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# **The Emergence of China's Mixed Ownership Enterprises and Their Corporate Governance**

A thesis submitted for the degree of Doctor of Philosophy

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March 2011

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## **Abstract**

Over the last three decades of the Chinese economic reform with a focus on the state-owned enterprises (SOEs) restructuring, one striking phenomenon is the rise of the mixed ownership enterprises (MOEs) in China. The objective of this thesis is to analyse the factors that can explain the emergence and the rise of the MOEs, to explore the corporate governance of the MOEs, and to assess the performance of the MOEs.

The research finds that the unique experiments and practices of China's SOEs reform in the past 30 years have formed the China Model of SOEs reform, China's mixed ownership has its roots in the China Model. One major explanation to the rise of the MOEs is the synergy effect gained from the combination of the different advantages of both the private enterprises and the state enterprises. The private enterprises have better operational mechanisms and the state enterprises have better access to business resources and political support.

The thesis has looked at 5 issues of the institutional arrangements of MOE's corporate governance, named as the SCORE. It is found that the largest shareholder in most of the MOEs is still the state, but the control structure is not always corresponding to the shareholding structure, and the governmental intervention in the business of the MOEs has been reduced although the reduction is limited. The thesis shows that there is no noted relationship between corporate performance and mixed ownership, but the transfer of corporate controlling powers is very important for the ownership-transformed companies from whole ownership to mixed ownership to improve the performance. On this basis, the thesis argues that China needs to push forward the further commercialization of the corporate governance of the MOEs in the future.

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## **Acknowledgements**

I am very grateful to those people who encouraged, assisted, and guided me to take the PhD program at Brunel University and to do this research.

I am thankful to Professor Guy Liu and Professor John Bennett, my supervisors at Brunel University, for their encouragement and guidance to help this research.

This thesis employed lots of empirical data from field surveys. I appreciate very much the assistance from the officials of some government agencies, especially the State Assets Supervision and Administration Commission (SASAC) of the State Council and local SASACs, from the presidents and managers of some enterprises, their warm welcome on my visits and my discussions with them during the interviews are very beneficial to my studies.

I am very grateful to my wife, Wei ZHANG, her support is very encouraging to me. Without her support, it would not have been possible for me to have this thesis finished.

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# List of Abbreviations

CEO	chief executive officer
CFO	chief financial officer
CPC	Communist Party of China
CSRC	China Securities Regulatory Commission
EMBO	employees and management buy-out
GDP	gross domestic products
IBM	International Business Machine Corporation
IT	information technology
M&A	merger and acquisition
MBO	management buy-out
MOEs	mixed ownership enterprises
OECD	Organization for Economic Cooperation and Development
PC	personal computer
PPP	public-private partnership
RCPs	red cap enterprises
R&D	research and development
RMB	Renminbi

ROA	return on assets
ROE	return on equity
SASAC	State Assets Supervision and Administration Commission
SEC	Securities Exchange Commission of the United States
SMEs	small and medium-sized enterprises
SOEs	state-owned enterprises
SOX	Sarbanes-Oxley Act
TVEs	township-village enterprises
UK	the United Kingdom
US	the United State of America
USD	United States dollar
WTO	World Trade Organization

# Chapter 1

## Introduction

### 1.1 Why Should the Mixed Ownership Enterprises in China Be Taken As an Important Research Object

In 1978, China's government and the ruling party, the Communist Party of China (CPC), decided to carry out the policy for economic reform, namely, to transform China from planning economy to market economy. This decision marked a formal start of the economic transition in China. Many other former-socialist countries including Russia, Poland, Czech, also experienced economic transition in the late 1980s and the 1990s. Within all the transitional economies, China is generally regarded as the country taking a gradualist and revisionist approach, which is quite different from the radicalist or big-bang approach adopted by Russia and many Eastern European countries. These countries launched the full privatisation of state-owned enterprises (SOEs). In comparison with the big-bang approach, the gradualist and revisionist approach has allowed China to enjoy the fast economic development with an average GDP growth of 9.8% per year during the period of 1979-2009.

Enterprises are the basis of economic growth. In many transitional economies, the key task of the transition is to restructure the SOEs. Djankov and Murrell (2002) studied China's SOEs restructuring, and emphasized its importance in the transition process. As a matter of fact, China has been regarding its SOEs restructuring as the pivotal aspect of the economic transition. Studying its SOEs restructuring should be very helpful to identify the distinctive characteristics of the economic transition in China.

During the progress of China's SOEs restructuring and its impressive GDP growth, one striking phenomenon is the rise of the state and private mixed ownership enterprises (MOEs) after the 1990s. In 1979, the SOEs dominated China's economy, their output in the total industrial output was as high as 78.5%, while the residual 21.5% came from the collective enterprises (State Statistics Bureau, 1980). The SOEs at that time were wholly-owned by the state. In contrast, as a result of deepening reform towards market economy, the sales of state-owned and state-controlled enterprises in 2008 accounted for only 29.9% of the total sales of all industrial enterprises (State Statistics Bureau, 2009). Furthermore, nowadays there are fewer and fewer wholly-state-owned enterprises in China. On the contrary, shareholding companies are prevalent. Although there still are some wholly-state-owned companies in China, most of them have been restructured by spin-off approach, which means the parent enterprises usually remain as wholly-state-owned holding vehicles to hold the state shares of their mixed ownership subsidiaries. In fact, since the late 1990s, lots of wholly-state-owned enterprises have been privatised to become companies who are controlled by non-state shareholders instead of state shareholders or are wholly-owned by private owners. This means that a lot of wholly-state-owned enterprises have been restructured into MOEs in which there are not only state shares but also private shares. For instance, the parent company of Lenovo Group Company who is famous for its take-over of IBM PC business in 2005, Lenovo Holdings Company, is a MOE originating from the restructuring of a wholly-state-owned enterprise. 36% of the total equity of Lenovo Holdings Company is owned by the state, 35% is owned by the management and core employees, and 29% is owned by a private company. Similarly, another Chinese large company, TCL Group Company who is famous for its take-over of Alcatel mobile business in 2004, is also a MOE originating from the restructuring of a wholly-state-owned enterprise. The pioneer company in the real estate development sector in China, Wanke Company, became a MOE from a wholly-state-owned enterprise in the 1980s.

In addition to those MOEs originating from SOEs restructuring, some private enterprises have been transformed to MOEs by taking in state shares. Wantong Company, a very famous real estate company in China, used to be a private company, but it took in a SOE as a strategic investor and became a MOE in 2004. Hainan Airline Group Company, the fourth largest airline company in China, used to be a private company. It experienced an ownership restructuring in 2005, then a new company called Xinhua Aviation Holdings Company, was established. Xinhua Aviation Holdings Company is a MOE. Moreover, the merger and acquisition (M&A) market in China is also producing MOEs everyday. In the M&A market, some SOEs purchase the shares of private firms or vice versa, then MOEs are produced.

The history of mixed ownership in the world is not short, but mixed ownership has not garnered good attention yet. This might be that mixed ownership is not a worldwide prevalent phenomenon. However, in its ownership transformation campaign, MOEs are emerging rapidly in China, which deserves more attention and more studies. The numbers of the MOEs in other countries are not big, and those MOEs do not have enough importance in the economy. On the contrary, mixed ownership in China is getting more and more prevalent, and the number of China's MOEs is increasing because many large-sized SOEs have been or will be restructured into MOEs and some large-sized private firms have taken in or will take in some state capital to become MOEs. Those MOEs in China are of great importance in many industries. In contrast, the mixed ownership in other countries usually exists in particular industries, say, infrastructure or utilities, or in specific periods. Sometimes, mixed ownership in some other countries just work as an interim tool during the progress of privatisation, and the governments usually have the definite plan of consecutive sales of state shares and full privatisation. However China is not the case. Moreover, other countries do not have a definite strategy of restructuring SOEs into MOEs, but China has a clear strategy of the development of mixed ownership and this strategy has been

reiterated by the ruling party and the central government in the official documents. The 15<sup>th</sup> party congress of the CPC officially introduced this strategy for the first time in 1997. The 15<sup>th</sup> party congress report said the ownership structure should be improved in the future and the public ownership should include not only wholly-state-owned enterprises, but also state shares in MOEs (Jiang, Zemin., 1997). The 4<sup>th</sup> plenary session of the 15<sup>th</sup> party congress of the CPC in 1999 pointed out that the large and medium-sized SOEs should be restructured into shareholding companies of mixed ownership (The Central Committee of the CPC, 1999). The 16<sup>th</sup> party congress of the CPC pointed out in 2002 that mixed ownership should be encouraged to a higher extent (Jiang, Zemin., 2002). The 3<sup>rd</sup> plenary session of the 16<sup>th</sup> party congress decided in 2003 to strive to develop mixed ownership, and mixed ownership should be regarded as the major way of public ownership (The Central Committee of the CPC, 2003). Apparently, the strategy of promoting mixed ownership in China is quite clear. India used to have some MOEs in the 1960s, but those MOEs were privatised afterwards. China is a fast growing-up country in the world, the rise of more and more MOEs will draw attention from the world. This is because MOE is different not only from the classic capitalist private enterprise but also from traditional socialist wholly-state-owned enterprise. From the perspective of corporate governance, MOE is more complicated than the conventional wholly-private-owned company and wholly-state-owned company since the different shareholders with distinguishable ownership attribute may have different orientations of interests and different manners of treating management and workers. Thus, the MOEs in China should be taken as an important research object.

## **1.2 The Definition of the Mixed Ownership Enterprise in This Thesis**

Generally speaking, MOE refers to the enterprise containing both state shares and non-state shares. But in this research, the MOE refers to the enterprise in which there are both a block of state shares and a block of domestic non-state shares, and these blocks of shares are not easy to be sold in securities market or the block shareholders are not the common securities investors whose purpose of holding shares is to earn money by selling securities in secondary market. A block of shares in this thesis is generally defined as the block accounting for not less than 5% of the total shares in the enterprise, and the purpose of holding these shares is not to earn money by selling securities in secondary market. Therefore, the MOEs in this research exclude the joint ventures containing foreign shares and state shares, and those listed companies without non-state block shareholders. The reason for this definition is based on the purpose of this research, which is to study the factors driving the emergence of the MOEs as well as the corporate governance of the MOEs. The driving factors of establishing joint ventures and getting SOEs listed are well known in China, and the corporate governance of joint ventures and listed companies is regulated by specific acts and ordinances.

## **1.3 Research Objective**

Based on empirical observations, I found that numerous MOEs had emerged in China, and they usually were large-sized enterprises and had important positions in many industries. The Chinese government has a definite strategy of promoting mixed ownership, so that more MOEs are expected to emerge. Against this background, the questions are, why have so many MOEs emerged in China? Why does not China restructure its SOEs into wholly-private-owned enterprises instead of MOEs? Why has the Chinese government chosen the strategy of promoting mixed ownership? Probing into the factors driving the emergence of

the MOEs in China will help explain the environment in which the MOEs are born, to learn the tendency of MOEs' further evolution, and will be useful to understand the different forces affecting China's economic transition and to put forward relevant policy recommendations for expediting China's economic transition.

As a great number of MOEs have emerged in China and some of them are going to the global business arena, the corporate governance of this kind of enterprises should be touched on. How is this kind of enterprises governed? Does this kind of enterprises establish board of directors? Are the key positions of the board and the controlling powers based on the shareholding structure? How do the state shareholders and the non-state shareholders exercise their rights and their powers? Are the executives selected by the board or still by the government? Does the government still play any other role in the MOEs than the state shareholder? All these questions are very important and must be answered. Answering these questions helps not only to capture the substance of the MOEs and to distinguish the characters of the MOEs from other kinds of enterprises, but also to comprehend the game rules the MOEs follow and to put forth some recommendations about the further reform of the MOEs.

Furthermore, as numerous MOEs exist in China, how do these MOEs perform? Do MOEs outperform SOEs and private companies? These questions should also be answered.

Thus, the research objective of this thesis is to analyze what factors drive the emergence and the rise of China's MOEs, to study the corporate governance of China's MOEs, and to do comparative analysis on the performance of MOEs and non-MOEs.

## **1.4 Research Methodology and Research Plan**

The major approach to achieve the objective of this research is the combination of empirical studies, theoretical discussions, data collecting and data processing, modelling and correlation coefficient analysis.

Since mixed ownership is a real phenomenon in China's economic transition, the first step to do this research is to observe and comprehend China's MOEs, and to observe and comprehend the practice of China's economic transition because it is closely correlated with the emergence of the MOEs. In order to effectively observe and comprehend China's MOEs and its economic transition, field surveys and literature review must be conducted. The literature to be reviewed includes publications both in Chinese and in English. The literature significant to my research is cited in this thesis. The field surveys involve some typical MOEs or their controlling shareholders, including Lenovo Holdings, Fuxing Group, Wanke Company, TCL Group, and some government agencies such as local state assets supervision and administration commissions. The selection of the enterprises and government agencies I visited is based neither on any statistical sampling method nor on random selection method, it is only based on my private liaison or working connection with them. This selection may not be helpful to draw statistical conclusions, but is helpful to comprehend the MOEs and the economic transition in China. The major enterprises and government agencies I visited are stated in the following chapters, especially in chapter 5, 6, and 7.

In order to obtain some statistical findings, especially the findings about the commonness degree of mixed ownership, about the shareholding structure of the MOEs, and about some corporate governance issues, a questionnaire survey was also conducted. The survey covers almost 1000 enterprises. The design of the questionnaire survey is explained in chapter 4, and the questionnaire itself is listed in the appendix in this thesis. The questionnaire survey provides a lot of

useful information about the shareholding, the management, the government regulations, and some other issues with regards to MOE's corporate governance. By analysing the questionnaire and processing the data, some calculations can be done and some conclusions can be drawn. The data from the State Statistics Bureau of China and some other sources should also be used to do the statistical work, especially the data from Shanghai and Shenzhen Stock Exchanges is useful to study the MOEs in the stock market. The explanations why different datasets were used and how the datasets were selected are respectively in chapter 4 and 8.

Empirical studies are indispensable but not sufficient. Theoretical discussions should be undertaken in order to find the driving factor of the emergence of China's MOEs hidden behind the phenomenon, and to find MOE's governance features. Theoretical discussions are combined with the empirical studies in this thesis. The theoretical discussions will be pursued on the basis of transitional economics and new institutional economics. A comprehensive review of the literature on new institutional economics, transitional economics, ownership theory, and corporate governance theory, is presented in the thesis. The existing literature is discussed to help explain the phenomenon of the rise of China's MOEs, explore the major factors driving the emergence of the MOEs. The relevant articles are cited in the following chapters. The theoretical discussions are presented almost in all chapters, especially in chapter 3, 5, 6, and 7. The theoretical discussions from the perspective of new institutional economics, ownership theory, are also presented to explore the institutional foundation of corporate governance in chapter 6 and 7. The papers by Williamson (1998, 2000), Tirole (2001), and Roe (2003, 2004) are very valuable to this research, I draw on their analysis methods and their research results about the institutions of corporate governance in my thesis. From the perspective of new institutional economics and transitional economics, corporate governance involves not only the function of board of directors and general meeting of shareholders, information disclosure and corporate transparency, but also the distribution of

controlling powers, game rules, contracting, management market and labour market, government regulations. The institutional arrangements of corporate governance are more important than board, management, and accounting. A basic analytical framework for the research of MOEs' corporate governance in this thesis is also based on theoretical discussions and some empirical studies. The basic analytical framework is to provide a matrix for MOEs' corporate governance research.

To estimate the performance of MOEs, the econometric analysis was also employed. The econometric estimation will allow the thesis to test the performance difference between MOEs and non-MOEs by using the data of the listed company in China. The estimation and the explanation for the usage of the database are presented in chapter 8.

The research plan is summarized as follows:

- (1) To conduct empirical studies based on field surveys, interviews, literature review, and questionnaire survey.
- (2) To discuss the major factors driving the emergence of China's MOEs.
- (3) To conduct theoretical discussions and commenting about new institutional economics, transitional economics and corporate governance theory.
- (4) To address the issue of the commonness degree of mixed ownership, and the mixture degree of the MOEs.
- (5) To analyse the institutional arrangements of the MOEs corporate governance in China.
- (6) To compare the performance of MOEs and non-MOEs by modelling and data processing of more than 1000 listed companies in China.

## **1.5 The Justification and Discussion of the Methodology**

By literature reviewing, I found there were few mixed ownership enterprises in other countries. Some mixed ownership enterprises in Western countries were usually in utility and infrastructure sector, they were often established according to public-private-partnership (PPP) programs. The existing English literature looking at MOEs, especially the corporate governance of MOEs, is very scarce. Even in China, the academic literature focusing on why mixed ownership has become prevalent and what the corporate governance of the MOEs is like is also scarce while newspaper articles talking about the necessity and rationality of promoting mixed ownership could be easily found. Therefore, empirical observations and analysis are the starting method to build up the necessary knowledge and comprehensive understanding of China's MOEs. Empirical observations include not only conducting field surveys but also consulting historical documents. The interviews with some famous Chinese MOEs, such as Lenovo Group, TCL group, and some famous Chinese private companies who had been enthusiastic in mixed ownership while expanding their business, such as Fuxing Group, Yili Group, were really very helpful to comprehend why and how mixed ownership emerged in China. The consequent analysis includes identifying and judging the documents as well as building up some basic concepts about the mixed ownership. Considering the scarcity of the existing literature on mixed ownership, the method of empirical observations and analysis is indispensable and irreplaceable. Based on the empirical observations and analysis, I could find that mixed ownership had been spreading in China and there were some hidden factors which had been driving the emergence of China mixed ownership.

Empirical observations and analysis could provide real facts. Particularly, field interviews and surveys and case studies could help identify the real factors which drove the emergence of mixed ownership in China and the material issues of

MOEs' corporate governance. Those are the strengths of empirical observations. This research involved lots of field surveys and case studies. But field surveys and case studies have their weaknesses. One major weakness is that this method could not present an overall picture from statistical perspective. In order to testify from the statistical perspective that mixed ownership is prevalent in China, Data collection and analysis is necessary. The easy way of doing statistical analysis is to take the listed companies in Chinese securities market as the sample because any listed companies even in China has to publish its shareholding information including large shareholders' ownership status. Of course I used the published information of Chinese listed companies to do the statistical analysis. I selected the 300 listed companies which indicate the Shanghai-Shenzhen Component Index to analyse the commonness degree and mixture degree of Chinese listed companies, because these 300 companies were representative of different sectors, including financial sector, energy sector, trade sector, and manufacturing sector. Furthermore I conducted a questionnaire survey to look at the non-listed companies. The combination of the listed company analysis and non-listed company analysis would be more convincing to testify the commonness of mixed ownership in China and to tell the distinguishable mixed ownership status. The questionnaire was designed by myself intentionally, not only the ownership structure but also some issues of the corporate governance, such as the presence of board of directors, the position of core managers, the government-enterprise relations, were covered by the questionnaire survey. The data analysis of the questionnaire survey was very helpful to recognise the distinctiveness of MOEs' corporate governance, and to make further investigations of the institutional arrangements of MOEs' corporate governance. Without the intentionally-designed questionnaire survey, no other existing dataset could have provided so much useful information regarding the institutional arrangements of MOEs' corporate governance.

