalent to 10 to 20% of their annual pay according to the length of service and other conditions. This formula has since spread widely to other regions, prompting the central government to set standards for the calculation of compensation.

The sale of state-owned and collective enterprises to private-sector companies tend to involve relatively large personnel reductions. Meihao Food was bought out on the condition that the privatized entity would take over only 150 of the former enterprise's 400 employees. In the case of Shenghe Pharmaceuticals, the company that bought it took over all the employees upon privatization, but later reduced about 40% of them in phases. Local governments often offer a deeper discount in the sale price when purchasing companies take over a relatively large number of employees. Employees not accepted by privatized enterprises get reemployment support from local governments.

2.2.2 Post-Privatization Development

(1) Results of Privatization

Since there has been no systematic official data published on privatization, we present here tentative evaluation of the results of privatization based on our survey samples.

Most of the visits to the companies in the survey were arranged by local governments, raising the possibility that the samples mostly represent enterprises with relatively favorable post-privatization performances. Any evaluation may need to take this potential factor into consideration.

Improved Performance after Privatization

Of the 24 survey samples, excluding the two enterprises that were scheduled for privatization at the time of the survey, nine enterprises were performing strongly at the time of privatization, while the remaining 15 were either turning in the average performance or in deep difficulties. Of the 15 enterprises, Jiangjin Confectionery and Suzhou Testing Equipment are still struggling, but 13 others have been able to improve their performance to varying degrees.

The improvement in earnings was particularly noticeable for enterprises privatized through the buyout or lease formulas (six out of 13). In all of these examples, the input of strong management resources of outside companies, such as effective management, channels of sales and funding, resulted in the significant improvement in performance. For Shenghe Pharmaceuticals and Changming Machinery, it appears that the reductions in outstanding debts all at once through bankruptcy proceedings helped them make a major turn for the better.

At the enterprises privatized through employee ownership, the effects on business performance were generally less dramatic than at those bought out or leased. At most of the employee-owned enterprises, management teams were not replaced upon or after the privatization. Moreover, they had little to gain from job reductions by way of improving earnings. Despite these generally disadvantageous conditions, however, seven of the eight enterprises that became employee-owned with the sub-par performance, excluding Jiangjin Confectionery suffering from the industry-wide slump, managed to improve their business to varying degrees. In particular, Fenghuang Packaging Materials and Yueliang Food achieved the rapid development of business after their privatization in the first half of the 1990s.

How did they manage to improve their performance without the input of external management resources or without major changes in the composition of personnel? To gain insight into the issue, we need to go back to the original significance of privatization.

Independence from Government Control and Strengthening of Management Discipline

The defeat of small and medium state-owned and collective enterprises in competition with village and township enterprises and other emerging enterprises stemmed from the lack of competitiveness in terms of cost and the flexibility and mobility of management (see Chapter 1). Underlying these problems were inadequate incentives for both managers and employees of state-owned and collective enterprises.

At pre-privatization state-owned enterprises, the distribution of income with differentials among employees met strong internal resistance. Managers had less authority at the production lines, and it was not uncommon that they failed to enforce a minimum of workplace discipline.[17] Under the former state-owned enterprise system, they were able to count on the ultimate bailout by government authorities in the event of business deterioration. Thus, managers and employees alike had few incentives to push for wider wage differentials or the strengthening of workplace discipline.

However, when small and medium state-owned and collective enterprises found themselves in deeper difficulties in the 1990s, county and other local governments overseeing these enterprises were no longer capable of fully supporting them. This situation triggered the drive toward privatization, forcing these enterprises, or more specifically, the groups of employees including managers, to become independent without relying on government support.

Privatization gave managers and employees the freedom of corporate management, but also placed them in a situation where the lack of efficiency would threaten the survival of their enterprises and hence employment. Therefore, privatized enterprises, almost without an exception, took measures to reinforce incentives by widening wage differentials according to jobs and the quantity of work. It became easier for managers to have control over production lines to help enhance the efficiency of production. The improvement of internal control combined with managers' abilities to achieve performance improvements with little additional input of management resources. Managers of the sample enterprises are unanimous in the opinion that privatization brought about noticeable improvements to the management in the workplace even when the improvement of earnings performance was less significant after privatization due to inadequate restructuring efforts or the industry-wide business slump (Weili Chemical Engineering and Yibin Electric Machinery) or when they still are unable to get out of difficulties (Jiangjin Confectionery and Suzhou Testing Equipment). Thus, it can be concluded that the separation from government control and the strengthened incentives for managers and employees were the most essential results of privatization.