Empirical observations were useful to build up the basic concepts about China's mixed ownership and the preliminary understandings of China's MOEs, but were not sufficient to explore major driving factors of the rise of China's mixed ownership. In particular, some driving factors closely connected with the Chinese-characteristic market economy during the economic transitional process could not be easily identified by empirical observations. I combined theoretical discussions with empirical observations in this research to explore the driving factors and to address some issues of the institutional arrangements of MOEs' corporate governance. Existing literature on firm theory, transaction cost theory, incomplete contract theory, principal-agent theory, ownership theory, was helpful to explain why the combination of state ownership and private ownership would produce positive synergy in the context of China's economic transition and how state assets and private assets could provide their respective advantages. The approach of combining empirical observations with theoretical discussions could avoid the possible superficiality of empirical observations and the possible hollowness of theoretical discussions. Especially, China's economic transition has lasted for long time and generated numerous distinctive practices, I analysed the practices of the SOEs reform in China by theoretical discussions and generalised the China Model of state-owned enterprises reform. The generalisation of the China Model of SOEs reform exactly reflects the approach of the combination of empirical observation and theoretical discussions in this thesis, and the China Model of SOEs reform in this thesis presents some new and material contents of China's SOEs restructuring. On the background of the China Model of SOEs reform, the rise of China's mixed ownership would be more understandable, and the significance of further improvements of MOEs corporate governance could be well recognised.

Theoretical discussions can provide rational analytical framework for practical facts and have theoretical power to explain practical facts. Theoretical discussions can also be helpful to identify the nature and essence of practical

matters. These are the strengths of theoretical discussions. But theoretical discussions themselves could not do econometric work. That is the weakness of theoretical discussions. One issue of studying China's MOEs is to assess the performance of China's MOEs. Modelling should be adopted while checking the performance of MOEs. The purpose of the modelling in this research was to compare the performance of MOEs and non-MOEs, then to find if MOEs outperform other enterprises. As many factors may impact on corporate performance, this research used the multivariate regression as usual to conduct the performance analysis. This method is very common and the analysis results are usually reliable. In order to avoid possible inaccuracy of the analysis of any single performance indicator, this research adopted a few indicators, including return on assets (ROA), return on equity (ROE), Tobin's Q, to assess the performance of MOEs and non-MOEs. I had some hypotheses about the correlations between mixed ownership and corporate performance, regression analysis was used to test these hypotheses, therefore I could check if mixed ownership has positive, negative, or neutral impact on corporate performance. Coefficient analysis is based on reasonable dataset. A dataset composed of China's listed companies was used in this research to assess the performance. Performance estimation needs panel data which involves time series and a reasonable sample of enterprises to bring out reliable results. A dataset of China's listed companies is good to analyse the performance of MOEs and non-MOEs. Before 2009, there were almost 2000 listed companies in China's securities market, and China's securities market has a history of almost 20 years until then. The sample of China's listed companies can satisfy the time series requirement and the reasonable size requirement. The time series data also helped analyse the possible performance change after the ownership transformation from whole ownership to mixed ownership. Modelling itself is only a technical tool to conduct econometric analysis, some findings can be drawn from modelling analysis, but further explanations and discussions should be made to produce valuable conclusions. This research made consequent explanations and

discussions about the findings of the modelling analysis, and argued that mixed ownership itself would not necessarily lead to better performance although mixed ownership had been applauded by many state-owned enterprises and private firms. The more important thing than the ownership transformation from whole ownership to mixed ownership would be the corporate governance transformation. That reflects even modelling analysis also needs theoretical discussions to produce meaningful conclusions and policy implications.

## **1.6 The Structure of This Thesis**

This thesis includes nine chapters.

### Chapter 1, Introduction

This chapter discusses why the MOEs in China should be taken as an important research object, and the MOE is defined in this chapter. This chapter also explains the research objective, the research methods, and the research structure.

### Chapter 2, Literature review

This chapter conducts comprehensive review on English and Chinese literature about the ownership restructuring of SOEs, the development of China's MOEs, and the mixed ownership in other countries. Commenting on the existing literature is also made in this chapter.

### Chapter 3, The China Model of state-owned enterprises reform and the emergence of the mixed ownership enterprises

As most of China's MOEs are related to SOEs reform, this chapter starts with China's SOEs reform and explores why numerous MOEs emerged in China. This chapter analyzes the radical control reform and the gradual ownership reform of

China's SOEs. The China Model of SOEs reform is generalized in this chapter, and the fact that MOEs are correlated to the China Model is explored.

Chapter 4, The commonness degree of the mixed ownership in China and the mixture degree

This chapter analyzes the commonness degree of the mixed ownership and the mixture degree of China's MOEs. The commonness degree and mixture degree are defined in this chapter. The analysis is carried out both by using the data of the questionnaire survey and by using the data of 300 listed companies of Shanghai-Shenzhen 300 Component Index in China. This analysis establishes a basis for the further research in the following chapters.

Chapter 5, The major factors driving the emergence of the mixed ownership enterprises in China

This chapter focuses on what particular factors bring about the emergence and the rise of numerous MOEs in China. I start with the economic alliance policy encouraged by the government in the 1980s in China, then gradually move on to SOEs ownership reform, and eventually conclude why so many MOEs emerged in China. It is explored why the government and SOEs as well as private firms all accept mixed ownership instead of whole state ownership or whole private ownership.

Chapter 6, Understanding the corporate governance of the mixed ownership enterprises from the perspective of institutional arrangements

This chapter carries out the literature review and the theoretical discussions on corporate governance from the perspective of new institutional economics, then establish a basic framework for the analysis of the institutional arrangements of MOEs corporate governance.

Chapter 7, The studies on the institutional arrangements of the corporate governance of mixed ownership enterprises: some findings

This chapter uses the basic analytical framework established in chapter 6 to conduct the studies on the institutional arrangements of MOEs' corporate governance. The shareholding structure of MOEs, the covenant among shareholders and the government, the office of the core managers, the special regulations imposed by the government, and the employment relations of the workers in MOEs, are analysed in this chapter, and some meaningful findings are presented.

Chapter 8, Do mixed ownership enterprises outperform others: empirical estimation

This chapter uses the data of listed companies in China's securities market. Some hypotheses about the correlations between corporate performance and corporate shareholding structure are put forth. Through modelling and data processing, the hypotheses are tested.

Chapter 9, Conclusions and further thinking

This chapter summarizes the research. The major research findings, the major contributions, the academic value and the policy implications of this research are highlighted in this chapter.

# Chapter 2

## Literature Review

### 2.1 Introduction

Since mixed ownership in China is highly related to the ownership reform of its SOEs, the literature review in this chapter will trace back to the SOEs reform and will involve some discussions on ownership theory. The literature review on mixed ownership is separated to the Chinese literature section and the English literature section. The Chinese literature is abundant, and has its own historical backdrop and time order, while the English literature is scarce but more theoretical and econometrics-styled. The literature review on corporate governance is not separated to different sections in chapter 2. The literature on MOEs' corporate governance is scarce since mixed ownership has not arrested good attention, therefore I start with a brief overview of corporate governance and proceed with discussing the corporate governance literature from the perspectives of ownership attribute and shareholding structure. Since chapter 6 will present some original studies on the corporate governance of China's MOEs, I need to balance the allocation of corporate governance literature review between chapter 2 and chapter 6. My solution is that chapter 6 focuses on the literature review of corporate governance from the angle of new institutional economics, while chapter 2 addresses the general issues of corporate governance. The practices and the progress of the corporate governance improvements in China and some other countries will be addressed in chapter 6.

## **2.2 The Chinese Literature on the Ownership Reform of State-Owned Enterprises**

### **2.2.1 The Early Studies on the Ownership Reform of State-Owned Enterprises**

At the start of China's economic transition in the late 1970s, the SOEs reform went along with the reform of controlling powers (control reform) and did not touch the ownership. As a result most of the early Chinese literature on SOEs reform focuses on the autonomy of SOEs. Dong, Furen.(1979), stated that there were a number of crucial problems related to SOEs: firstly, the enterprises had become subsidiary bodies of the administrative organisations; secondly, the state had total control to both the revenues and expenditures of the enterprises; thirdly, the state monopolised the purchases and sales of products; fourthly, the enterprises lacked the minimum power of decision-making for both production and management; fifthly, the enterprises had no rights for independent accounting; sixthly, the enterprises did not care about their profit or loss. He concluded that the most imminent issue was the enforcement of the autonomy of SOEs.

Moreover, Jiang, Yiwei. (1980) put forth "the enterprise standard doctrine" in 1980. Jiang argued that China's economic system was based on the Soviet Union's model, the state was directly responsible for managing SOEs. To sum up, he stated that the SOEs should have independent power both in operation and business accounting, and should be responsible for their own profit and loss. Jiang, Yiwei. (1980) then argued that SOEs should enjoy their due rights and powers entrusted by the state, which he called "the enterprise standard doctrine". He also created a detailed illustration of the key points of this doctrine: firstly, the independent enterprises were the basic units of the economy; secondly, the

enterprises should become dynamic bodies with powers for operation; thirdly, the enterprises should enjoy independent economic interests and should also be held responsible for their own profit and loss; fourthly, governmental functions should be separated from the enterprises. Jiang, Yiwei. (1980) argued that the state should manage the enterprises just by the following means: formulating economic policies and economic laws, making economic plans, using economic levers such as price and taxation to regulate the economic activities of the enterprises.

The above studies encouraged the government to start the SOEs reform at that time, but the defects of those studies were also obvious. Those studies neglected not only the owner's rights but also the corporate governance. At that time, the Chinese economists' understanding of "the state" was only the role as the public administrator, but the role of state assets administration as the owner was neglected. Those economists did not realise that the function of the equity investor and the function of public administrator could be separated. Thus, Chinese scholars had all along emphasized the separation of operation from ownership. As the separation went along, it was found that the SOEs were under the firm control of the insiders and that brought about corruptions. The autonomy argument and "the enterprise standard doctrine" touched on the issue of incentive mechanism, but those papers could not clearly define, from the perspective of corporate governance, the relationship between the state and SOEs. Jiang, Yiwei. (1980) held that the state's control over the enterprises should be just confined to the following aspects: to formulate economic policies and economic laws, to make economic plans, to regulate the economic activities of the enterprises by using the economic levers such as price and taxation. Obviously, the above functions were not in line with the shareholder's rights, and he failed to mention how the state as a shareholder should select and change the managers.

From the mid-1980s and on, as the defects of the control reform were widely

recognised, some Chinese economists began to call for the reform on state ownership (ownership reform). Dong, Furen.(1987) argued that the control reform would not work well without the ownership reform. The state ownership itself meant that SOEs were not responsible for money loss, the soft budgeting had become the inborn illness of SOEs. He stated that separating operation from ownership could not solve the problem of the soft budgeting. He suggested that the government should turn some small-sized SOEs into private or collective enterprises, and the large-sized SOEs could try shareholding system. Furthermore, he noted that the state should play its role only as a shareholder in the board of directors in shareholding enterprises, and could no longer issue orders to those enterprises. This is one of the earliest papers that argued the state ownership system could be transformed into shareholding system and touched slightly upon the issue of corporate governance.

Although Chinese scholars started to discuss possible ownership reform, the privatisation was still forbidden in the 1980s. In the early 1980s, the introduction of some non-state shares into SOEs by developing shareholding system was welcomed. Tong, Dalin.(1986) called enthusiastically for the shareholding system. This paper was published in the official newspaper, People's Daily. Tong himself was a high-level official at the State Economic Restructuring Commission. He stated that some cities in China had tried shareholding system and argued that socialist enterprises, including SOEs, should be restructured into shareholding companies. He also highlighted four patterns of shareholding restructuring: the stock issuance to employees, the stock issuance to the public, the cross-shareholding among SOEs, and the joint venture invested by SOEs and foreign companies. His paper implied the idea of mixed ownership even though the word of mixed ownership was not used. Furthermore, his paper implied that shareholding enterprises had emerged in reality since then, and the cross-shareholding between SOEs and non-SOEs was natural. Thus, as long as

shareholding trial was accepted by the government, mixed ownership might emerge naturally.

Since the late 1980s Chinese people shrewdly strove to enhance the political legitimacy of mixed ownership by introducing employees' shareholders. Jiang, Zemin. (1992) stated that it was possible to establish the socialist shareholding system based on public shares, but he argued that public shares should include not only the state shares, but also corporate shares and employees' shares. He raised in clear terms the concepts of the employees' collective shares and the employees' cooperative shares, and held that these shares were of public ownership attribute instead of private ownership attribute. His statement of the socialist shareholding system is very interesting. Namely, employees' shareholding is socialist rather than capitalist, and should be encouraged. According to Jiang, the employees could own some individual shares in SOEs. This statement had a major impact on the policy option. Afterwards, a good number of SOEs implemented the "insiders-typed ownership reform", some state shares were sold to employees.

The literature on shareholding system also touched upon the issue of property rights arrangements of SOEs. Chinese economists came to study Western theories on property rights since the mid-1980s. Chinese economists think R. Coase is the founder of modern property rights theory. In his classical paper "The nature of the firm", Coase (1937) analysed the reason for the existence of firms. R. Coase attributed the existence of firms to transaction cost. In his another influential paper, "The problem of social cost" (1960), he highlighted the importance of property rights. With regard to the theory of property rights, the Western economists, H. Demsetz, O. Hart, E. Fama, and B. Holmstrom, also have great influence on Chinese economists. Demsetz (1967) summarized the function of property rights, saying that the main function was to encourage people to internalize the cost. Holmstrom (1982) noted that the moral hazards of

the management would impair the efficiency of enterprise, but the ownership function could check the moral hazards, so that property rights arrangements are relevant. Fama (1980) revealed that the market for managers in capitalist economies would put pressure on the management and could create to some extent the incentives. Later, Grossman and Hart (1986), Hart and Moore (1990) gave another explanation for property rights from the perspective of incomplete contract. They held that property rights become significant due to the incompleteness of contract and thus property rights should be defined as residual control rights. Putterman (1993) highlighted that the efficiency of public ownership is not as high as private ownership because the public do not have enough motives to monitor the performance of the management. Chinese economists widely accepted the research results of these scholars, thinking that the property rights system is the most fundamental system of firms and SOEs reform could not avoid the reform of property rights arrangements. Chinese economists also accepted the property rights analytical framework which has been established by Western economists, thinking that property rights can be defined as residual claim rights and residual control rights. Ostrom (1990) insisted that the public ownership would cause the tragedy of the commons. To counter this, Jozef and Van Brabant (1992) argued that the practical way of solving the tragedy of the commons problem in SOEs is privatisation. Their views also had big influence in China.

In the early 1990s, some Chinese economists carefully raised the issue of selling the state equity to non-state investors. Tang, Fengyi. et al. (1990) stated the lack of a clear boundary line of property rights between SOEs and the state, noted the soft budgeting of the SOEs, and highlighted the necessity to sell some state assets to private investors and foreign investors.

Since the defects of the control reform had been increasingly recognised and some shareholding companies were budding in silence, the early literature on

SOEs ownership reform in China appealed to encourage the shareholding system and to bring different ownership to mix up in particular enterprises. Some literature was influenced by property rights theory from Western countries. The advantages of private ownership and the disadvantages of state ownership were widely recognised by many Chinese economists, and they argued that partial private ownership should be introduced into SOEs so that the state ownership could be restructured. Those studies helped the government to clarify its idea, to accept the ownership reform. Interestingly, the practice usually went ahead of the theory, ownership reform trials and shareholding experiments occurred in reality before the economists called for the government to accept the reality and to improve its policy.

### **2.2.2 The Early Studies on Mixed Ownership**

The issue of developing mixed ownership was originally raised in the mid-1980s. The first economist to put forth the concept of mixed ownership is Xue, Muqiao. (1987). He found that the ownership patterns of China's enterprises were becoming more and more complicated in reality and were ever-evolving. Joint investment and joint business among different enterprises such as SOEs, collective enterprises and private firms, were developing quickly. As these enterprises had different ownership attribute, the mixed ownership would emerge. Although those mixed ownership enterprises were shareholding companies, they still belonged to socialist enterprise because the purpose of this kind of shareholding was only to identify the investment from different investors. Moreover, some SOEs and collective enterprises raised funds by issuing stocks to employees. These enterprises which contained state ownership and non-state ownership are mixed ownership enterprises. But Xuan still asserted that the state ownership should dominate the national economy.

It can be learned from Xuan's studies that the practice of mixed ownership was evidently earlier than the theory of the mixed ownership. In 1988, Sichuan Economic Restructuring Institute (1988) published an article which was based on a field survey. The article stated that mixed ownership was emerging in Sichuan Province, and called for the official admission of the mixed ownership.

In 1992, the 14th party congress of the CPC determined that the direction of China's economic reform was to establish the socialist market economy. In order to liberalize—the ideology of SOEs reform, an important paper by the China Academy of Social Science (1993) was published in 1993 that definitely called for developing mixed ownership in order to improve the ownership landscape in China. This paper noted that the non-state sector had been showing very positive vigour and the boundary between state ownership and non-state ownership was becoming vague as different attributes of ownership had been melted together in the market. It was impossible to differentiate the firms in terms of ownership attribute, and more enterprises would become mixed ownership enterprises. This article belongs to the earliest literature about mixed ownership in China. More articles on MOEs were published afterwards, but most of them focused on the argument of the compatibility of mixed ownership with the socialist system, the paper by Dai, Wenbian. (1993) is a typical one. This paper just argued that only mixed ownership could successfully combine the socialist system with the market economy together.

A research report by Wu, Jinglian. et al. (1998) made a turning point. The purpose of this research was to provide policy recommendations for the 15th party congress CPC which was held in the autumn of 1997. This research argued that China had to carry out the strategic restructuring of the state sector, namely, the state sector should be streamlined and the size of the state sector should be dwindled. In order to streamline and diminish the state sector, state equity should be withdrawn from competitive lines and some small SOEs in these lines should

be sold out, the ownership structure of SOEs should be diversified by introducing non-state equity, and these ownership-restructured enterprises should be encouraged to establish good corporate governance. The main contents of this research were adopted by the 15th party congress of the CPC. This is an important research report promoting mixed ownership even though it did not use the term of mixed ownership.

On the basis of that, Zhang, Wenkui. (1999) focused on the issue of restructuring SOEs' shareholding structure. After analysing the enforcement of modern corporate system since 1994, he found that the dominant and controlling position of the state ownership had not been changed and this had constituted a major obstacle for the improvement of corporate governance of SOEs. Therefore, the most urgent task was to change the shareholding structure of SOEs and to realise the ownership diversification. He clearly stated the realisation of the ownership diversification should be based on selling state share. In his paper, ownership diversification was almost identical to mixed ownership.

These studies on mixed ownership played a positive role in liberalizing the official ideology and changing the policies in China. However, the above literature was based on summarising the practical trials of mixed ownership in reality, instead of theoretical creation. The early Chinese literature on mixed ownership did not touch upon the driving factors of the emergence of mixed ownership.

### **2.2.3 The Latter Studies on Mixed Ownership**

Since the 15th party congress held in 1997 and the 4th plenary session of 15th party congress held in 1999, the literature on mixed ownership has quickly expanded as the two conferences clearly called for developing the mixed ownership.

He, Lisheng., and Guan, Renqin. (1999), discussed the compatibility of mixed ownership and market economy. They stressed the superior compatibility of MOEs with market economy. It is regrettable however, they did not provide solid empirical evidences to support their claims. Xiao, Liang. (2004) studied some obstacles to developing mixed ownership and discussed how the government could remove them. Shao, Mingzhao. (2004) discussed the policy tendency of promoting mixed ownership in China.

Since the beginning of the 21st century, Chinese economists have begun to conduct some empirical studies on MOEs. However, the empirical analysis with credible data and solid logic is scarce. Some empirical papers focused on the numbers of MOEs and their contributions to economic growth as well as their ownership structure, while a few papers conducted studies on performance analysis of MOEs. Wang, Yongnian. et al. (2006) conducted empirical analysis on MOEs in Anhui Province, but their definition of MOE referred to those registered as joint stock companies, limited liability companies, cooperative shareholding companies, joint operation companies and other companies. Actually, the MOEs in this paper included all enterprises other than SOEs, such as collective enterprises and private firms. This definition is inappropriate. They conducted comparative analysis and found that the total assets return ratio, labour productivity, and profit ratio of the MOEs were all lower than the SOEs, collective firms and private firms. Due to the problematic definition of the MOE, their findings were not credible.

Xu, Shanchang. (2006) also conducted some empirical analysis on MOEs in Jiangsu Province and Zhejiang Province, but his study focused only on the changing numbers of MOEs in these two provinces. He argued that the basis of the development the MOEs in Jiangsu Province was the rise of township and village enterprises (TVEs) in the 1980s. For Zhejiang Province however, he attributed the development of MOEs to the rise of “red cap enterprises”(RCEs)

which were actually private firms but registered as collective firms. Since 1992, many TVEs had experienced ownership restructuring and many RCEs had experienced the transaction of “taking of the cap”. Then in the late-1990s, more than 98% of TVEs and most of the RCEs became MOEs in which private equity was usually dominant. In 1997, the MOEs output in Jinagsu Province contributed to more than 40% of the local GDP. Until 2003, 98.3% of the SOEs administered by local counties and all collective enterprises had finished their ownership restructuring, 90% of the ownership-restructured enterprises became MOEs. After entering the 21st century, the mixed ownership developed more quickly. In 2005, the number of registered MOEs in Zhejiang Province was 313,571, which accounted for 61 % of the total number of all registered enterprises.

In general, the Chinese literature on mixed ownership has become abundant over time since the late-1980s. In the past years, a few papers with empirical analysis can be found. The above literature has shortcomings however. The literature before the mid-1990s focused on arguing the compatibility of mixed ownership with the socialist system. Some latter papers conducted empirical analysis, though these papers often focused on the ever-increasing numbers of MOEs and their contributions to the local economy. It is difficult to find any studies highlighting the factors that drove the emergence of the MOEs and highlighting the corporate governance issues of the MOEs, which are exactly the focus of my research.

## **2.3 The English Literature on Ownership Theory and Mixed Ownership**

### **2.3.1 Literature on Ownership Theory**

In the 1930s, Coase (1937) built up the firm theory by analysing the nature of the firm and the transaction cost. Alchian and Demsetz (1972), and Willimsom

(1975), developed the firm theory by the approach of transaction cost. In the 1970s, Jensen and Meckling (1976) established the principal-agency theory, they argued that many problems in firm's operation and management could be explained by principal-agency issue. Afterwards many economists used the principal-agency theory to analyse the management and the governance of the firm. Holmstrom and Milgrom (1991) did the multi-task principal-agency analysis, and noted that the agency cost might become more complicated in the multi-task environment. According to the principal-agency theory, ownership matters because ownership may change the agency cost. In the 1980s and 1990s, Hart (1988, 1989, 1995a) expanded the theory of the firm by introducing the analysis of incomplete contract. He noted that the property rights matter due to the incompleteness of contract, and ownership is connected with the residual control of the firm. The introduction of the analysis of incomplete contract marked the new phase of the studies on the firm theory. Hart and Moore (1990) explained that the property rights should be defined on the basis of the distribution of corporate control, the nature of the firm should be understood from the perspective of the incompleteness of contract. In the past 20 years, the principal-agency theory and incomplete contract theory have been widely used to discuss the ownership and the control of the firm. Holmstrom and Milgrom (1991, 1994) argued that ownership has important impact on the incentive system of the firm that could affect firm's efficiency. Sappington (1991) also held that incentive is connected with ownership because of agency cost. Harris and Raviv (1991) analysed the relationship between corporate control and corporate capital, and noted that the distribution of corporate control and the design of controlling powers are very important. Shleifer and Vishny (1994) stepped forward in their studies on the state ownership and government interference. They argued that the state ownership should be reformed so as to improve corporate efficiency, and the privatisation is a suitable choice. Boycko et al. (1996) discussed theoretically the significance and the related policies of the state ownership restructuring, they believed that the privatisation is helpful to improve the corporate performance.

Brada (1996) described the privatisation happening in transitional countries, and explained the connection between the economic transition and the privatisation of state ownership. Schmidt (2000) even discussed the different styles of the privatisation and the corresponding results, and found that the outsider-oriented privatisation seems more efficient.

The above studies on ownership theory demonstrate or imply that private ownership has clearer and more efficient property rights arrangements than state ownership. But unfortunately, mixed ownership has not arrested enough theoretical discussions from the perspectives of transaction cost, principal-agency, and incomplete contract.

### **2.3.2 Literature on Mixed Ownership**

After reviewing major economic journals, I found only a few papers touching on mixed ownership. Brooks (1987) conducted case studies on mixed ownership by using the cases of the British Petroleum Company (BP) and the Canada Development Investment Company, and found that the governments were liable to use the state equity in MOEs to force them to operate in favour of policy priorities and then the commercial value was neglected. That means the mixed ownership was employed as an instrument of public policy which might impair the commercial value. This analysis is enlightening, but its analysis is regrettably based only on case studies. Puffer et al. (2000) studied three mixed ownership cases. This paper recorded the history of these companies and their business activities but did not provide any data or other relevant materials. Schmitz (2000) conducted a theoretical study on partial privatisation from the perspective of incomplete contract, and argued by the modelling analysis that only if the corporate management faces the investment decisions, it may be optimal to choose partially privatised ownership instead of whole state ownership and whole private ownership. Mattijs et al. (2001) conducted some empirical studies

on the major international airline companies with mixed ownership. This paper selected 50 airline companies as the sample and found 13 of them were MOEs during 1993 to 1997. The empirical studies found that the performance of the state-owned airline companies were poorer than private airline companies. The shortcoming of this paper is the small sample of the enterprises.

Some economists studied the practices of partial privatisation. Of course, partially-privatised enterprises are usually MOEs. Ramamurti (1997) took the case of Argentine Railroads Company and found partial privatisation was more acceptable. Matsumura (1998) analysed the partial privatisation in mixed duopoly and found partial privatisation would be an optimal choice. Bennett and Maw (2003) conducted partial privatisation studies in some transitional economies. They found that the governments were sometimes liable to maintain some state shares when privatising SOEs. They also found that the maintenance of some state shares impacted upon the investment and the production of the enterprises. Beladi and Chao (2006) also studied the practices of the partial privatisation in some developing countries, and found that the higher the degree of privatisation was, the more favourable the privatisation was to the long-term growth and long-term employment.

Pisano (1990) also did studies on partial ownership arrangement or “equity linkage”. It was argued that partial ownership would dominate the contractual governance when a relationship involves uncertainty, transaction-specific capital, and other variables, and it was hypothesized that equity linkages are more likely when R&D is to be done during the collaboration, and less likely when there are more potential collaborators. The analysis on biotech industry supports these claims. Apparently, the studies on mixed ownership in this paper just focus on specific industries. Menard (1996) also did some studies on hybrid companies, but still looked at the specific industries.

In general, there is little English literature on mixed ownership. The reason might be mixed ownership is not common in Western countries. Although a few papers on mixed ownership were found but these papers focus only on case studies or performance analysis. These papers are not directly related to China's MOEs or to my research questions.

### **2.3.3 Literature on Public-Private Partnership**

From the early 1990s, public-private partnership (PPP) has enjoyed a growing standing, China is one of the countries which introduced PPP in recent years. Under PPP system long-term and stable contracts between the government and private firms are established. These contracts may concern infrastructure and public service. This enables private funds to be introduced while service scale and service quality are expected to be improved.

PPP program usually encourages private investment. The contracts can also set future ownership arrangements between governments and private firms, thus a company under PPP program may be a MOE or may become a MOE in the future.

Aubert and Laffont (2002) studied the issues of negotiation and contracting of PPP programs. They argued that the government and the political system had a big impact on the contracting of the investment and the operation of infrastructure. Their conclusion implied it was difficult for the companies containing some state shares to follow commercial rules. Iossa and Martimort (2008) established a basic analytical framework from the economics perspective for PPP system. They also studied the ownership arrangements issue of PPP program. Bennett and Iossa (2006) studied the ownership issue and the incentives of PPP program. They found that the introduction of private ownership increased the incentives, reduced the service cost and improved the service quality. That means the introduction of the private ownership is significant for the

performance improvement. Martimort and Pouyet (2007) established a model to analyse the efficiency of PPP program, they found that PPP would reduce the agency cost while the positive externality existed between the project builder and the manager, but the ownership arrangements were not so important. Some scholars, such as Guash (2004), Engel et al. (2006) studied the impact of the government activities on contract achievement and service quality. They found that the government might act against the contract in pursuit of the political interests, which had a negative impact on the service price and quality. Therefore, if PPP depended only on the contract and the ownership arrangements were not involved, the uncertainty of the political system would increase the risk of PPP program. That means even under PPP program, ownership is still important. Empirical analysis by Brench et al. (2005), and by Guasch et al. (2006), substantiated the above arguments. Furthermore, the paper by Hammami et al. (2006) noted that the political system and institutional environment was very crucial to the seriousness of the PPP contract. In the countries with the stable political system and sound institutional environment, the PPP contracts were usually enforced. From this perspective, ownership matters because the degree of the social respect to ownership is usually much higher than the degree of the social respect to contract in many countries. De Bettignies and Ross (2007) studied PPP from the perspective of incomplete contract, they argued that the introduction of private ownership was significant. Hart (2003) also conducted studies on PPP from the perspective of incomplete contract, and noted that the state ownership had a lot of disadvantages and the introduction of the private ownership could offset these disadvantages to some extent. Hart et al. (1997) argued that private investments and private operations could be introduced even in the jailing sector.

The literature on PPP is much more abundant than the literature on mixed ownership. The reason is that PPP developed very quickly in the Western countries, while China is the only country where mixed ownership grew up

quickly due to China's distinctive system. PPP may result in mixed ownership, but usually involves contracting issue. Nevertheless, much literature points out ownership arrangements are still significant even under serious contracts and the introduction of private ownership can enhance the incentives and improve the efficiency. The control structure does not depend fully on the ownership arrangements, the political system and the government priorities may impact on the control structure. This means the governance under PPP can not avoid the impact from the government and the politics.

#### **2.3.4 The Empirical Studies on Mixed Ownership Enterprises**

Some scholars studied the MOEs originating from ownership restructuring of state owned enterprises. Mihalyi (1996) found that some SOEs were restructured into MOEs rather than private firms in the early stage of Hungary's economic transition, but the government did have a clear plan to sell the residual state shares in the MOEs. Some scholars conducted studies on China's SOEs reform and the performance of China's MOEs. Liu and Woo (2001) found that the ownership structure of SOEs in China moved in the direction of ownership diversification since its entrance to WTO. The introduction of non-state equity was useful not only to raise more funds but also to improve corporate governance and to enhance their market competence. Although the authors did not mention the causes of the rise of the MOEs in China, their conclusions implied that all the institutions would be helpful to the enterprises as long as these institutions could promote the development of enterprises and encourage the enterprises to follow market rules. This paper is very valuable to my research because it points out the opening-up of the ownership structure of SOEs and the introduction of non-state capital is helpful for the enterprises to raise funds and to change the institutions. Xu and Wang (1999) conducted empirical analysis on the companies listed in Shanghai Stock Exchange. They analyzed the correlation between the ownership structure of the companies and their performance, found the lower the proportion

of state ownership was, the higher the performance was. Those papers are valuable to my research. But unfortunately, those papers did not touch upon the driving factors of the emergence of China's MOEs, their corporate governance, and the performance comparison.

## **2.4 Literature on Corporate Governance**

### **2.4.1 An Overview of Corporate Governance**

There is plenty of literature on corporate governance since it is a very important research issue in both economics and law. This concept however, has been defined quite differently. Generally speaking, economists think that corporate governance is related to principal-agency problem.

Principal-agency problem originates from the separation of ownership and control. Berle and Means (1932) described the impacts of the separation of ownership and control. Jensen and Meckling (1976) summarized the relationship between owner and controller after the separation as the principal-agent relationship. This paper laid the foundation for the corporate governance theory. But the first economist who initially used the concept of governance structure may be Williamson (1975). But in his paper, the term of governance structure was not identical to corporate governance. Cochran and Wartick (1988) gave a clear definition of corporate governance, argued that corporate governance was to handle the issues of responsibilities, powers and interests among managers, shareholders, board of directors, and the stakeholders. The essential issues include: Who actually get the interests from the company's decision-making and transactions? Who ought to get the interests? How should the disagreements be solved? According to Monks and Minow (2001), corporate governance is usually regarded as the role of board of directors, the role of management, the role of owners, and the role of stakeholders. In addition, corporate transparency,

corporate compliance, the independence of corporate business and corporate finance, and the safety of corporate assets, are also the important issues of corporate governance (OECD, 2004).

But from the perspective of institutional economics, corporate governance means more. Hart (1995b) emphasized the importance of control structure in corporate governance. He based the analysis on the theory of incomplete contract. His research pushed forward the studies of corporate governance and was helpful for people to understand corporate governance from the perspective of economics, rather than from the perspective of law. Shleifer and Vishny (1997), Becht et al. (2002), studied corporate governance from the perspective of the protection of investors' interests, and found that good corporate governance usually involved a set of institutions to protect investors' interests. Tirol (2001) developed an economic analysis of the concept of shareholder value, described its approach, and discussed some questions including monitoring structure, control structure, and managerial incentives. He pointed out that the traditional shareholder value approach is too narrow for an economic analysis of corporate governance, and defined corporate governance as the design of institutions that induce or force management to internalize the welfare of both shareholders and stakeholders.

It is meaningful to explore who will be liable to harm shareholder welfare. Existing literature finds that insiders are liable to promote their own interests instead of investors' interests. Studies by Hall and Murphy (2002) showed that the CEOs' compensations of some American companies increased by two fold in the period of 1994 to 2001, a figure much higher than the increase of the performance and the shareholders' return. This means managers are more interested in increasing their own interests instead of shareholders' interests. They also found that executives sometimes misled investors through accounting manipulation. Bergstresser and Philippon (2005) found that the executives in some large companies manipulated the stock price through accounting fraud and

exercised the stock option favourably in order to increase their own interests. These activities undoubtedly are harmful to shareholders' interests and hurt the best practices of corporate governance.

It was the Cadbury Report published in the early 1990s that aroused the global attention to corporate governance. Cadbury Report believed that the bankruptcy of some companies listed in the stock market resulted from specific problems related to the corporate governance of these firms. The report held that in order to improve corporate governance of the firms in the UK, it was necessary to intensify the role of the board of directors, to establish auditing committee and to increase the number of the outside directors. The Greenbury Report was published in 1995, raising the suggestions about the reform in executive compensations and the promotion of transparency. This report is another very important piece of literature on corporate governance.

Many studies on the function of the board of directors and its check on executives have been conducted since then. Bebchuk and Fried (2004) found that the boards in many companies collaborated, sometimes even colluded, with executives, and were liable to convey interests to each other instead of promoting shareholders interests. The boards did not monitor the executives effectively but were more interested in pleasing executives in order to be reappointed. The boards might help the executives to block M&As which would challenge their positions. Yermak (2004) found the poor corporate transparency was very harmful to corporate governance. This means information disclosure should be enhanced in order to protect investors' interests and to obtain the trust of investors. Transparency is of course a very important standard of good corporate governance.

Blair (1995) held that corporate governance should cover a wider scope. She argued that corporate governance should be regarded as an integrated organism which governs the distribution of the enterprise controlling powers and risks as

well as the guarantee of the employees' interests. She emphasized in particular the importance of employees who are the enterprises' stakeholders, and pointed out it is very important to safeguard the interests of employees for the long-term and healthy development of the enterprises. Since then more scholars accepted her assertion. O'Sullivan and Lazonic (2005) analyzed the crucial standing of insiders, they argued that the rights of insiders should be more enhanced in corporate governance.

## **2.4.2 Shareholding Structure and Corporate Governance**

Shareholding structure is undoubtedly one of the major research issues for corporate governance. Apart from the initial studies of the relationship between ownership structure and agency cost by Jensen and Meckling (1976), some other scholars conducted in-depth research on corporate governance from the perspective of shareholding structure. Many people thought that shareholding structure has a direct impact on firm value and the effectiveness of corporate governance. Morck et al. (1998) believed that the disagreement between the decisions made by the managers and the interests of outside investors was very common and when the managers' shareholding proportion increased, the agreement between the managers' interests and the outside shareholders' interests would gradually be raised. The empirical studies by McConnell and Servaes (1995) showed that the proportion of the shares held by insiders was highly related to Tobin's Q. Cho (1998) also made empirical studies and came to the conclusion that firm's value was closely related to insiders' shareholding proportion.

Other scholars studied the relationship between shareholding structure and the effectiveness of corporate governance from different perspectives. Many economists viewed the impact of shareholding concentration on corporate governance as an important issue. The shareholding concentration differs widely

by countries, it is very high in some countries and very low in other countries. Franks et al. (1996) found that a number of large companies in many continental European countries including France, Germany, Italy and Sweden, had high shareholding concentration. This was very true in Italy, where more than 50% of equity for most listed companies was held by one particular shareholder, and the position of small shareholders in corporate governance was very weak. Holderness and Sheehan (1988) made comparative studies on the listed companies with a particular shareholder grabbing the controlling powers and the listed companies with ownership diversification. They found the company performance did not have any direct relation with shareholding structure and believed it was hard to say ownership diversification or shareholding concentration had any material impact on corporate performance or corporate value. Faccio and Lang (2002) analyzed statistically the shareholding concentration ratio of the companies with a sample of 5,232 listed corporations in thirteen Western European countries, and found that 54% of these companies had only one large shareholder with strong control over the company. Claessens et al. (2000) conducted similar statistical analysis on 2,980 listed companies in nine Eastern Asian economies, found that those companies also had a high shareholding concentration ratio, more than half of those companies had only one large shareholder who strongly controlled the company affairs. But La Porta et al. (1998) found that the listed companies in the US and the UK had a much lower shareholding concentration ratio in comparison with Eastern Asian companies and continental European companies, and it was difficult to find a large shareholder who controlled the company affairs in the listed companies in the US and the UK. In contrast, the executives usually controlled the companies. Economists are also concerned about the correlation between the shareholding concentration ratio and corporate performance, but research conclusions differ enormously. Holderness and Sheehan (1988) conducted comparative studies on the listed companies with and without the controlling shareholders and found that there was no noted correlation between shareholding concentration ratio and

corporate performance. But studies by McConnel and Servaes (1990) showed that corporate performance was strongly correlated to shareholding concentration ratio, the corporate value was related not only to the shareholding concentration but also to insiders' shareholding proportion. They argued that corporate performance was correlated to shareholding structure.