There is no question that the privatization-induced improvement in efficiency alone does not guarantee the survival and further development of enterprises. In Yibin Country, it was reported some privatized enterprises already went bankrupt as early as in 1999. As more and more public enterprises become privatized, it is expected, privatization itself is increasingly likely to become less of a panacea for improved business performance.

(2) Limits on Privatization through Employee Ownership

Privatization through employee ownership produced visible results in terms of improved incentives through the severance of ties between government authorities and enterprises. This actually led to the improved business performance at many enterprises.

However, in areas where privatization began earlier than others, like Yibin County and Zhucheng City, Shandong Province it became obvious soon after privatization that the employee ownership with the relatively equal equity shares among employees have the serious problem regarding management efficiency.

At enterprises privatized through employee ownership, employees attend general meetings of shareholders as shareholders, getting involved in management decision-making. Given the relatively equal distribution of shares among employees, it is virtually impossible to implement management policies that are not endorsed by a majority of employees. The problem, however, is the fact that managers/executives and employees do not infrequently share the same understanding and interests. In the eyes of managers, this represents a major obstacle to management efficiency. Specifically, the following points are particularly problematic.

Constraints on Personnel Reduction Programs

As described earlier, even enterprises privatized through employee ownership have cut the number of employees gradually. This is a major progress compared with the pre-privatization days when it was not so easy to dismiss even delinquent workers. However, in comparison with enterprises bought by private companies, there is no denying that employee-owned enterprises do have greater constraints on personnel reductions.[18] In the case of Jiangjin Confectionery, when management proposed to introduce a system of early retirement for men at the age of 50 and for women at the age of 40 as part of rationalization to respond to intensified market competition, the general meeting of shareholders, meaning employees, voted against the proposal.

Lingering Egalitarianism

Even when privatization contributes to stronger management discipline, it is still difficult to wipe out egalitarianism dating back to the years of state-owned enterprises as long as the equal equity ownership is in place. In this climate, even when managers/executives are playing a crucial role in the growth of enterprises, they cannot raise their own salaries substantially due to disapproval of employees, a possible major disincentive. Among the survey samples of employee-owned enterprises, managers of enterprises with good performance, such as Fenghuang Packaging Materials and Nanyang Electrical Engineering, were all the more aware of this particular problem. At these enterprises, salary differentials between managers and employees were just several times, not much different from the levels seen at state-owned enterprises. Salaries of managers of employee-owned enterprises are far lower than those of purely private companies.

Problems with Appropriation of Earnings

Among the survey samples of employee-owned enterprises, those that made information on dividend rates available all had the high dividend rates. From the standpoint of corporate management, managers naturally want to keep as large internal reserves as possible by curbing an outflow of cash in order to secure financial buoyancy and prepare for long-term investment. From the standpoint of employees as shareholders, it is only natural to demand dividends commensurate with risks they are taking. If the subject of dividend rates is put to a vote at a shareholders' meeting, employees prevail on the strength of numbers.[19]

Privatization through employee ownership had a measure of success in reforming the inefficient way of management under state ownership. While management executives of the surveyed privatized enterprises acknowledged this, they emphasized that the present ownership structure characterized by the near-equal equity distribution among employees is hampering efficient decision-making.[20] With this perception deepening, the adequacy of the employee ownership with equal equity participation has increasingly been called into question.

(3) Developments toward Concentration of Ownership

In Sichuan Province, the adverse effects of the employee ownership with equal equity participation came to be recognized by around 1995-1996, and moves emerged toward the concentration of ownership on managers/executives. However, managers of employee-owned enterprises would risk their positions if the confrontation with employees comes into the open. Moreover, employees at enterprises with good business performance would not relinquish their equity shares easily because of high dividends they can expect to receive. So, managers are very discreet in their approach to the problem.

Holley Group provides an interesting example of success in ownership concentration.[21] The predecessor of Holley Group was a small collective enterprise established in the 1970s. It turned itself into a maker of electric meters later, and became the industry leader with remarkable growth under the present manager that took the helm in 1987. In 1995, Holley Group was designated by Zhejiang Province as the model of the enterprise system modernization and converted itself into a joint stock company. In the reform of the enterprise at the time, the local government of Yuhang took an equity share of 30%, with the remaining 70% being owned almost equally by employees.

With the adverse effects of the employee ownership with equal equity distribution becoming apparent later, Holley Group launched into the "second reform" designed to promote the centralization of capital. A holding company was established with the investment by a group of 127 core employees hand-picked by the manager, and this holding company bought back shares held by the local government and employees in stages. The repurchase program encountered strong resistance from employees, and the manager often had to directly persuade employees to sell their holdings. After two years from 1998, the share repurchase program was completed in 2001, with the manager owning 20% and the core employees 80% to make the enterprise a purely private entity.