From the above literature review it can be found there are different views about the correlation between corporate governance and shareholding structure. Furthermore, the definition of shareholding structure in the above literature is also different. It refers to the proportions of the equity held separately by insiders and outside investors in some literature, but to the concentration of the equity held by a particular shareholder in other literature. All those understandings of shareholding structure are different from the definition of shareholding structure in this thesis.

### **2.4.3 Ownership Attribute and Corporate Governance**

Alchian and Demsetz (1972) studied the difference between socialist and capitalist enterprise. They found that the supervision cost of socialist enterprise was very high due to the laziness and inadequate incentives of the management. Boycko et al. (1996) made theoretical discussions and modelling analysis on privatisation. They believed that only privatisation could solve the problems of the laziness and corruption of the management. Through privatisation the corporate operation could be quickly commercialised. Shleifer (1998) further illustrated the significance of privatisation. He argued that it did not stand for the state to adhere to state ownership under the excuse of realising social goals. He held that some of the social goals should be shouldered by the government itself instead of by SOEs. He claimed privatisation could greatly improve efficiency and help alleviate the financial burden. Allen and Gale (1999) conducted studies on the correlation between corporate governance and competition. Although their

studies did not touch ownership attribute, they implied that state ownership was not helpful in establishing a competitive market or in improving corporate governance.

Some Chinese economists have paid good attention to China's SOEs reform from the perspective of ownership attribute and corporate governance. Zhang, Weiying. (1994) made a systematic analysis on the principal-agency relationship of China's SOEs. His research indicated that the decentralization of the state sector could be helpful to enhance the incentives of the management. He summarized the features of the principal-agency relationship for China's SOEs into two caste systems: the authorisation chain of the first caste system is from the initial principal to the "central" principal with an upward principal-agency direction; the authorisation chain of the second caste system is from the "central" principal to the insiders of the enterprise (final agent) with a downward principal-agency direction. Apart from the initial principal and insiders, each person in the two chains has dual status of both the principal's agent and the agent's principal. His research indicated that the supervision activism of the initial principal and the working endeavour of the final agent will decrease with an increased degree of public ownership and increased size of public ownership within the economy. Decentralization of the public ownership will increase the supervision activism of the initial principal and the working endeavour of the final agent. He held that this conclusion can explain why the decentralisation in terms of the SOEs reform can promote the efficiency of the SOEs. His studies did not give adequate illustrations, however, to the issues related to corporate governance. Qian, Yingyi (1994) made a special study on corporate governance in China's SOEs reform. He illustrated the changes of the governance structure of China's SOEs since the 1980s, found that a large share of controlling powers and residual claims of SOEs had been transferred to the managers through decentralization. On the basis of that, some informal privatisation occurred, that led to insiders' control. By informal privatisation, he referred to the fact that when the government was

the nominal owner, the managers received high income through the contracting or leasing system without being responsible for any losses. In other words, when the nominal ownership was not changed, the managers obtained lot of interests from the SOEs by employing their controlling powers. He also believed that the informal privatisation and the insiders' control in China were not as serious as in Russia or Eastern Europe. One reason for this was that the Chinese Communist Party, as the ruling party, still had the final decision-making power for the appointment and removal of the SOEs' managers. Therefore, the party's power on the managers' appointment and removal was an important force to check the insiders' control. However, the party did not depend on the managers' economic performance as the criteria for appointing and removing the managers. He considered that China's SOEs options for ownership reform and corporate governance improvement should include the following methods: the small-sized SOEs should be sold to the mangers and employees and some of the large- and medium-sized SOEs should take in some foreign capital and turn into joint ventures. With regard to other large-sized and medium-sized enterprises where corporate governance improvement would be difficult, the non-banking financial institutions and banks should play their roles in the governance reform of the SOEs. Aoki (1994), a Japanese economist, came up with the proposition of "checking the insiders' control". He held that the corporate governance reform of the SOEs during the transitional period meant that some of the conditions inherited from the planning economy had a major impact upon corporate governance reform. In the planning economy, the management of the SOEs was appointed by the government, and during the transitional period the ownership of the SOEs would undergo some changes and the government would no longer hold the power for the appointment and removal of the SOEs managers. Through analysing the cases in Russia and Eastern Europe, Aoki pointed out that the insiders' control was a common issue during the transitional period. He suggested that in order to check the "insiders' control" and to improve the

corporate governance, one option was to play the role of the banks and other financial institutions as the outside supervisors.

However, the research jointly conducted by Kang and Stulz (1998) found that the Japanese banks did not do much to improve the corporate governance of Japanese enterprises. On the contrary, they provided unnecessary loans for enterprises bogged down in financial difficulties. The studies by Weinstein and Yafeh (1998) found that the Japanese main banks did not play the expected role in improving corporate governance and caused the banks and the insiders to join their hands in resisting corporate restructuring.

Even by the end of the 1990s, many Chinese economists still focused on how to make use of the outside financial institutions to check the “insiders’ control”. Wu, Jinglian, et al. (1998) held that the issue of “insiders’ control” during the process of SOEs reform stood side by side with the non-implementation of the autonomy of enterprises. They suggested that China should allow banks to hold some shares of the SOEs. Their studies also touched upon the relations between the “new three committees” and the “old three committees”. The “new three committees” refer to the general meeting of shareholders, the board of directors, and the board of supervisors, while the “old three committees” refer to the party committee of the CPC, the workers’ congress, and the trade union. But since entering the 2000s, more deep-going studies have been conducted on the issue of corporate governance in SOEs reform. Tenev and Zhang (2002), the experts from the World Bank, were also highly concerned about the conflicts between the “new three committees” and the “old three committees”. They carried out surveys mainly on ownership-diversified enterprises and found that, even if the ownership structure had realized a certain level of diversification, the conflicts between the “new three committees” and the “old three committees” were still very serious. They also found that the power boundaries and decision-making procedures were not very clear and the literal powers and decision-making

procedures became a mere formality. Under many circumstances, corporate governance was still associated with the traditional methods and means. For instance, party meetings or management meetings still occupied an important place in decision-making while the position of the board of directors was still weak. In spite of the realisation of ownership diversification, the relationship between the enterprises and the government did not have any substantial change. The government still kept some key powers, including the power for the appointment and the removal of the management. The government still played the role of the arbitrator for the internal conflicts of the enterprises. To some extent, the management and the staff were pursuing the government's intervention because they did not want to free themselves from the patriarchal protection by the government. Zhang, Chunlin. (2003) further claimed that it was necessary to establish a board of directors system in compliance with the international norm and to rely on the board of directors.

Some scholars conducted studies on the issue of corporate governance of privatised SOEs in transitional countries. Boycko et al. (1994) conducted an empirical study on the privatisation in Russia. Their research indicated that, in comparison with the voucher privatisation in Russia, the privatisation in Eastern Germany and Hungary was more successful for raising the efficiency of corporate governance. Estin and Wright (1999) made a comparison between the privatisation of Ukraine and some other countries. They held that it was recommendable to sell enterprises directly to outside investors.

Boycko et al. (1996) sharply pointed out that the successful realisation of the ownership reform of SOEs was not as simple as transferring the ownership to non-government institutions or individuals. They believed that this process should include two transfers: first, the decision-making power should be transferred from the government to the professional management so that the management could make commercialised decisions and could undertake

accountabilities for the performance; second, the controlling powers for cash flow should be transferred from the government to the professional management and social shareholders so as to form a rational incentive mechanism. It is obvious that they are highly aware of the importance of corporate governance for SOEs ownership reform. Sachs et al. (2000) held that, apart from the necessary ownership transfer, the basic market competition system and market rule system were also crucial to establish the framework for corporate governance. D' Souza et al. (2001) also conducted some empirical studies on privatised enterprises, concluding that while ownership was transferred, it was necessary to substantially restructure the enterprises and to establish proper corporate governance. Kim, T. K. (2003) took the privatisation of some Korean SOEs as the example, indicating that the successful reform of SOEs depended on the proper corporate governance, the diversified ownership structure, and the professional management.

It can be found that the issue of corporate governance in SOEs ownership reform has been highly raised. It is quite clear that the establishment of good corporate governance is crucial during the process of SOEs ownership reform.

#### **2.4.4 The Corporate Governance of Mixed Ownership Enterprises**

Many economists are concerned about the corporate governance of China's enterprises as those enterprises are becoming more and more commercialised. Clarke (2003) tried to conduct some studies on the corporate governance of China's enterprises, but he just delineated the current conditions and pointed out how the political system might jeopardize good corporate governance. Shirley and Xu (2001) conducted some studies on the performance of China's enterprises and on the relationship between the enterprises and the government. Their studies are useful for people in understanding the corporate governance of China's

enterprises. Bai et al. (2004) conducted studies on the corporate governance of China's enterprises, but they only focused on listed companies. Pistor and Xu (2005) conducted studies on the corporate governance of listed companies in China, the sample included some state-controlled listed companies. Liu (2006) studied the corporate governance of China's enterprises from the perspective of law and politics, and pointed out that China's enterprises usually did not have enough transparency or clear enterprise-government relationship, and their transactions sometimes did not follow the law. Fan and Wong (2007) studied the corporate governance of some privatised SOEs in China and found that the managers of those companies were still controlled by the politically-orientated government. Aivazian et al. (2005) studied the corporatisation issue of China's SOEs and the corporate governance of those companies. However, these studies did not involve mixed ownership.

MOE is a special kind of enterprise. The distinctive ownership structure usually leads to distinctive corporate governance (Lin, 2000). But it is regrettable that existing literature hardly touches upon the corporate governance of MOEs. Only a few papers touching on the corporate governance of the MOEs in China were found. Tong, Dalin. (1986) may be the earliest economist in China to mention the corporate governance of MOEs. His article appealed that China's SOEs should be restructured to shareholding companies and should introduce some non-state equity. He further suggested that the board of directors should be established in these companies so that a new system could be set up. He argued that most of the directors should be the representatives of the shareholders, but some outside experts could also be appointed as directors. The State Economic and Trade Commission (1993) published an article putting forward the idea that the corporations in China should establish congress of shareholders and board of directors. But this article also emphasized that the function of the communist party committee in these corporations. The early literature on the corporate governance of MOEs usually focused on the functions of the board of directors,

board of supervisors, the congress of shareholders as well as the communist party organisations. In 1993, the first Company Law was enacted in China, there were no more legal obstacles of establishing board of directors and boards of supervisor as well as congress of shareholders. Latter on, some papers on the corporate governance of MOEs emerged. The paper by Li, Zhengtu. (2005) is one of them. However, this paper was short of basic academic regularity. The author asserted that he employed the theory of stakeholder as the basis of his studies and then argued that the stakeholders of MOEs should include the owners of factory buildings, the owners of money, the owners of human capital and the owners of market resources. He argued that the traditional company emphasizes the interests of shareholders, but the MOEs should emphasize the interests of stakeholders. Yao, Shengqun., and Ma, Jian. (2008) also studied the corporate governance of MOEs. They did some empirical studies, but the so-called ‘MOEs’ in this paper were actually listed companies. They talked about some traditional corporate governance issues such as insiders’ control, but no special issues about MOEs were touched upon.

In short, I found that little Chinese and English literature had touched on the corporate governance of MOEs. There are some articles in Chinese touching on the corporate governance of MOEs, but their academic regularity and academic value are quite poor.

## **2.5 Concluding Remarks**

This chapter provides a comprehensive review of the Chinese and English literature on ownership restructuring of SOEs and mixed ownership. It is found that the number of Chinese articles on mixed ownership has increased over time since the mid-1990s, but most of these articles focused on asserting the compatibility of mixed ownership with the socialist system, and on appealing the government to build up the political legitimacy of mixed ownership. There are

only a few articles that pursue the empirical research. There is hardly any English literature on the corporate governance of MOEs, only a few English papers are found but these papers focus on case studies. Studies on the factors driving the emergence of China's MOEs as well as the corporate governance of China's MOEs are an undeveloped land. However, plentiful literature on the relationship between corporate governance and ownership structure, and on the relationship between ownership attribute and corporate governance, is still enlightening although the definition of the ownership structure in the above literature is not related to mixed ownership.

## **Chapter 3**

# **The China Model of State-Owned Enterprises Reform and the Emergence of the Mixed Ownership Enterprises**

### **3.1 Introduction**

The background of the emergence of China's MOEs is its economic transition since 1978. It is impossible to understand the rise of China's MOEs if its economic transition is not understood well since most of the MOEs originated from the ownership restructuring of SOEs. Actually, SOEs reform has been regarded as the key task of the economic transition by the government.

Since the 1980s, economic transition has taken place in many countries, such as China, Russia, Eastern European countries and Vietnam, and SOEs reform was usually the top priority of the transition agenda. Interestingly, apart from the transitional economies, some other countries, including Western European countries such as Britain and France, Northern European countries such as Sweden and Norway, and many developing countries such as Brazil and Argentina, have also experienced SOEs reform since the early 1980s. With the exception of China and Vietnam (Vietnam copied China's reform), almost all of the above-mentioned transitional and non-transitional countries chose definite and planned path of privatisation in their SOEs reform. According to the studies by Kikeri and Nellis (2002), the worldwide privatisation movement advanced enormously in the 1990s. The ratio of SOEs output within GDP in middle-income countries stood around 11% in the mid-1980s, privatisation however pulled this ratio down to about 5% in 1997. The privatisation movement in low-income countries was even more aggressive. Studies by Chong and

Lopez-de-Silanes (2005) showed that the ratio of SOEs output in GDP in low-income countries was pulled down from about 15% to about 3% over the same period by the privatisation movement.

Nellis (1994) raised the question whether privatisation is necessary in the transitional process. It is widely believed that the worldwide privatisation movement was not accidental, though privatisation in Russia and Eastern European countries was caused mainly by the political quake. It is undeniable that the poor efficiency of SOEs has been criticised in the world. In the 1960s, Friedman (1962) criticised state ownership. The survey by the World Bank (1995) demonstrated the poor efficiency of SOEs. Boycko et al. (1996) argued that only privatisation could solve the problems of weak incentives and strong governmental interference. La Porta and Lopez-de-Silanes (1999) asserted the benefit of privatisation of SOEs. The studies by Megginson and Netter (2001) testified that the privatisation in some circumstances was very helpful for enterprises to operate by market rules. Studies by Megginson et al (1994) showed that privatisation was helpful in improving the performance of enterprises. Shleifer (1998) asserted that SOEs had many disadvantages and privatisation was undoubtedly necessary. It is fair to say, the worldwide privatisation movement is not only the result of the political changes since the 1980s, but also the result of the studies testifying the poor efficiency of SOEs.

China is an exception however. Firstly, the process of the SOEs reform in China is very long. The SOEs reform in China has lasted for more than thirty years to date, from 1978, without a conclusion. Secondly, China does not follow a definite and planned path of privatisation, although as a matter of fact many SOEs have been privatised since the mid 1990s. In fact, the government rejected privatisation for a long time after 1978. Thirdly, most transitional countries suffered drastic output decline after SOEs privatisation, but China's state sector survived and experienced output growth. While the non-state sector expanded

over time, the state sector still maintains one-third of the total industrial output nowadays. The present state sector in China however does not mean wholly-state-owned enterprises any more. As a matter of fact, most of the so-called SOEs are those enterprises with the majority of the equity owned by the state but some shares owned by non-state shareholders. Although there are still some wholly-state-owned enterprises, they usually have a strange organizational structure in which the parent company is wholly-owned by the state but the subsidiaries are MOEs.

In chapter 2 it is mentioned that privatisation is not admitted officially during China's transitional process, but the government has established a strategy of promoting mixed ownership. Promoting mixed ownership is undoubtedly the product of China's ideology and its politics. However, it remains unclear whether selecting mixed ownership is only due to the political obstacles of privatisation, or whether there are other some driving factors. Considering the fact that mixed ownership emerged in reality before it was justified and admitted by the government, there were certainly some other factors than the government strategy and the political system which had driven the emergence of the MOEs. This chapter reviews and analyses China's SOEs reform first, then explains the China Model of SOEs reform and ponders on the linkage between the emergence of China's MOEs and the China Model of SOEs reform.

## **3.2 The Formation of the China Model of State-Owned Enterprises Reform**

### **3.2.1 The Radical Reform in the Control of State-Owned Enterprises**

In 1977, the output of the state sector constituted about 80% of the total industrial output in China. Most of the SOEs produced goods according to the

state plan and the products were distributed by the government, while the profits should be remitted to the government and the possible deficits would be offset by the government. Workers were employed according to state plan while their salary and welfare were determined by the government. The literature (Dong, Furen., 1999) showed that the government began to accept the market mechanism in 1977. This was to encourage SOEs to increase the output and produce more manufacturing goods according to the market signal. These initial motivating policies played a pilot role for the following nationwide SOEs reform.

In response to the requests from six SOEs, the Sichuan Provincial Government at the end of 1978 agreed to conduct a trial reform program to grant those six SOEs some operational powers. According to the program, those SOEs were allowed to operate according to market demand and to retain certain profits for self-development and for workers' bonus. The implementation of the trial reform quickly led to the increase of the output. This trial program was called "delegating powers and conceding profits". The enterprises obtained the autonomy to manufacture more products and then retained some profits (Zhang, Dicheng., 2006). The policy of delegating powers and conceding profits belongs to the reform in the control of SOEs (the control reform). The early trial of the control reform of SOEs resulted soon in the increase of both output and workers' income, and then more enterprises and local governments followed automatically this new policy. The central government accepted this new policy later on. In July of 1979, the State Council, namely the central government, issued the Ordinance on Expanding SOEs Operational Autonomy. As a result, the policy of increasing SOEs autonomy was swiftly adopted nationwide. In 1984, the State Council issued the Ordinance on Further Expanding SOEs Operational Autonomy, stipulating that SOEs had ten items of autonomy including the decision of production, the sales of products, the purchase of raw materials, the outlay of retained funds, the disposal of assets, the set-up of internal departments, the employment of workers, the pricing of products, the determination of salary,

and the decision of business alliance (Dong, Furen., 1999). In 1992, the State Council issued the Ordinance on the Transformation of Operational Institutions of SOEs, stipulating SOEs had fourteen items of autonomy. The four extra items were the decision of investment, the decision of M&As, the rights of import and export, and the rights to reject unlawful charges (Dong, Furen., 1999).

The literature by the State Statistics Bureau (1998) showed that the policy of delegating powers and conceding profits had a very good effect nationwide. The output of the manufacturing sector increased enormously year by year, the profitability of SOEs and the income of workers also increased. It is fair to say that the control reform was very successful.

It is necessary to comprehend the background and the purpose of the policy of delegating powers and conceding profits in order to understand well the huge success of the control reform of China's SOEs. The background is that, after the Cultural Revolution during 1966-1976, China was suffering a severe shortage of manufacturing goods, the top priority of China's government was to increase the supply of industrial goods. The very purpose of SOEs reform at that time was to try everything possible to motivate the production of SOEs. Would this purpose be served by privatisation or granting autonomy? Even without ideological considerations, privatisation was not a suitable option.

For privatisation to occur, the expertise in corporate assets distribution, the financial markets, are indispensable. These were not very easy to come by at that time in China. Under the circumstances of the late 1970s and early 1980s, privatisation would also have led to grave uncertainty. If the SOEs were privatised, who would own the enterprises and how would the management be selected? What would be the arrangements for ordinary workers? Should the enterprises receive subsidies from the government or should the government let them go bankrupt when they made losses? These problems might be easily solved in the Western countries, but this was not the case with China, where

private ownership and market mechanism had not taken deep roots. In the process of transition, uncertainty was regarded as the critical and decisive issue to the success of the transition by Dewatripont and Roland (1995). They argued that the results of privatisation and liberalisation were not convincing due to the uncertainty of the progress and the effect. They went on to say that partial and trial reforms would produce information feedback in order for people to deal with the uncertainty to some extent and then to revise or speed up the reform program. The reform of delegating powers and conceding profits in China was a very good example of this. Sanders and Chen (2005) also argued that outright privatisation was not a good choice for China. The positive feedback of the trial reform in Sichuan Province and the huge success of the nationwide practice were very significant to the consequent reform of China's SOEs.

On the contrary, the policy of delegating powers and conceding profits would not cause much uncertainty. It was easy for the government departments, the managers and the workers to comprehend what results the control reform would bring to them: the government departments would see more supply of manufacturing goods, the managers would see more controlling powers and more cash flow, and the workers would see higher income although they might work harder. Although the state ownership was not touched, the revolutionary significance of the control reform at that time is beyond doubt. Studies by Groves et al. (1994) showed that the autonomy reform was very useful in providing motives and initiatives for managers and workers. Studies by Hay et al. (1994) showed that the autonomy reform in the 1980s in China promoted competition and improved incentives, although the reform did not impact upon state ownership. In their book "Comparative Economic Systems: a Decision-making Approach", Neuberger and Duffy (1985) created a DIM analytical framework to examine economic systems from the perspectives of decision-making, information and motives. When using the DIM framework, it is easy to identify the institutional changes spurred by the control reform. Firstly, the control reform

enabled SOEs to gain certain autonomy of decision-making that was previously gripped by the government. On this basis, SOEs could respond to market information, meaning price signals began to matter and market mechanisms came into force. Moreover, against the backdrop of the severe shortage in manufacturing goods, enterprises could effortlessly develop their business in the market. With more autonomy, SOEs began to enjoy economic gains, to retain more profits and increase employees' income. In this way, the initial reform in the control of SOEs brought in positive feedback effect, which spurred the enterprises to ask for more autonomy.

However, the positive effect of delegating powers and conceding profits gradually diminished over time. The substance of delegating powers and conceding profits is the contracting between the SOEs and the government. Hart and Moore (1990) found that the incompleteness of contracting and argued that ownership matters. That implies the SOEs reform based on contracting must lead to renegotiation between the SOEs and the government, and the struggle between the SOEs and the government can not be solved by contracting itself. Renegotiation first resulted from the struggle of the profits conceding of SOEs. As the initial trial of profits concession was impossible to be stipulated for a reasonable ratio, two or three years latter, the government found that the profit retention in SOEs and the income of the workers increased rapidly but the government revenue stopped increasing from 1979 to 1982. The government then asked to renegotiate with the SOEs about the profit distribution (Dong, Furen., 1999). In 1981, the State Council issued the Ordinance on the Economic Responsibilities System of Industrial Production. The so-called 'economic responsibilities' here were actually the responsibilities of the remittance of SOEs' profits. This ordinance stipulated that the SOEs had to guarantee the remittance of the profits by way of a profit sharing program. In 1984, the State Council decided to carry out a new trial policy of transforming profits to taxation (Dong, Furen., 1999). In 1986, the State Council launched the contracting and leasing

system (Dong, Furen., 1999). The core of the contracting system was to regulate the submission of SOEs profits. The SOEs had to submit a fixed amount of profits to the state, the rest could be retained. The contracting system was a radical reform in the control of SOEs and led to increased autonomy of SOEs. The leasing system was even more radical, lessees were not obliged to submit economic residuals to the state. Although the contracting and leasing system overcame the problem of stagnant fiscal revenue, it could not handle the issue of the loss-making of some SOEs. The contracting and leasing system went to the end in 1993. After the contracting and leasing system, the radical control reform still continued in other ways.

Although the contracting and leasing system belongs to control reform, this system began to touch upon the rights of the residual claims of the SOEs. According to Demsetz (1988), residual claims are related to ownership. In 1979, when the policy of delegating powers and conceding profits was launched nationwide, the distribution system of the SOEs' profits was not on the agenda of the government, who was too preoccupied with motivating the SOEs to increase the output. Afterwards, the residual claims of the SOEs were becoming the critical issue between the government and the SOEs. In the repeated negotiations with the SOEs' insiders, the state gained nothing, and the residual claims were gradually grabbed by the insiders under the cloak of the control reform. That means the control reform would lead to informal ownership reform.

However, not all the policies of radical control reform could be completely implemented at the local level. As a matter of fact, there has been a long-lasting dispute about the distribution of the controlling powers of the SOEs. On one hand, the government has always been making complaints that it had lost the total control on the SOEs and the insiders' control had been gone too far. But on the other hand, the SOEs have always been making complaints that the government had still been trying to interfere in SOEs' business. In reality, the

excessive delegating of the controlling powers could be interwoven with the inadequate delegating of the controlling powers. The radical control reform could transfer most items of the official controlling powers from the government to the managers of the SOEs and the governmental official control on the SOEs could gradually tapered off, but some of the government departments might seek to increase the unofficial control on the SOEs. On the whole though, the radical control reform facilitated the transfer of the controlling powers from the government to the insiders of the SOEs.

### **3.2.2 The Gradual Ownership Reform**

Although the government did not want to touch the state ownership, the ownership reform occurred spontaneously. Unofficial ownership reform was initiated by SOEs' insiders. By the mid 1980s, some small SOEs in retailing sector began experimenting with "degrading ownership", turning state ownership into collective ownership, and collective ownership into private ownership. According to Liu, Mingsan. (1985), by the end of 1984, the ownership of 55,892 small SOEs in the retailing sector had been degraded, accounting for 55.2% of the small SOEs in this sector. According to Changzhou Economic Restructuring Commission (1985), in Changzhou City of Jiangsu Province, the government turned 20% of the state-owned industrial enterprises, 80% of the state-owned retailing enterprises, 97% of the state-owned restaurants and 100% of the state-owned coal ball shops, into collectively-operational firms. Some nominal collective ownership enterprises were actually owned by the employees. Except for "degrading ownership", some SOEs also went for official ownership reform by issuing stocks. A typical case was Tianqiao Department Store of Beijing, which was turned into a shareholding firm in 1984. After the ownership reform, the state owned 50.0% of the total equity, a bank owned 25.9%, Tianqiao Department Store of Beijing itself owned 19.7%, and the employees owned 4.4%.

In the same year, Shanghai Feile Diansheng Factory issued stocks to the public for the first time in China.

Since the mid 1980s, Chinese economists have been calling for the official ownership reform, but the central government was not determined to launch the nationwide official ownership reform except for some local experiments. Privatisation was strictly forbidden. The 14th party congress held in the fall of 1992, spelled out the target of China's economic transition. This was to establish the socialist market economy (Jiang, Zemin., 1992). In 1993, the 3rd plenary session of the 14th party congress determined that the direction of China's SOEs reform is to establish the modern enterprise system featuring "clear property rights, well defined powers and responsibilities, separation of enterprises from government, scientific management" (The Central Committee of CPC, 1993). In the same year, the first Company Law of the People's Republic of China was promulgated. The declaration of establishing the modern enterprise system marked the first step of the official ownership reform for SOEs. Afterwards, the financial difficulties of the state sector in the mid-1990s prompted the official ownership reform. In the mid-1990s, more and more local governments began to carry out audacious ownership reform, the driving factor was that a great deal of SOEs fell into financial distress and became a burden to the governments (China Group and Company Promotion Association, 2003). Zhucheng City, Shandong Province, was one of the audacious localities. In 1993, many small and medium-sized SOEs in Zhucheng City were sold due to their running at a loss for many years. Ownership reform of the small and medium-sized SOEs in Zhucheng City was mainly done through insiders' privatisation, lots of the small SOEs were sold to the managers and the workers, usually at a preferential price.

The approach of the SOEs reform in Zhucheng City changed the roadmap of China's SOE reform, shifting the radical control reform to official ownership reform. The ownership reform of insiders' privatisation in Zhucheng City was

quickly copied by lots of localities across China. For the same reason, by the mid-1990s, most of the TVEs in Jiangsu Province went for insiders' privatisation, serving as another powerful example. In the late-1990s, the financial troubles of the SOEs intensified, which justified the privatisation of the small-sized SOEs and medium-sized SOEs. Correspondingly, outside investors were provided with more and more opportunities to buy SOEs or state shares, and then the privatisation towards outsiders officially went to the arena. From 1998 to 2000, lots of SOEs were closed and a great number of SOEs were ownership-reformed (Chen Qingtai, 2008). At that time, the mainstream pattern of ownership reform was partially privatisation for insiders, some portion of the shares of SOEs were sold to the management and employees. Also, some small SOEs were fully privatised.

Based on local experiments and pushed by local enthusiasm, the central government then decided to carry out the nationwide official ownership reform of the SOEs. The 15<sup>th</sup> party congress held in 1997 was a very important event for the ownership reform of China's SOEs. This conference called for the strategic restructuring of the state sector (Jiang, Zemin., 1997). Actually, the so-called strategic restructuring refers to the ownership restructuring in China. This call enormously expedited the ownership reform of China's SOEs. Small SOEs were allowed to be sold to both insiders and outsider investors, including private firms, individuals, and foreign investors. Medium-sized and large-sized MOEs were allowed to be partially privatised and be restructured into MOEs. According to the statistical data covering twenty-one provinces (State Economic and Trade Commission, 1999), by August 1998, 47,613 small and medium-sized SOEs were ownership-transformed. Among those 47,613 SOEs, 10,769 (22.6%) adopted cooperative shareholding system, 3,893 (8.2%) were sold in all, 3,470 (7.3%) were leased out, 2,197 (4.6%) were contracted, 2,982 (6.2%) were turned into joint stock companies, 2,098 (4.4%) were consolidated, and 1,340 (2.8%) were declared bankrupt.

The 15<sup>th</sup> party congress in 1997 called for the all-out development of shareholding ownership for the first time. In 1999, the 4<sup>th</sup> plenary session of the 15<sup>th</sup> party congress again declared that the state sector should be streamlined, and the state capital could withdraw from competitive industries, even medium-sized SOEs could be “let go”, large-sized SOEs could try ownership reform to be more activated. Afterwards, more and more medium-sized and large-sized SOEs were officially transformed into MOEs. Since entering the 21st century, the ownership reform has sped up, most of the small SOEs have been sold, and many large and medium-sized SOEs have been restructured into MOEs.

Since the ownership reform of China’s SOEs occurred on the basis of the long-term radical control reform, its ownership reform is path dependent. Path dependence is a concept initiated by North and Thomas (1973), it refers to the institutional evolution process that depends on the prior path. Before the ownership reform program, China’s SOEs reform had experienced the radical control reform, including the policy of delegating powers and conceding profits, and the contracting and leasing system. The radical control reform for long time conceded lots of controlling powers to the management and the workers of the SOEs, some of the conceded powers, say, the decision about recapitalization and dividend distribution as well as ownership restructuring, were also inappropriately held by the management and the workers. Namely, SOEs were insiders-controlled. Radical control reform accumulated enough driving force to start the insiders-favoured unofficial ownership reform and evolved to gradual official ownership reform. Consequently, when ownership reform occurred, ownership reform program was usually mastered by the management and the workers because the ownership reform process depended on the prior control reform process. It is imaginable that the ownership reform proposal would naturally be resisted or sabotaged by the management and the workers if it was not mastered by and then not desirable with the management and the workers. That is the power of path dependence. As a result, the ownership reform in China

often leads to insiders' shareholding. Many SOEs, especially small and medium-sized enterprises, were bought out by the management at preferential price, this approach is called MBO in China. Actually, some of them were bought out jointly by the management and the employees, this approach is called EMBO. MBO and EMBO are the major patterns of ownership transformation for small and medium-sized SOEs. Although the insiders' buy-out of SOEs also occurred in some other countries such as Poland and Russia, the insiders-mastered ownership reform was more obvious and lasted for longer time in China.

The ownership reform since the late 1990s also catalysed the reform in workers' employment status of SOEs. Employment status transformation is quite unique and extremely significant in China's SOEs reform, the same reform can not be found in other transitional countries. The employment status transformation was not designed and promoted by the government, but occurred spontaneously. In the era of planning economy prior to the 1990s, Chinese SOEs had to apply to the governmental labour administrative department for planned quota when recruiting employees, who actually received permanent employment status upon entering the enterprises until their retirement. All managers were appointed by the party or the government departments, and enjoyed the status of "state cadre". The wage of SOEs' employees also had to get approved by government. In the era of planning economy before the 1990s, the employment status of the workers and managers in SOEs can be generalized as the "three irons": the iron rice bowl, the iron chair, and the iron wage. Iron rice bowl means workers enjoy the permanent employment without the possibility of firing, iron chair means managers can keep their positions without the possibility of demotion, and iron wage means workers should receive their standard wages on time even if the enterprises are out of funds. In addition, the status of the employees in SOEs brought a sweeping welfare system and traditional security system, the apartments of SOEs workers were provided by SOEs, their medical expenses were fully reimbursed by SOEs, their heating expenses in winter were subsidized

by SOEs, and some SOEs might also have welfare kindergartens, elementary school and middle schools free of charge. Moreover, Chinese government might often issue red-headed documents to provide for the welfare of SOEs employees, such as transportation allowance, housing allowance, or allowance for buying books and newspapers. Employees enjoyed corporate security but not social security, the retirement wages of SOEs' employees were paid by the enterprises instead of social pension system, and their medical expenses were also reimbursed by the enterprises instead of social security system. While ownership reform occurs, the new private shareholders usually request that the employment status of SOEs' employees should be transformed at the payment of compensation fees. The transformation of employment status usually means that the permanent employment is transformed to contractual employment, employees' retirement wages and medical reimbursement are transferred to the social security system, and the employees' welfare burden extended from the era of the planning economy should not continuously be assumed by the enterprises after the ownership reform. However, workers are usually unwilling to be status-transformed unless the acceptable compensation fees are paid to them. Thus the employment status transformation is costly. Compensation fees greatly increase the cost of ownership reform, and the payment of compensation fees become a very uncertain factor impacting the progress of the ownership reform of China's SOEs. As the ownership reform in China usually involves not only ownership transformation itself, but also employment status transformation, ownership reform is also called systematic transformation (Gai Zhi) or dual transformation.

Dual transformation means ownership reform involves two aspects. One is to introduce non-state capital to SOEs, including partial and full privatisation. The other is to transform the employment status from the traditional status of permanent employment and the non-pensioned retirement treatment to contractual employment and pensioned retirement treatment.

### **3.3 Defining the China Model**

China's SOEs reform has taken a unique path and unique measures, formed a special model over the three decades. However, how to define and identify this uniqueness is not easy. There has been a huge division about it in the literature. Ramo (2004) argued in his famous article "Beijing consensus" that China's transitional experience repudiated the traditional transition model featuring privatisation. Yusuf et al. (2006) on the other hand, argued that China's SOEs reform since the late 1990s involved privatisation. Interestingly, Sanders and Chen (2005) pointed out that "fuzzy property rights" served China well. I think the uniqueness of China's SOEs reform should not be identified only by privatisation or non-privatisation. The experiments and experiences over the last three decades have formed the China Model of SOEs reform. On the basis of these experiments and experiences, I define the China Model of SOE reform in the following aspects.

First, the China Model means pragmatist doctrine, radical control reform and gradual ownership reform. The success of the policy of delegating powers and conceding profits led many people to believe that the Chinese people have outstanding wisdom to replace ownership reform with radical reform in controlling powers. The reform was largely guided by pragmatic thinking. Over a long period of time, China's SOE reform sought to resolve the urgent practical challenges, rather than to determine a specific ultimate goal. The pragmatist-oriented reform produced prompt and positive results in each stage of the reform progress because the reform measures were able to resolve the urgent problems. As Hay and Liu (1997) pointed out, the introduction of competition was very helpful in improving SOEs performance, even without the ownership reform in the early stage of China's SOEs reform progress. Pragmatist, however, usually leads to opportunist, which was confined to overcoming pressing dilemma without taking a long-term perspective to root out deep-seated problems.

That is why each round of reform gave rise to new problems requiring further rounds of reform. Pragmatist thinking and the shunning of ownership reform went hand in hand and reinforced each other. The ownership reform progress has been very gradual. Ownership reform started with small SOEs and gradually spread to medium-sized and large-sized SOEs, started with insiders' shareholding and gradually spread to outsiders' shareholding, started with small proportion of private shareholding and gradually spread to large proportion of private shareholding.

Second, the long-standing radical control reform spontaneously evolved into the long period of gradual ownership reform, which led to the path dependence of the ownership reform progress and to the massive insiders' shareholding. Before the official ownership reform program, China's SOEs reform had experienced the long-term radical control reform. The long-term radical control reform brought the SOEs to a situation of insiders' control. While ownership reform occurred, the management and workers were usually able to master the ownership reform proposal, and insiders' shareholding proposals were more likely to be accepted. MBO and EMBO were greatly welcomed by the management and workers of the small and medium-sized SOEs. Even if the SOEs were sold to outsiders, the ownership transformation proposals had to be approved by the insiders.

Third, the SOEs reform cashed in on the competition effect and the demonstration effect of the ever-growing non-SOEs. Since the SOEs reform has been very gradual and moved along for long time, the non-state sector has enough time to develop to larger and larger scale. That is not the case with most of other transitional countries. The good performance of non-SOEs served as an example for SOEs and helped the government introduce market rules to SOEs. The epidemic of the contracting and leasing system in TVEs, as well as the MBO experiments in TVEs, directly produced the demonstration effect for the SOEs. The rise of private firms and TVEs also drove the SOEs into increasingly fierce

competition, many SOEs were trapped in the financial difficulties, the fierce competition brought about tremendous pressure on SOEs. The rise of non-state sector also provided buffer effect for the ownership reform. From 1998 to 2003, a great number of SOEs experienced ownership reform and financial restructuring. The data from the State Statistics Bureau and Ministry of Labour and Social Security (2005) showed that 309 millions of SOEs' workers were laid-off during this period. Many of these workers were re-employed by non-state enterprises. According to Ren, Wenyan. (2004), the Vice Chairperson of the National Association of Industries and Commerce, from 1994 to 2004, the number of re-employed workers by private enterprises for each year was as high as 100 million. When the private sector grew up, it provided not only competition effect and demonstration effect, but also other resources, say, employment opportunities and investment funds, to support to the restructuring of the state sector (Wang, Mengkui., 2003).