Lida Textile is another example that successfully realized the equity control by managers/executives by implementing the "second reform" in a similar way with Holley Group. The two enterprises had two things in common in their successful second reforms: the present management teams played a decisive role in overcoming the past financial crises and turning their enterprises around to become excellent companies and that the very strong earnings performance allowed them to offer higher prices for the repurchase of shares owned by employees.

Compared with these two exceptionally successful enterprises, other privatized enterprises have to take more time and cautiously proceed with ownership concentration plans. Yibin Food, Weili Chemical Engineering and Nanyang Electrical Engineering are among the enterprises that sought or are planning to seek the concentration of employee-owned shares through separate companies or shareholding funds established by groups of core employees. Another method of ownership concentration is the allocation of newly issued shares to managers/executives (the case of Yibin Electric Machinery).

In the latter half of the 1990s, local governments pushing ahead with privatization programs also came to recognize the adverse effects of the employee ownership with equal equity distribution, prompting a shift in privatization policies. Among the survey samples of the more recently privatized enterprises, the proportion of employee-owned enterprises with equal equity distribution declined relative to the privatization cases involving the buyout by managers/executives and core employees or the sale to outside companies (see Table 3 above). It can be safely assumed that the surveyed cases more or less represent a national trend. The central government also made a policy shift in 1998, regarding the buyout by competent managers/executives as well as private companies as an important means of privatization of small and medium enterprises. Thus, privatization of small and medium state-owned and collective enterprises entered a new phase.

2.3 Dynamics of Ownership Transformation

2.3.1 Implementation Process of Privatization

This chapter examined the overall trend of privatization of small and medium state-owned and collective enterprises in the 1990s, and based mainly on the survey samples, made an analysis of the specific examples and characteristics of privatization as well as post-privatization developments. On the basis of the results of the analysis, this section looks at the logic of privatization of small and medium enterprises in China below.

At first, the acquisition by employee groups was the priority method of privatization over the sale to outside interests because of the circumstances described below.

Deficiency of Private-sector Capital Regions that embarked on privatization earlier were mostly economically underdeveloped regions, including Yibin City and Dachuan City, and there were few private-sector business concerns capable of buying out state-owned or collective enterprises then since the development of private-sector businesses itself was still in the incipient stage.

Information Asymmetry There was the great asymmetry of information available to insiders and outsiders on the real business conditions of state-owned or collective enterprises. This meant enormous risks for outside capital in the buyout of publicly-owned enterprises.

Avoidance of Employment Problems It was always possible that the sale of state-owned or collective enterprises to private companies would require massive personnel reductions. Thus, both employees and local governments at first tended to repulse privatization ideas.

Ideological Constraints There were big ideological impediments to the sale of state-owned or collective enterprises to private companies because it meant private ownership both in name and in substance. On the other hand, employee ownership, which was regarded a type of "public ownership," posed few ideological problems.

For employees of enterprises being privatized, privatization meant the loss of vested interests they had been enjoying as workers at state-owned enterprises, the biggest of them being job guarantee. Besides, the purchase of equity shares in enterprises with deteriorating performance, even though they were their employers, involved big risks. Under these circumstances, pro-privatization local governments, as a measure to help ease employees' resistance against privatization, opted for deep discounts in sale prices to promote employee ownership.[22]

For local governments, employee ownership was the realistic option to carry out privatization. Privatization that was realized after these developments produced visible effects in improving the performance of privatized enterprises. Privatization achieved the first objective of the separation between government authorities and enterprises.

2.3.2 Post-Privatization Readjustment

Although the separation between administration and enterprises was the great accomplishment of privatization, for employee-owned enterprises, privatization in no way meant the completion of corporate reform. By getting rid of the fetters of government control, enterprises were at last allowed to follow an autonomous process in earnest to choose an optimal corporate system.

Problems with employee ownership came to the fore immediately after privatization was implemented. Relative to corporate managers and executives, ordinary employees usually do not have sufficient information on the status of business, particularly information on future prospects of enterprises. In addition, given the low levels of income, employees tend to be very risk-averse. Under these circumstances, it is only natural for employees, as shareholders, to demand high dividends on their investment. From the standpoint of managers/executives, however, the payout of high dividends means nothing less than an outflow of cash flows that are otherwise available for investment in the future. A similar clash of views could arise regarding salaries of managers/executives. All these things reinforced the desire on the part of managers/executives to establish a firm grip on management through the concentration of ownership, if conditions permitted.