Fourth, the ownership reform is usually combined with the employment status transformation. The prevalence of dual transformation in China is very creative. Radical control reform and gradual ownership reform incurred huge costs. According to Chen, Qingtai.(2008), the reform costs of SOEs include two aspects: reorganisation cost, and privatisation cost. The funds for offsetting SOEs' bad loans reached 20 billion Yuan in 1996, and rose to 30 billion Yuan in 1997. The above is just a small part of the reorganization cost. Privatisation cost is mainly the payment for the placement of laid-off workers, the compensation fees of employment status transformation. Although the privatisation in other countries is also costly, the composition of the costs in China is much more complicated. Moreover, China's long odyssey of SOEs reform increases these costs enormously.

The existing literature about China's SOEs reform is very fluent, and some authors have analysed the characteristics and uniqueness of China's SOEs reform

(Lin, et al, 1998; Gu, 2001; Mengistae and Xu, 2004; Yusuf et al, 2006; Garnaut et al, 2006), including the competition, the radical control reform and gradual ownership reform, the incentives to managers. Nevertheless, it is still necessary to summarise and clarify these characteristics. Moreover, it is valuable to define the China Model of SOEs reform on the basis of refining the existing findings and exploring new findings. My definition of the China Model of SOEs reform is unprecedented not only because I combine the above 4 aspects together, but also because the analysis of the employment status transformation and the reform cost is original. Employment status transformation is unique and extremely significant in China's SOEs reform, no existing literature did notable studies on it and counted it in while addressing the characteristics of China's SOEs reform. The employment status reform has big impact on the institutional arrangements of MOEs' corporate governance which I will discuss in chapter 6 and 7. Besides, my definition of the China Model of SOEs reform includes the path dependence of the ownership reform of China's SOEs, and it is pointed out that the path dependence lead to strong insiders' mastering in the ownership reform and then the intense insiders' shareholding. This analysis is also original.

### **3.4 Mixed Ownership Is Rooted in the China Model**

The China Model brought about the emergence of MOEs. One aspect of the China Model is the gradualism of the ownership reform. Roland (2000) argued that the gradual ownership reform was helpful in smoothly commercialising China's SOEs. Yusuf et al. (2006) studied the progress of China's SOEs reform and found that gradual ownership reform was the unique feature. Gradualism implies that the ownership reform approach for many SOEs is not the outright full sale, instead the correct approach is to diversify the ownership structure and gradually decrease the proportion of state ownership. As a result, mixed ownership emerges. Gradualism also implies that the ownership reform generally starts with small SOEs before spreading to large SOEs, the latter is liable to

adopt mixed ownership. Even for the former, its ownership reform usually happens to insiders, and the insiders are short of funds to fully buy out the SOEs, resulting in mixed ownership. TCL Group Company, a famous Chinese company, experienced a long and gradual ownership reform, which introduced both the insiders' capital and the outsiders' capital step by step, and became a MOE. Even now, the local government still has some shares in this company.

In order to contain the future business uncertainty of the ownership-reformed SOEs and to reduce the ideological risk, it is an important strategy for the government to maintain large enterprises in mixed ownership. Therefore, most MOEs maintain their mixed ownership structure for long time instead of short time, and the government does not have any clear plan to fully privatise the MOEs. Generally speaking, mixed ownership can build up a relatively opening ownership structure, so that the long-term tendency is that the state shareholding proportion will decrease over time while the non-state shareholding proportion will increase.

### **3.5 Why Did the China Model Occur the Way It Did?**

Why did this model emerge in China? As stated in the previous paragraphs, the direct purpose of China's SOE reform in the early stage was to promote SOEs enthusiasm in order to tackle the shortage of manufacturing goods at that time, which was based on the pragmatic reform thinking. Therefore, it is understandable why the policy of delegating powers and conceding profits was a reasonable option. But why did the control reform last for such a long time? Why was the ownership reform so gradual? It must be remembered that ownership reform was put forward by Chinese economists in the mid and late 1980s (Dong, Furen., 1987) while some local small enterprises were also experimenting with privatisation-oriented ownership reform at that time (Liu, Mingsan, 1985). Meanwhile, the ownership reform of SOEs had not yet begun in the Soviet Union

or Eastern Europe. The following explanations make sense: ideological restraint, pragmatist doctrine, and too much scruple about uncertainties and risks, were the foremost factors in shaping the China Model.

Given the ideological restraint, emancipating the minds was particularly important for China's SOEs reform. Pragmatist thinking derives from China's profound cultural tradition. Deng Xiaoping was a typical pragmatist. It seems pragmatist thinking led China's SOEs reform to a world where there were only winners, but no losers (Lau et al. 2000), and the problem-solution-oriented reform was highly praised (Studwell, 2002). Although pragmatism was good, its efficacy in the initial period of reform backfired, as it became ossified. Pragmatism is actually opportunism, which means the perfunctory policy orientation. Too much caution about uncertainties and risks dominated the process of China's economic transition. As an underdeveloped country, China needed the reform that could promote the economic development and eliminate the poverty. Would privatisation effectively promote the economic development and yield good results immediately? The answer may not always be yes. On the contrary, the reality may be embarrassing: after radical privatisation reform, Russia and Eastern European countries experienced years of recession. Dewatripont and Roland (1995) argued that the direct result of radical privatisation and liberalisation is indeed uncertain, the result may be output increase, but may easily be the opposite. Sachs et al. (2000) conducted empirical studies on over twenty countries, and found that besides ownership transfer, market competition, good regulation system and good corporate governance all matter to the efficiency improvement and the economic growth. Liu, Shaojia., and Li, Ji. (1998) explored the confines of privatisation from the perspective of beyond property rights argument. They asserted that property rights arrangements were not versatile and privatisation could not help improve their performance without a competitive market environment. They argued that there were three basic factors that influence market competition, the first was the

contestability of enterprises' target, the second was the cost of default and the benefit of cooperation, the third was the asymmetry among enterprises. They asserted that competition was not only based on private ownership, creating a competitive market had nothing to do with private ownership. Vining and Boardman (1992) got similar findings from their studies. Wallsten (2001) also conducted studies on the impact of privatisation and competitive market on the performance of enterprises. Vickers and Yarrow (1991) studied privatisation from a macroeconomic perspective. It has been shown that the correlation between privatisation and enterprise performance is very complicated (Harper, 2002), many factors, including privatisation and market competition, will impact upon enterprise performance. Many studies have emphasized the complexity of the effect of ownership reform in transitional economies (Otchere and Zhang, 2001; Pohl et al, 1997; Sachs and Woo, 1997). In comparison with other countries such as Russia and Eastern European countries, China tends to deliberate more before taking a reform action: will it mobilize the enthusiasm and achieve its expected purpose? What kind of measures will increase certainty and reduce uncertainty? At the inception of launching the policies for the rural household contracting system and the control reform of the SOEs, these questions actually had ready answers, which could be retrieved from the memory of farmers, enterprises managers and government officials. These policies were once adopted in the 1950s and early 1960s and proved successful. The actual results of these policies in the 1950s and the early 1960s were output increase and fast growth. In the mid-1980s, odd privatisation transactions occurred in China, but these transactions mainly happened in retailing and services sector. The main cause was in the 1950s those firms in retailing and services sector were usually privately-owned. That exactly illustrates that the selection of reform measures in China were guided by memory and empirical knowledge, instead of theory and book knowledge. However, after the initial stage of reform, further answers could not be retrieved from the past experiences, and had to draw on the international experiences and theories. In addition to ideological disputes, the

scruple about uncertainties and risks was a very important factor. China once experimented with radical pricing liberalization in 1988, but the result was an unexpected inflation that doomed the big-bang price reform into a complete failure. Without doubt, the unpleasant memory of this reform kept both the public and the politicians alert to a new system.

A big uncertainty about ownership reform of the SOEs was the strong resistance to privatisation from SOEs workers in China. They stuck strongly to the permanent employment status of SOEs, known as the iron bowl, and enjoy the master role of the SOEs. For the promoters of ownership reform, the risks came not only from the uncertainties of its results, but also from the political system, the social environment and the corruption in the reform process. Ownership reform is liable to bring up corruption and state assets loss as well as unemployment, all these will cause risks. Nevertheless, China has a delicate way of reducing uncertainties and risks, that is to allow a few who are willing to take risks, to conduct a regional experiment, so as to see the result and test how the bureaucratic system and the public react (Chen, Qingtai, 2008). Experimenting is deemed as a good approach (Roland, 2000). Fortunately, the fact there were numerous SOEs across many regions, made regional tests possible. With the state sector trapped in growing financial problem in the 1990s and pushed by the momentum of insiders' ownership reform, ideological restraint, ossified pragmatism, and scruple about uncertainties and risks, all weakened. It is the combination of these factors that nurtured the China model.

Although the scruple about uncertainties and risks protracted the process of SOEs reform, it did help increase SOEs output and stimulate the economic growth. Sustained growth of the output was realised during the ownership reform process. The China model, which may have various flaws, minimized the sense of uncertainties for SOE insiders, thereby effectively avoided a decrease in output. Radical privatisation would surely lead to fears and loss of future

expectations for SOEs. Sudden privatisation would make insiders feel worried: they did not know who would be their bosses, whether they would keep their job or how much they would earn in the future. As Arrow (1984) revealed in his study, personal choices under uncertainties are very difficult and may involve questions such as non-cooperative game, and shirking may be the workers' best option. The China model adopted certain measures, such as the policy of delegating powers and conceding profits, the contracting and leasing system, so that insiders could clearly calculate how much they would gain after an increase in output. Hence, workers would work hard, leading to higher output. Even during the gradual ownership reform in the mid and late 1990s, output growth and improved performance were widely reported. Moreover, gradual ownership reform led to insiders' shareholding, which decreased the uncertainty sense of insiders. Even if outsiders' shareholding occurred, in many instances the ownership reform proposals should be approved by insiders. Even for those SOEs without ownership reform, the output growth has still maintained. One reason is the incentive mechanism of delegating powers and conceding profits still works, and the improved calibre of the entrepreneurs of SOEs almost coincides with the development of China's market economy. Moreover, for those enterprises that superficially stick to state ownership, some degree of ownership reform has actually realised through devious ways such as the partial privatization of their subsidiaries, joint ventures and listing.

However, the output growth was realised at the cost of sacrificing social equity. Radical control reform increasingly shifted the balance towards insiders, whose interests eroded the profits. After 1993, SOEs even stopped submitting profits to the state. Gradual ownership reform led to tremendous reform costs. All these costs have to be borne by the public. Although pro-insiders ownership reform was a feasible option under the backdrop of path dependence, it still jeopardized the social equity.

### **3.6 Concluding Remarks**

As mixed ownership derives mainly from the ownership reform of China's SOEs, probing the process of China's SOEs reform and the features of the reform is necessary while studying the driving factors of the emergence of China's MOEs. It is found that in the past thirty-two years, the reform process has formed the distinctive China Model of SOEs reform. Mixed ownership is rooted in the China Model of SOEs reform.

## Chapter 4

# The Commonness Degree of the Mixed Ownership in China and the Mixture Degree

### 4.1 Introduction

As stated in chapter 1, during the process of China's SOEs restructuring and its GDP growth, a striking phenomenon is the emergence of the MOEs. The mixed ownership in many other countries usually exists in particular industries and in specific time period. This chapter analyses the commonness degree of the mixed ownership in China and the mixture degree of the MOEs, and shows that mixed ownership in China is indeed very common.

This chapter first outlines the conditions of the mixed ownership in some specific regions according to the existing documents, then analyses the commonness degree of the mixed ownership nationwide and investigates the mixture degree.

In this chapter two indicators are established. The first is commonness degree of mixed ownership, it is the percentage of the number of the MOEs against the total number of all enterprises in a specific sample. The commonness degree is denoted as  $P_m$ . The second indicator is mixture degree of a specific MOE or the MOEs in a specific sample, it is the quotient of the state shareholding proportion against the non-state shareholding proportion, or the quotient of the non-state shareholding proportion against the state shareholding proportion, the bigger proportion figure should be the denominator while calculating mixture degree so that mixture degree will be between 0 and 1. The closer the quotient is to one, the higher the mixture degree is. The mixture degree is denoted as  $Q_m$ .

## **4.2 The Conditions in Some Localities**

The conditions of mixed ownership in some localities have been examined by existing literature. Xu, Shangchang. (2006) found that 98% of the TVEs in Jiangsu Province during the late 1990s had been restructured to MOEs in which the non-state shareholders were usually the major shareholder. In 1997, the output of MOEs in Jiangsu Province accounted for over 40% of the local GDP. Until the end of 2003, 98.3% of all county-administered SOEs and urban collective enterprises had been ownership-reformed, 95% of which became MOEs. In 2005, the number of MOEs in Zhejiang Province reached 313,571, accounting for 61% of its total enterprises. Huang, Zhong. (2007) conducted studies on the commonness of mixed ownership in Zhejiang Province, but his definition of MOE included cooperative shareholding enterprises, other joint-operation enterprises, limited liability corporations, joint-capital and cooperative enterprises in the category of Hong Kong and Taiwan capital enterprises, and foreign enterprises. He found that the industrial value-added of MOEs accounted for 31.5% of the total industrial value-added of all above-scale industrial enterprises in 1998. He also found that between 2001 and 2004, the number of MOEs in this province increased from 42,000 to 240,000, accounting for 54.9% of total enterprises in 2001 and 59.4% in 2004. The revenue of these enterprises was 2001.1 billion RMB Yuan in 2001 and 3983.3 billion RMB Yuan in 2004, accounting for 66.4% of total revenue of all enterprises in 2001 and 78.4% in 2004. These enterprises employed 6.94 million people in 2001 and 10.68 million in 2004, accounting for 24.8% of the total employment in 2001 and 35.7% in 2004. Ning, Lixin. (2005) conducted studies on the commonness of mixed ownership in Harbin City and found that the MOEs accounted for 10% of total enterprises in 2004.

The above studies are helpful in identifying the commonness of mixed ownership. But it is difficult to find the literature that shows the overall commonness of the

mixed ownership nationwide and shows the mixture degree. Moreover, the definition of mixed ownership in the above documents is problematic or unclear.

### **4.3 The Questionnaire Survey and Data Analysis**

A nationwide survey is organised by me in an attempt to overcome the shortcomings of the existing literature. As many MOEs originated from the ownership reform of SOEs, the survey was designed to check how many ownership-reformed SOEs were restructured into MOEs. As the ownership reform is usually called systematic transformation (Gai Zhi), the term of ownership reform was identical to ownership reform in this survey. The systematic transformation (Gai Zhi) was defined in the questionnaire as the transaction that introduces non-state equity to SOEs through selling existing state shares or issuing new shares, this transaction then accomplishes full privatization or partial privatization. Questionnaires were circulated to 5,103 enterprises, in which 1,524 enterprises used to be administered by the State Assets Supervision and Administration Commission of the Central Government (central SASAC), and others used to be administered by local SASACs of Beijing, Chongqing, Heilongjiang, Liaoning, Hebe, Henan, Shandong, Jiangsu, Jiangxi, Hubei, Hunan, Guangdong, Guangxi, Shanxi, Gansu, and Sichuan. The reason why the enterprises administered by the 16 local SASACs were selected is that those 16 localities were listed as the key regions for the ownership reform trial, and those key regions were determined by the central government. Those central SOEs were also in the list of the ownership reform trial.

2,696 filled-out questionnaires was received, 1,184 of these 2,696 enterprises had been systematically-transformed. But within those 1,184 enterprises, 950 provided full and reliable data. These 950 enterprises are the sample for my analysis.

The sample provides the information of their first largest shareholders, the second and third largest shareholders, and the ownership attribute of these shareholders. In the sample, 652 enterprises, accounting for 68.6% of the total sampled enterprises, are found to have the state first largest shareholders, and others have the non-state first largest shareholders.

Table 4-1 The Ownership Attribute of the First Largest Shareholders  
(The Sample of 950 Enterprises)

	The Number of the Enterprises	The Percentage in the Sample
The First Largest Shareholder is of State Ownership Attribute	652	68.6%
The First Largest Shareholder is of Non-State Ownership Attribute	298	31.4%
Total	950	100.0%

The further analysis is to look at the specific status of their first largest shareholders. There are 486 enterprises whose first largest shareholders are SOEs; there are 123 enterprises whose first largest shareholders are state assets management companies; there are 91 enterprises whose first largest shareholders are employees; there are 64 enterprises whose first largest shareholders are private firms; there are 63 enterprises whose first largest shareholders are individuals; there are 48 enterprises whose first largest shareholders are the management; there are 43 enterprises whose first largest shareholders are governmental organisations; there are 13 enterprises whose first largest shareholders are foreign companies.

Table 4-2 The Specific Status of the First Largest Shareholders  
(The Sample of 950 Enterprises)

The Specific Status of the First Largest Shareholders	The Number of the Enterprises	The Percentage in the Sample
SOE	486	51.2 %
State Assets Management Company	123	12.9 %
Employees	91	9.6 %
Private Firm	64	6.7 %
Individual	63	6.6 %
Management	48	5.1 %
Governmental Organisation	43	4.5 %
Foreign Company	13	1.4 %
Others	19	2.0 %

The shareholding proportions of the first largest shareholders are also calculated. When the management is the first largest shareholder, the average shareholding proportion is 34.4%. When governmental organisations, state asset management companies, SOEs, private firms, foreign companies, and employees are the first largest shareholders, their average shareholding proportion exceeds 60%.

Table 4-3 The Average Shareholding Proportions of the First Largest Shareholders  
(The Sample of 950 Enterprises)

The Specific Status of the First Largest Shareholders	The Average Shareholding Proportion
Governmental Organisation	69.8%
Private Firm	65.3%
SOE	63.6%
Employees	62.4%
State Assets Management Company	61.9%
Foreign Company	60.7%
Management	34.4%
Others	42.0%

Moreover, the studies on the commonness degree of mixed ownership and the mixture degree can be conducted by data analysis. The commonness degree is

denoted as  $P_m$ , and shows the percentage of the number of the MOEs against the total number of all enterprises in the sample. The number of MOEs in the sample is denoted as  $N_m$  while the total number of the enterprises in the sample is denoted as  $N_s$ . Thus the  $P_m$  is:

$$P_m = N_m/N_s (\%)$$

$N_m$  is the number of MOEs in the sample.

$N_s$  is the total number of the sampled enterprises

It is found that most of the enterprises in the sample have the ownership structure of multi-shareholders, namely, no matter whom the first largest shareholder is, they do not be able to hold the entire equity of the company. Instead they co-own this company with other shareholders. Once the status of those shareholders and their ownership attribute are identified, the commonness degree of mixed ownership and their mixture degree can be figured out.

In the sample, while governmental organisations and state assets management companies or SOEs are the first largest shareholders, there are the second largest shareholders. 33.2% of them have the state as the second largest shareholder, 31.7% of them have the employees as the second largest shareholder, 9.2% of them have the private firm as the second largest shareholder, 8.9% of them have the individuals as the second largest shareholder, 2.8% of them have the foreign companies as the second largest shareholder, and 1.5% of them have the management as the second largest shareholder. It must be pointed out that although 33.2% of the second largest shareholder is state shareholder, these enterprises are still MOEs because they have introduced non-state equity through ownership reform. This means there must be non-state shareholders in these enterprises, the non-state shareholders may not be the second largest shareholders but may be the third or fourth largest shareholders.

While private firms, management, employees or foreign companies are the first largest shareholder, the ownership structure of multi-shareholders is also very common. Furthermore, different shareholders usually have different ownership attribute. There are 298 enterprises whose first largest shareholders are non-state shareholders. In these 298 enterprises there are 83 enterprises whose second largest shareholders have state ownership attribute. That means the 83 enterprises are MOEs

As mentioned, in the 950 enterprises, there are 652 enterprises whose first largest shareholders are state shareholders. All these 652 enterprises should be MOEs because they have been ownership-reformed and have introduced non-state shareholders. There are other 83 MOEs. Thus, at least 735 enterprises in the sample of 950 enterprises are MOEs, accounting for 77.3% of the total sample.

The commonness degree of the mixed ownership in the 950 sampled enterprises is:

$$P_m=77.3\%$$

There should be some other MOEs who are not included in the above 735 enterprises. Some of the enterprises whose first and second largest shareholders are all non-state shareholders may have the state-owned third largest shareholders. Those are also MOEs. While counting in those enterprises, the commonness degree of mixed ownership in the sample should be around 80%.

It must be pointed out that the 77.3% commonness degree of mixed ownership is calculated from the sample of questionnaire-surveyed enterprises. This figure is not fitting to all ownership-reformed SOEs in China, because the questionnaire survey does not cover those ownership-reformed enterprises which used to be administered by city and county governments. According to my field surveys however, most of those ownership-reformed enterprises of county and city level

have been fully privatised, meaning most of those enterprises are whole private companies, rather than MOEs. Therefore, the nationwide commonness degree of mixed ownership is likely to be much lower than 77.3%. But it is still fair to claim that the mixed ownership is highly prevalent in China. In particular, large-sized SOEs usually opt for mixed ownership while conducting ownership reform. Lenovo Holdings Company and TCL Group Company are large-sized MOEs originating from the ownership reform of large-sized SOEs.

The mixture degree of the MOEs in the sample can also be analysed. All shares in a MOE can be divided into two categories: state shares and non-state shares. The total shareholding proportion of these two categories of shares should be 100%. It is easy to calculate the total shareholding proportion of all state shares in a MOE, which is denoted as  $E_s$ , and the shareholding proportion of all non-state shares, which is denoted as  $E_p$ . To calculate the quotient, or the mixture degree, the higher proportion figure is set as the denominator while the lower is set as the numerator. Therefore the mixture degree is:

$$Q_m = E_p/E_s \text{ when } E_s > E_p$$

$$Q_m = E_s/E_p \text{ when } E_s < E_p$$

Thus, the highest possible value of  $Q_m$  is 1, in that case both the proportion of state shareholding and the proportion of non-state shareholding are respectively 50%. The lower the  $Q_m$  is, the lower the mixture degree is. It must be noted that the mixture degree is only a measurement. I do not imply the higher mixture degree is better.

In order to distinguish whether the state shareholding proportion is higher than the non-state shareholding proportion while reading  $Q_m$ , I denote the  $Q_m$  with state shareholding proportion higher than non-state shareholding proportion as  $Q_{ms}$ , and the  $Q_m$  with non-state shareholding proportion higher than state

shareholding proportion as  $Q_{mp}$ . If the mixture degree of a MOE is  $Q_{ms} = 0.25$ , the state shareholding proportion for this MOE must be 80% while the non-state shareholding proportion must be 20%. The privatisation degree is therefore low. If the mixture degree of a MOE is  $Q_{mp} = 0.25$ , the non-state shareholding proportion for this MOE must be 80% while the state shareholding proportion must be 20%, the privatisation degree here is high.

On this basis, the mixture degree of the 950 enterprises in the sample can be analysed. According to the specific status of the first largest shareholders, the 950 enterprises can be categorized into a few groups. The enterprises whose first largest shareholders are government organisations are classified to the “GV Category Enterprises”, The enterprises whose first largest shareholders are state asset management companies are classified to the “SA Category Enterprises”, the enterprises whose first largest shareholders are SOEs are classified to the “SE Category Enterprises”, the enterprises whose first largest shareholders are private firms or individuals are classified to the “PE Category Enterprises”, the enterprises whose first largest shareholders are the management are classified to the “MG Category Enterprises”, the enterprises whose first largest shareholders are employees are classified to the “EP Category Enterprises”, and the enterprises whose first largest shareholders are foreign companies are classified to the “FI Category Enterprises”. Within the 950 enterprises, 868 enterprises provided full information about their ownership attribute and the shareholding proportions of the first, second and third largest shareholders. These 868 enterprises are divided into groups of GV, SA, SE, PE, MG, EP and FI, and then the analysis on the shareholding structure of these groups of enterprises can be undertaken. When calculating  $E_p$  and  $E_s$ , I just consider the first the second, and the third largest shareholders. The average  $E_p$  and  $E_s$  can also be calculated according to the shareholding proportions of the first, second and third largest shareholders. The results are shown in table 4-4.

Table 4-4 The Es and Ep of 868 Enterprises

Group	Es (%)	Ep (%)
GV Group	79.1	20.9
SA Group	69.3	30.7
SE Group	70.2	29.8
PE Group	10.6	89.4
MG Group	3.7	96.3
EP Group	8.8	91.2
FI Group	18.3	81.7

On the basis of the above table, the Qm of each group can be figured out. The results are shown in table 4-5.

Table 4-5 The Qm of 868 Enterprises

Group	Mixture degree
GV Group	Qms=0.26
SA Group	Qms=0.44
SE Group	Qms=0.43
PE Group	Qmp=0.12
MG Group	Qmp=0.04
EP Group	Qmp=0.10
FI Group	Qmp=0.22

In order to measure the mixture degree of these 868 enterprises more clearly, the mathematical average Qm and the weighted average Qm of them can be calculated. The mathematical average Qm is calculated from the average amount of every group, and the weighted average Qm is calculated from the weighted average Es and Ep of those 868 enterprises. The results are shown in table 4-6.

Table 4-6 The Mathematical and Weighted Average Qm of the 868 Enterprises

The Mathematical Average Qm	The Weighted Average Qm
0.23	0.81

It is clear to see that there is a big gap between the mathematical average mixture degree and the weighted average mixture degree. The major cause of the gap is that the state shareholding proportion in the enterprises whose first largest shareholders are management is very low, so that the Qm of this group of enterprises is also very low. The same is true for the enterprises whose first largest shareholders are employees. These two groups bring the mathematical average mixture degree down. However, the numbers of enterprises within these two groups is not high, and their weight is not significant in calculating the weighted average mixture degree.

Generally speaking, the ownership-reformed enterprises in China have a noted feature of mixed ownership, and their mixture degree is quite high.

#### **4.4 The Commonness Degree and Mixture Degree of China's Listed Companies**

While assessing the commonness degree of mixed ownership in China, using the sample of 950 surveyed enterprises is not very representative because this sample only covers the enterprises with systematic transformation (Gai Zhi) but excludes the enterprises without systematic transformation. As many systematically-transformed enterprises are MOEs in China with the prevalence of partial privatization, therefore the sample of 950 systematically-transformed enterprises undoubtedly exaggerates the commonness of mixed ownership in China. In order to offset this shortcoming, the studies on the listed companies in

China's stock market have been taken. At the end of July of 2008, there are 1,573 listed companies in China's A-share market. The 300 companies of Shanghai-Shenzhen Component Index is chosen as the sample of listed companies to analyse the commonness of mixed ownership of China's listed companies, because these 300 companies are carefully selected by China Securities Regulation Commission (CSRC) and Shanghai and Shenzhen Exchanges at the consideration of representing different industries and different company sizes. These 300 companies publish their information of shareholders, including the names of the first to the tenth largest shareholders and their shareholding proportions as well as the types of their shares. Based on the published information, the commonness degree and the mixture degree of these 300 companies are examined.

The examination is based on the data of the first to the tenth largest shareholders. That means the calculation excludes the negotiable stocks, therefore the calculated commonness degree and mixture degree here for the listed companies are not accurate enough. Nevertheless, these are still credible measurements.

The shares of the first to tenth largest shareholders are categorised as state shares, state corporate shares, domestic corporate shares, overseas corporate shares, negotiable shares, and other shares. The state shares are included in state ownership class, the domestic corporate shares are included in the non-state ownership class.

In order to simplify the calculation, the shares held by investment funds and the shares below the proportion of 2% is disregarded. The calculation results are shown in table 4-7.

Table 4-7 The MOEs in 300 Listed Companies of Shanghai–Shenzhen  
Component Index  
(As of June 30 of 2008)

The Serial Number	The Corporation Name	The Name of the First Largest Shareholder and Its Shareholding Proportion	The Mixture Degree of the Top 10 Largest Shareholders
1	Haitong Securities Company	The first largest state shareholder: Shanghai Shangshi Stock Company  The shareholding proportion : 6.8%	The state shareholding proportion: 29.6%  The non-state shareholding proportion: 13.9%  Qms=0.47
		The first largest non-state shareholder: Dongfeng Group Industrial Stock Company  The shareholding proportion: 5.1%	
2	Guojin Securities Company	The first largest state shareholder: Jiuzhitang Group Company  The shareholding proportion: 27.4%	The State shareholding proportion: 45.3% ,  The non-state shareholding proportion: 39.9%  Qms=0.88
		The first largest non-state shareholder: Yongjin Investment Holdings Company  The shareholding proportion: 15.9%	
3	Wanneng Power Company	The first largest state shareholder: Anhui Power Group Company  The shareholding proportion : 54.5%	The State shareholding proportion: 54.5%  The non-state shareholding proportion: 11.2%  Qms=0.21
		The first largest non-state shareholder: Anhui Xinneng Chuangye Investment Company	

		The shareholding proportion : 7.6%	
4	Guangming Dairy Company	<p>The first largest non-state shareholder: H.I.FOOD PRODUCTS LIMITED</p> <p>The shareholding proportion: 35.2%</p>	<p>The non-state shareholding proportion: 49.0%</p> <p>The state shareholding proportion: 25.2%</p>
		<p>The first largest state shareholder: Shanghai Dairy Group Company</p> <p>The shareholding proportion: 25.2%</p>	Qmp=0.51
5	Southwestern Stock Company	<p>The first largest non-state shareholder: Chuanghua Group Company</p> <p>The shareholding proportion: 16.1%</p>	<p>The non-state shareholding proportion: 16.1%</p> <p>The state shareholding proportion: 7.7%</p>
		<p>The first largest state shareholder: Kaihua County State Assets Management Company</p> <p>The shareholding proportion: 7.7%</p>	Qmp=0.48
6	Changjiang Securities Company	<p>The first largest non-state shareholder: Qingdao Haier Investment Company</p> <p>The shareholding proportion: 16.0%</p>	<p>The state shareholding proportion: 34.9%</p> <p>The non-state shareholding proportion: 30.7%</p>
		<p>The first largest state shareholder: Hubei Power Group Company</p> <p>The shareholding proportion: 11.6%</p>	Qms=0.88
7	Changcheng Development	<p>The first largest state shareholder: Changcheng Science and Technology Company</p>	<p>The state shareholding proportion: 49.6%</p> <p>The non-state shareholding</p>

	Company	The shareholding proportion: 49.6%	proportion: 8.3%
		The first largest non-state shareholder: Fuxu (Hong Kong) Limited Company The shareholding proportion: 8.3%	Qms=0.17
8	Jinbin Development Company	The first largest state shareholder: Tianjin Taida Construction Company The shareholding proportion: 23.3%	The state shareholding proportion: 23.3 The non-state shareholding proportion: 7.0%
		The first largest non-state shareholder: Tianjin Huatai Group Holdings Company The shareholding proportion: 4.8%	Qms=0.30
9	Hualing Iron and Steel Company	The first largest state shareholder: Hualing Iron and Steel Group Company The shareholding proportion: 33.9%	The state shareholding proportion: 33.9% The non-state shareholding proportion: 33.0%
		The first largest non-state shareholder: ARCELORMITTAL The shareholding proportion: 33.0%	Qms=0.97
10	Jinfeng Science and Technology Company	The first largest state shareholder: Xinjiang Wind Power Science and Technology Company The shareholding proportion: 18.3%	The state shareholding proportion: 36.2% The non-state shareholding proportion: 20.2%
		The first largest non-state shareholder: Yuanjing Xinfeng Investment and Consulting Company	Qms=0.56

		The shareholding proportion: 4.4%	
11	Baoli Land Company	<p>The first largest state shareholder: Baoli South Group Company</p> <p>The shareholding proportion: 49.0%</p>	<p>The state shareholding proportion: 49.0%</p> <p>The non-state shareholding proportion: 11.2%</p>
		<p>The first largest non-state shareholder: Huamei International Investment Group Company</p> <p>The shareholding proportion: 8.7%</p>	Qms=0.22
12	Weicai Dongli Company	<p>The first largest state shareholder: Weicai Group Holdings Company</p> <p>The shareholding proportion: 14.9%</p>	<p>The state shareholding proportion: 21.5%</p> <p>The non-state shareholding proportion: 14.8%</p>
		<p>The first largest non-state shareholder: Peixin Holdings Company</p> <p>The shareholding proportion: 4.5%</p>	Qms=0.69
13	Dongbei Securities Company	<p>The first largest state shareholder: Jilin Yatai Group Company</p> <p>The shareholding proportion: 30.6%</p>	<p>The non-state shareholding proportion: 36.3%</p> <p>The state shareholding proportion: 33.3%</p>
		<p>The first largest non-state shareholder: Jilin Trust Investment Company</p> <p>The shareholding proportion: 23.0%</p>	Qmp=0.92
14	Yasheng Group Company	The first largest state shareholder: Gansu Salt Chemical Group Company	The State shareholding proportion: 14.7%

The non-state shareholding

		The shareholding proportion: 14.7%	proportion: 4.5%
		The first largest non-state shareholder: Hengsheng Agriculture Development Company  The shareholding proportion: 4.5%	Qms=0.31
15	Zhongse Stock Company	The first largest state shareholder: China Zhongse Group Company  The shareholding proportion: 33.3%	The state shareholding proportion: 33.3%  The non-state shareholding proportion: 7.8%
		The first largest non-state shareholder: Wanxiang Resources Company  The shareholding proportion: 7.8%	Qms=0.23
16	Liaotong Chemical Company	The first largest state shareholder: Huajing Chemical Group Company  The shareholding proportion: 51.1%	The state shareholding proportion: 51.4%  The non-state shareholding proportion: 23.5%
		The first largest non-state shareholder: Naixi Investment Company  The shareholding proportion: 3.8%	Qms=0.46
17	Tianwei Baobian Company	The first largest state shareholder: Baoding Tianwei Group Company  The shareholding proportion: 51.1%	The state shareholding proportion: 51.1%  The non-state shareholding proportion: 5.5%
		The first largest non-state shareholder: Baoding Huiyuan Consulting Company	Qms=0.11

		The shareholding proportion: 5.5%	
18	Neusoft Group Company	<p>The first largest state shareholder: Northeast University Industrial Group Company</p> <p>The shareholding proportion: 17.6%</p>	<p>The non-state shareholding proportion: 42.1%</p> <p>The state shareholding proportion: 27.5%</p>
		<p>The first largest non-state shareholder: Huixu Science and Technology Company</p> <p>The shareholding proportion: 17.2%</p>	Qmp=0.65
19	Zhonglian Zhongke Company	<p>The first largest state shareholder: Changsha Construction Machinery Research Institute Company</p> <p>The shareholding proportion: 41.9%</p>	<p>The state shareholding proportion: 41.9%</p> <p>The non-state shareholding proportion: 11.2%</p>
		<p>The first largest non-state shareholder: Jiazhuo Group Company</p> <p>The shareholding proportion: 11.2%</p>	Qms=0.27
20	China Bao'an Company	<p>The first largest non-state shareholder: Shenzhen Baoan Holdings Company</p> <p>The shareholding proportion: 8.3%</p>	<p>The non-state shareholding proportion: 8.3%</p> <p>The state shareholding proportion: 7.0%</p>
		<p>The first largest state shareholder: Shenzhen Baoan District Investment Management Company</p> <p>The shareholding proportion: 7.0%</p>	Qmp=0.84
21	Zhenhua Harbour Machinery	<p>The first largest state shareholder: China Transportation Construction Stock Company</p>	<p>The state shareholding proportion: 24.9%</p>

	Company	The shareholding proportion: 24.9%	The non-state shareholding proportion: 18.0%
		The first largest non-state shareholder: Zhenhua Engineering Company The shareholding proportion: 18.0%	Qms=0.72
22	Chongqing beer company	The first largest state shareholder: Chongqing Beer Group Company The shareholding proportion: 32.3%	The state shareholding proportion: 32.3%
		The first largest non-state shareholder: S&N Asia Company The shareholding proportion: 17.5%	The non-state shareholding proportion: 19.7%
			Qms=0.61
23	Orient Pearl Company	The first largest state shareholder: Shanghai Broadcast and Television Development Company The shareholding proportion: 45.2%	The state shareholding proportion: 45.2%
		The first largest non-state shareholder: Shanghai Culture and Broadcast Media Group Company The shareholding proportion: 10.1%	The non-state shareholding proportion: 13.4%
			Qms=0.30
24	Hailuo Cement Company	The first largest state shareholder: Hailuo Group Company The shareholding proportion: 45.7%	The state shareholding proportion: 45.7%
		The first largest non-state shareholder: Hailuo Changye Investment Company	The non-state shareholding proportion: 16.3%
			Qms=0.30

		The shareholding proportion: 16.3%	
25	Nanbo Company (A share)	<p>The first largest non-state shareholder: Ping'an Trust Company</p> <p>The shareholding proportion: 6.7%</p>	<p>The non-state shareholding proportion: 17.9%</p> <p>The state shareholding proportion: 11.9%</p>
		<p>The first largest non-state shareholder: Citic Securities Company</p> <p>The shareholding proportion: 6.7%</p>	Qmp=0.66
26	Baotou Steel Rare Metal Company	<p>The first largest state shareholder: Baotou Steel Group Company</p> <p>The shareholding proportion: 36.7%</p>	<p>The state shareholding proportion: 36.7%</p> <p>The non-state shareholding proportion: 12.1%</p>
		<p>The first largest non-state shareholder: Jiaxin Limited Company</p> <p>The shareholding proportion: 12.1%</p>	Qms=0.33
27	Dongguan Holdings Company	<p>The first largest state shareholder: Dongguan Highway and Bridge Development Company</p> <p>The shareholding proportion: 41.5%</p>	<p>The state shareholding proportion: 41.5%</p> <p>The non-state shareholding proportion: 28.0%</p>
		<p>The first largest non-state shareholder: Yumin Development Company</p> <p>The shareholding proportion: 28.0%</p>	Qms=0.67
28	Xianmen wolfram company	<p>The first largest state shareholder: Fujian Melting Holdings Company</p> <p>The shareholding proportion: 33.6%</p>	<p>The state shareholding proportion: 33.6%</p> <p>The non-state shareholding</p>