In the early stage of privatization, managers/executives would have faced difficulty in raising enough capital in their attempts to control capital of privatized enterprises. But the situation gradually changed to make it possible to raise buyout funds through formal and informal channels of financing. In the case of Holley Group, managers/executives were able to procure share purchase funds for the first-stage privatization in 1995 from a local financial institution. In the case of Suzhou Testing Equipment, the top manager borrowed a massive amount of one million RMB from a friend and entrepreneur to achieve controlling share of equity. As these examples indicate, with the increasing availability of various financing means, it has become no longer impossible for managers/executives to buy out even relatively large enterprises with payrolls in excess of 1,000.

As the momentum began to build up for ownership concentration in the hands of managers/executives at employee-owned enterprises, local governments also began to encourage the buyout by competent managers/executives or private companies in new privatization cases.

Flexible and agile management is the lifeline of small and medium enterprises. Thus, the most suitable management method is the corporate system that combines ownership and control, giving the top manager or a select group of executives the ultimate right to make management decisions as shareholders. The great majority of small and medium enterprises in the market economy are owner-controlled enterprises where the top manager and close associates or relatives exert direct control over capital. The trend toward concentration of ownership in privatization of small and medium enterprises in China can be described as reflecting "natural law," so to speak, in favor of the convergence of ownership and control.

2.3.3 Centralization and Decentralization of Capital

However, it is necessary to note that the post-privatization reorganization of small and medium enterprises in China involves aspects that cannot be simply described as developments toward owner-controlled enterprises. In the "second reform" initiatives at Holley Group and Lida Textile, the top managers who were successful in business rehabilitation and in turning the privatized entities around as excellent enterprises earned themselves the status of de facto owner-managers, while a number of management executives and core employees also took part in the buyout. At other enterprises seeking recentralization of capital and enterprises privatized in relatively recent years, all managers plan to establish or established control of capital in association with other management members and core employees. The size of core groups that centralized capital varies from enterprise to enterprise, but in most cases, a portion of several percentage points of all employees participate in the centralization of capital as key players.

The alliance between top managers and executives/core employees may prove a transient phenomenon in the process of privatization. But some top managers regard the shared ownership by executives and core employees in more positive light. As long as enterprises exist as joint stock companies or private limited companies, top managers need to disclose detailed management information to share-holding management executives and core employees. By letting executives and core employees share privileged management information, which is usually reserved for owner-managers and their close associates at purely owner-controlled enterprises, top managers hope to enhance their sense of involvement in management. Since top managers, though they may be top shareholders, tend not to control a majority of equity stakes, executives and core employees can expect to hold top managers in check as long once they form alliance. If some sense of confidence can be built under these circumstances, it may prove beneficial to top managers as well.[23] Following the similar logic, some purely privately-held companies are starting to introduce stock ownership plans for executives and employees.

Conclusion: Future Prospects

The policy switch by the CPC that progressively occurred from the late 1990s through 2001 all but eliminated political constraints over privatization of small and medium state-owned and collective enterprises. In parallel with this development, local governments also proactively pushed ahead with privatization of public enterprises. Recent statistics show the slowing decline in the number of state-owned enterprises, raising the possibility that further progress in the privatization drive has hit a snag in such areas as disposal of debts and personnel reductions. Amid continuously intensifying market competition, however, most publicly owned enterprises, unless privatized, are expected to be forced out of the market through bankruptcies. In that direction, the process of privatization of small and medium enterprises in China is highly likely to be completed in the not-so-distant future.

The focus of privatization is likely to shift to public enterprises of larger scale going forward. In the embryonic market economy as China's, innovative abilities of corporate managers can play an enormously important role in the development of enterprises. Among large state-owned and collective enterprises that have gained prominence through market competition, there are not a few where management powers have been significantly concentrated in the hands of top managers. The dynamics of capital centralization seen in the process of privatization of small and medium enterprises is expected to become a crucial factor in the privatization of manager-controlled large enterprises as well.

(Ken-ichi IMAI)

Notes:

1. Privatization of collectively owned village and township enterprises is discussed in Chapter 2 of the Japanese version of this report. Hereinafter, in order to avoid complication, urban small and medium state-owned and collective enterprises are simply called "small and medium state-owned and collective enterprises." Due to the limitations on data available, subject to the analysis in this chapter are limited, in principle, to enterprises in the mining and manufacturing sector.
2. In late 1998, the State Economic and Trade Commission and the National Bureau of Statistics worked out the new criteria based on sales and total assets. But four years later, as of December 2002, the new criteria have yet to be put into force.
3. China stopped publicizing data on the financial conditions of state-owned enterprises by size in 1994. Thus, Chart 1 only covers the period up to 1997.
4. It was reported the sale of small and medium state-owned and collective enterprises was conducted sporadically in the 1980s as well.
5. The example of Yibin Country was described on the basis of interviews with concerned parties and Zhonggong Sichuan Yibin Shiwei Xuanchuanbu Qiye Gaige Ketizu, "Yibinshi tansuo gongyouzhi shixian xingshi duoyanghuade diaocha yu qishi," *Jingji Tizhi Gaige,* No. 1, 1999
6. According to the state-owned enterprise consolidation program of Sichuan Province, a total of 342 state-owned enterprises are to be consolidated by 2005 either through bankruptcy or privatization (Website of the Economic and Trade Commission of Sichuan Province, http://www.scjm.gov.cn/lianjie4.htm).
7. The number of state-owned enterprises in 1995 and later includes "state-holding enterprises." State-holding enterprises include (1) enterprises in which the government holds an equity share of 50% or more for absolute control of management, and (2) enterprises in which the government holds an equity share of less than 50% but is the top shareholder, or is not the top shareholder but keeps control of management under some arrangements, for relative control. 8 The number of bankruptcy applications accepted for state-owned enterprises ranged from 2,800 to 4,100 in 1996-2000(on an all-industry basis,based on *Zhongguo Falu Nianjian* [China Yearbook of Law],various years).
9. According to the results of a comprehensive sample survey on institutional reform of state-owned enterprises conducted by the National Bureau of Statistics in 1998, state-owned enterprises sold to private enterprises or unincorporated business owners accounted for a little over 6% of the total of enterprises undergoing the institutional reform. (National Bureau of Statistics, "Recent Progress in Institutional Reform of State-Owned Industrial Enterprises," *Economic Management,* No. 11, 1998 (in Chinese))
10. In the survey of 15 enterprises in Sichuan Province, the IDE selected the typical privatization samples with the cooperation of the Institute of Economic System Reform of the Sichuan Academy of Social Sciences. In the survey of the additional 11 enterprises, the IDE also selected the representative local privatized enterprises. Therefore, it can be safely said that the survey samples of privatized enterprises largely represent the overall state of privatization in China. By the nature of the surveys, there are few samples of contracting, leasing or bankruptcies that do not constitute privatization in the strict sense of the word.
11. They often avoid breaching the upper limit on the number of shareholders for limited joint stock companies under the company law by registering the names of representatives chosen for a group of several employees each as shareholders.
12. In Zhucheng City, Shangdong Province, known for being one of the earliest to privatize small and medium enterprises along with Yibin County, the egalitarian approach was also the dominant mode of conversion to employee-owned enterprises.
13. Based on an interview at the Economic Committee of the Hangzhou Municipality Government on October 30, 2001.
14. The Chinese term is "*anzhifei.*" In this case, the term means compensation for the loss of job guarantees as employees of state-owned enterprises.
15. The central government does not allow the transfer of state-owned enterprises without consideration (based on an interview with officials of the State Economic and Trade Commission on September 4, 2001). In reality, however, such transfer seems to be taking place, often with collateral conditions on job security or debt repayment in many regions.
16. The seriousness of debt-evasion problems can be seen in the fact that the State Council in 1998 issued an official notice regarding measures to strengthen the protection of claims in the process of institutional reform of small and medium state-owned and collective enterprises.
17. In a pre-privatization episode at Suzhou Testing Equipment, when municipal officials visited its factory for inspection without advance notice at 11 a.m., most of workers were already on lunch break, and only

eight workers were on job.

18. The method of management-employee buyout was widely used in the privatization of middle-scale or smaller enterprises in the former Soviet republics and East European countries.
19. President at Lida Textile said: "Workers want to get as large an allocation of profits as possible. On the other hand, management executives lay stress on the development of enterprises. Employees have diversified views about management, and it seems quite unreasonable if we have to coordinate all these views." (An interview on September 14, 2000)
20. In fact, Weili Chemical Engineering and Yibin Electric Machinery, both of which have the most equal equity distribution among employees of the surveyed enterprises, have shown less pronounced improvement in business performance.
21. Privatization of Holley Group was described in detail in an article of *Far Eastern Economic Review* (August 17, 2000, pp. 42-44).
22. It appears that it was not unusual to force employees to buy shares in privatized enterprises. The central government issued an official notice to ban this practice. Among the survey samples, Lida Textile required employees to purchase shares in exchange for their continued employment.
23. Among the survey samples, Sanxin Electronics and Nanyang Electrical Engineering are the good examples. At both enterprises, top managers, who are de facto founders, own the equity stake of around 10% for relative control of capital. But they give high marks to the share ownership by management executives and core employees to retain competent personnel.