		<p>The first largest non-state shareholder: Japan United Material Corporation</p> <p>The shareholding proportion: 9.4%</p>	<p>proportion: 9.4%</p> <p>Qms=0.28</p>
29	Huawen Media Company	<p>The first largest state shareholder: Capital Airport Group Company</p> <p>The shareholding proportion: 20.3%</p>	<p>The state shareholding proportion: 20.3%</p> <p>The non-state shareholding proportion: 14.6%</p>
		<p>The first largest non-state shareholder: Shanghai Huawen Investment Company</p> <p>The shareholding proportion: 14.6%</p>	<p>Qms=0.72</p>
30	Citic Bank	<p>The first largest state shareholder: Citic Group Company</p> <p>The shareholding proportion: 62.3%</p>	<p>The state shareholding proportion: 77.3%</p> <p>The non-state shareholding proportion: 4.8%</p>
		<p>The first largest non-state shareholder: Spanish Foreign Bank</p> <p>The shareholding proportion: 4.8%</p>	<p>Qms=0.06</p>
31	Bank of Beijing	<p>The first largest non-state shareholder: ING Bank</p> <p>The shareholding proportion: 16.1%</p>	<p>The non-state shareholding proportion: 22.2%</p> <p>The state shareholding proportion: 20.2%</p>
		<p>The first largest state shareholder: Beijing State Assets Management Company</p> <p>The shareholding proportion: 10.4%</p>	<p>Qmp=0.91</p>
32	China Pacific	<p>The first largest state shareholder: Huabao</p>	<p>The state shareholding</p>

	Insurance company	Investment Company The shareholding, proportion: 17.4%	proportion: 45.4% The non-state shareholding proportion: 17.3%
		The first largest non-state shareholder: Parallel Investors Holdings The shareholding proportion: 13.7%	Qms=0.38
33	Shengyi Science and Technology Company	The first largest non-state shareholder: Huawei Electronics Company The shareholding proportion: 22.2%	The state shareholding proportion: 26.9% The non-state shareholding proportion: 24.7%
		The first largest state shareholder: Dongguan Electronics Company The shareholding proportion: 17.9%	Qms=0.92
34	Communication Bank	The first largest state shareholder: Ministry of Finance The shareholding proportion: 26.5%	The state shareholding proportion: 28.5% The non-state shareholding proportion: 18.6%
		The first largest non-state shareholder: Shanghai HSBC The shareholding proportion: 18.6%	Qms=0.65
35	Ningbo Bank	The first largest state shareholder: Bureau of Finance of Ningbo city The shareholding proportion: 10.8%	The non-state shareholding proportion: 43.2% The state shareholding proportion: 18.0%
		The first largest non-state shareholder:	Qmp=0.42

		Singapore Alien Bank  The shareholding proportion: 10.0%	
36	Nanjing Bank	The first largest state shareholder: Nanjing State Assets Management Company  The shareholding proportion: 13.0%	The non-state shareholding proportion: 27.1%  The state shareholding proportion: 13.0%
		The first largest non-state shareholder: BNP PARIBAS  The shareholding proportion: 12.6%	Qmp=0.48
37	Shenhuo Stock Company	The first largest state shareholder: Shenhuo Group Company  The shareholding proportion: 25.2%	The state shareholding proportion: 25.2%  The non-state shareholding proportion: 24.8%
		The first largest non-state shareholder: Shangqiu Putian Economic and Trade Company  The shareholding proportion: 11.9%	Qms=0.98
38	Chengzhou Mining Company	The first largest state shareholder: Huanan Jinxin Gold Group Company  The shareholding proportion: 44.0%	The state shareholding proportion: 44.0%  The non-state shareholding proportion: 28.1%
		The first largest non-state shareholder: Beijing Qingyuan Changye Company  The shareholding proportion: 9.5%	Qms=0.64
39	Lutian Coal	The first largest state shareholder: Zhongdiantou Huolinguo Coal and Electricity	The state shareholding

	Company	Company  The shareholding proportion: 70.5%	proportion: 78.5%  The non-state shareholding proportion: 5.6%
		The first largest non-state shareholder: Jilin Niusente Industrial Company  The shareholding proportion: 5.6%	Qms=0.07
40	Fujian Industrial Bank	The first largest state shareholder: Bureau of Finance of Fujian Province  The shareholding proportion: 20.4%	The state shareholding proportion: 26.4%  The non-state shareholding proportion: 22.2%  Qms=0.84
		The first largest non-state shareholder: Hengsheng Bank  The shareholding proportion: 12.8%	
41	Huaxia Bank	The first largest state shareholder: Capital Steel Company  The shareholding proportion: 14.0%	The state shareholding proportion: 36.4%  The non-state shareholding proportion: 23.3%
		The first largest non-state shareholder: Dutch Bank  The shareholding proportion: 11.3%	Qms=0.64
42	Tianyin Holding Company	The first largest state shareholder: China News Development Shenzhen Company  The shareholding proportion: 13.9%	The state shareholding proportion: 31.4%  The non-state shareholding proportion: 16.7%
		The first largest non-state shareholder: China	

		Huajian Investment Company The shareholding proportion: 9.5%	Qms=0.53
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It is found that within these 300 enterprises, there are 42 MOEs, accounting for 14% of the 300 enterprises. Thus the commonness degree of mixed ownership of the 300 listed companies of Shanghai-Shenzhen Component Index is:

$$P_m = 14\%$$

It is fair to say 14% is not low since very small portion of China's enterprises can get listed in the stock market. The 14% of the commonness degree is more representative of the mixed ownership in China than the 77.3% of the commonness degree for the sample of 950 systematically- transformed enterprises. The mixture degree of these 42 MOEs is:

$$Q_{ms} = 0.53.$$

## **4.5 The Recent Development of Mixed Ownership in China**

The most recent development of the mixed ownership in the localities shows that the number of the MOEs in China is still rising. A field survey of Jiangxi Province in 2008 found that the provincial government had decided to launch a new round of ownership reform for local SOEs<sup>1</sup>. In May of 2008, the provincial government launched the program of speeding up the systematic transformation in Jiangxi Provincial state-owned enterprises. This program stipulated that systematic transformation of provincial SOEs should be finished within 2 years, the breakthrough point of the systematic transformation should be ownership reform, and the direction of ownership reform was to transform the

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<sup>1</sup> The interview with the vice director of Jiangxi SASAC in December 2008

wholly-state-owned enterprises to MOEs. In 2008, an important wholly-state-owned enterprise in Jiangxi Province, Jiangxi Wolfram Company, finished its ownership reform and became a MOE. Jiangxi SASAC held 70% of the total equity and Shanghai Wanchao Investment Company, a private firm, held 30% of the total equity of Jiangxi Wolfram Company. Another wholly state-owned enterprise, Jiangzhong Group Company, was on the track of ownership reform at that time and its reform program was approved by the provincial government. According to the approved plan, both the management and an outside strategic investor would hold some shares in post-reform Jiangzhong Group Company. The company would then become a MOE. The provincial SASAC would sell some state shares, resulting in its holding of 37% of the total equity, and the management would hold 30%, Jiangxi China Traditional Medicine College would hold 3%, China Defence Science Academy, collaborating with Jiangzhong Group Company, would hold 10%, and the other 20% would be sold to another non-state strategic investor. Jiangxi Coal Group Company, another wholly-state-owned company, was preparing to bring in a private firm, Zhonghong Zhuoye Investment Company, as a new shareholder. As these examples illustrate, the new round of ownership reform of the SOEs will bring more MOEs in China.

Mixed ownership is not only the government's favourite choice, but also the favourite choice of some private firms. A visit was paid to a private company called Yili Resources Group Company, who is one of the largest and most famous private companies in China<sup>2</sup>, and it is found that in the past few years, Yili Resources Group Company had accomplished a huge business expansion by adopting mixed ownership. Moreover, the company had a plan to develop more mixed ownership subsidiaries. It is a company with only just ten years history, but its sales in 2008 exceeded 10 billion RMB. Five years ago, however, Yili Resources Group Company was much smaller. Since then it has taken a strategic

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<sup>2</sup> The interview with the president of Yili Resource Group Company in June 2009.

decision to enter the sectors of coal mining, coal chemistry, power generation, cement, and salt chemistry, by cooperating with large-sized SOEs and establishing MOEs. Shenghua Yili Power Limited Company was established to run the coal mining and power generation businesses, they are co-owned by Shenghua Group Company, the largest coal company and one of the first tier SOEs in China. Yili Chemistry Company was established to conduct the PVC processing business, which is co-owned by Shenghua Group Company, Shanghai Huayi Group Company, a very famous SOE in the chemistry sector, and Yili Resources Group Company. Yili Jidong Cement Company was established to do the business in the cement manufacturing market, which is co-owned by Jidong Cement Company, one of the largest cements enterprises in China and also a SOE, and Yili Resources Group Company. Zhongyan Yili Chemistry Company was established to do the business of salt chemistry, which is co-owned by China Salt Company, a very famous SOE, and Yili Resources Group Company. The president of Yili Resources Group Company admitted that the cooperation with SOEs and the establishment of the MOEs helped overcome some shortcomings, such as the lack of the funds and the professional people. Furthermore, mixed ownership helped go around the rigid regulation when entering the sectors of coal mining and power generation. Since Yili Resources Group Company is located and originated in E'Er'duosi city, which is very famous for its coal resource, it has very deep relations with the local government. Furthermore, it had made very big contributions to treating the deserts, so that the local government often supports the business development of Yili Resources Group Company. These advantages could not be obtained by Shenghua Group Company or other investors from outside even they are large-sized SOEs. Therefore, when those state-owned investors such as Shenghua Group Company, China Salt Company, went to E'Er'duosi city to develop their business, they were willing to cooperate with Yili Resources Group Company by means of mixed ownership.

## 4.6 Concluding Remarks

This chapter discusses how common the mixed ownership is in China. A sample of 950 surveyed enterprises is employed to analyse the commonness degree and mixture degree. In the sample 77.3% of the enterprises are MOEs. Another sample of 300 listed companies of the Shanghai-Shenzhen Component Index is also employed to examine the commonness degree and the mixture degree of the listed companies, 14% of them are MOEs. The mathematical average mixture degree of the MOEs in the 950 enterprises is 0.23, while the weighted average mixture degree is 0.81. The mixture degree of the 42 listed MOEs is 0.53. But in most of the MOEs the state is still the majority shareholder. As mixed ownership is quite common in China, the further question is, what factors drive the rise of the mixed ownership in China? This will be discussed in the next chapter.

## **Chapter 5**

# **The Major Factors Driving the Emergence of the Mixed Ownership Enterprises**

### **5.1 Introduction**

The analysis on the China Model of SOEs reform is helpful to understand that the mixed ownership has its roots in China's unique economic transition. However, until now it is unknown yet what specific factors drive the emergence of the mixed ownership in China. There is hardly any existing literature addressing this issue. A few articles touched upon this issue but it is hard to find convincing and valuable explanations. Wu, Xinxin. (2005) tried to analyse the causes of the MOEs' emergence in Ningbo City, Zhejiang Province. He stated that the major causes of the development of MOEs in Ningbo City were related both to the government and to the enterprise, they adopted a flexible attitude towards the property rights arrangements in an attempt to promote the business expansion. Furthermore, the flexible attitude towards the property rights arrangements is related to the distinctive cultural traditions in Ningbo area that features the openness, the innovation, and the pragmatism. But those explanations were not substantial. It is necessary to conduct systematic and deep analysis on the driving factors of the emergence of the mixed ownership in China. As the emergence of China's MOEs is an empirical phenomenon, this chapter first analyses the driving factors of China MOEs from the perspective of empirical observations, then make some discussions.

## **5.2 The Horizontal Economic Alliance and the Origin of Mixed Ownership**

Chapter 3 highlights that the gradual ownership reform leads to mixed ownership. To a large extent, mixed ownership grew up alongside the China Model of SOEs reform. However, in the early-1980s, there were some MOEs emerging in China and these MOEs had nothing to do with the ownership reform, although they were not noticed by many people. Probing into the reason why mixed ownership emerged in the early-1980s will be very helpful to comprehend the causes of the early origin of China's mixed ownership.

Historical documents show that the origin of mixed ownership in the early-1980s was related to the advocacy program of the economic and technological co-operation as well as horizontal alliance, which was encouraged by the government. The economic and technological co-operation and horizontal alliance was very prevalent in the 1980s among enterprises across different industrial sectors, different administrative regions, and different ownership sectors. The specific patterns include collaborative manufacturing, collaborative R&D, joint investment, and collaborative operation. The objective of this advocacy program was to re-allocate the resources among different enterprises and to accomplish the mutual supplements of different advantages of different enterprises. It is easy to understand the mixed ownership might emerge when the collaborations occurred between the enterprises with different ownership attribute although the term of mixed ownership was not used at that time. Three officials in the State Economy Commission, Yang, Xuguang., Xu, Changzhong., and Zhang, Wenguang. (1983), described in detail the major patterns: technology service, compensation trade, technology transfer, and joint investment. Gao, Shangquan. (1983), the vice president of the State Economic Reform Office, argued in his article that the state must allow co-operation and joint investment to go ahead among enterprises of different ownership attributes. The practices had

shown that keeping state ownership dominant but introducing other kinds of ownership as supplementary, was fitting to China's conditions and useful in promoting economic prosperity and employment. Since there were few private firms at that time, the economic and technological co-operation and horizontal alliance usually occurred among SOEs across different industrial sectors and administrative districts. However, as TVEs began to emerge, some SOEs did co-operate with TVEs, and the collaboration began to develop from co-operative manufacturing to joint investment and new enterprises were established. Joint operation and joint investment among SOEs, collective firms and private firms occurred, then MOEs containing state ownership and collective ownership as well as private ownership emerged. The advantage of mixed ownership in the form of joint investment and co-operative management was clear according to Gao Shangquan's article, that was the economic prosperity and the rising employment. Thus Gao Shangquan called for the government to "allow" the emergence of those new forms of economic collaborations. It is clear to see that mixed ownership grew up in reality then the government was urged to admit the emergence of mixed ownership.

The article by the State Light Industry Ministry (1986) recorded the case of Zhanjiang Home Electrical Apparatus Company in Guangdong Province. This company was a SOE, and expanded its business very quickly in the early-1980s. As a result, it faced a shortage of factory buildings, equipments and workers. The company wanted to construct new factory buildings, to buy new equipments and to hire more workers but failed to get enough regulatory quotas in time. Therefore, it decided to set up horizontal economic alliance with the thirteen factories administered by Zhanjiang Second Light Industry Bureau. Those thirteen factories were collective firms. The pattern of the horizontal economic alliance involved joint investment and joint operation. Those collective firms invested fixed assets, including equipments and factory buildings, while Zhanjiang Home Electrical Apparatus Company invested some cash, to set up a

new joint-capital company. The profits of the new company were shared between the two sides, and the board of directors was set up. The new company was managed by a factory chief, supervised by the board. This article also recorded that the employment shareholding was introduced to this new company afterwards, enabling employees to buy stocks of the new company. It was further stipulated that the dividends must be paid to them every year. This new company was of course a MOE, because it contained not only state ownership, but also collective ownership and private ownership.

By analysing these documents, it can be substantiated that the early mixed ownership was related to the advocacy program of the economic and technological co-operation and horizontal alliance. Mixed ownership tended to emerge spontaneously. There was no government strategy or plan to develop mixed ownership, but once the economic and technological co-operation and horizontal alliance proceeded forward, it could not be confined within SOEs, the joint investment and joint operation among SOEs and collective firms as well as private firms would happen, resulting in the origin of MOEs. Xuan, Muqiao (1987) also stated that the joint investment and joint operation among enterprises with different ownership attributes had happened in reality. In this article, he used the term of mixed ownership for the first time in China.

As a matter of fact, the non-state enterprises, including TVEs, other collective firms and private firms, had more flexible operational mechanisms since they had less governmental control. For example, they had flexible options regarding marketing, money spending, and making payments. As a result of this flexibility, SOEs were willing to co-operate with them. However, SOEs also had their own advantages in terms of technology and funds, and SOEs could get more trust from banks, clients. Thus non-SOEs were also willing to co-operate with SOEs. Namely, the alliance between SOEs and non-SOEs was able to produce benefits from the mutual supplements of different advantages. It is fair to say that the

mixed ownership in this circumstance was catalysed by the voluntary activities of two sides. The major factors driving the two sides to set up MOEs were as follows: SOEs had the advantage for business resources while non-SOEs had the advantage for operational mechanisms, the combination of the two kinds of advantages enabled them to accomplish mutual supplements.

### **5.3 The Ownership Reform of State-Owned Enterprises and the Rise of Mixed Ownership**

The above-mentioned mixed ownership was only the start of the emergence of China's MOEs. More MOEs originated from the ownership reform of SOEs. In the early stage of SOEs ownership reform, some small SOEs were wholly sold to private firms or individuals. Some large SOEs on the other hand were reformed by way of mixed ownership. According to Liu, Mingshan. (1985), 55,892 small SOEs in the retailing and service sector were let go in 1984, in which 5,500 firms were turned to collective firms, and 5,800 were leased to individuals. For those turned to collective firms, some state assets were sold to employees, but the state still kept some shares, thus those enterprises became MOEs. In 1984, Beijing Tianqiao Department Store undertook the ownership reform, the reform also adopted mixed ownership. After the ownership reform, the state shareholding proportion was exactly 50%, and employees' shareholding proportion was 4.4%. The residual shares were owned by other shareholders.

Why was the mixed ownership adopted at the early stage of SOEs ownership reform? At that time the government did not choose mixed ownership as a strategic policy. The most important cause was that full privatisation at that time was ideologically forbidden and might incur big political risk. As stated while analysing the China Model of SOEs reform, reform itself is a risky venture. Especially in the early stage of the economic transition, the political risk was very high. Political risk mainly came from the ideological constraints. The

literature (Chen, Qingtai, 2008) showed that the concern how to carry out SOEs reform was once a very sensitive and rigid political choice. Thus, in order to decrease political risk and to avoid ideological confines, adopting a balanced and ambiguous strategy of partial privatisation through the introduction of non-state shares instead of full privatisation, was much politically safer. Of course, the ownership reform in the early stage was also constrained by the shortage of private capital. At that time the non-state shareholders introduced to SOEs were likely to be employees, who did not have enough funds to buy out the SOEs, but buying a small proportion of shares was the most feasible choice.

Some people initiatively opted for mixed ownership, that was not the case of the ideological confines or the shortage of non-state capital. Studying the case of Wanke Company, the largest real estate company in China, could shed light on this point (Twenty First Century Herald, 2008) . The predecessor of Wanke Company was Shenzhen Xiandai Science and Technology Instrument Exposition Centre, an independent business department of Shenzhen Special Zone Development Company, who was a SOE. This centre was established in 1984 by Mr. Wang Shi, a former government official. He struck an agreement with Shenzhen Special Zone Development Company to set up the centre, Shenzhen Special Zone Development Company did not invest any funds but agreed to provide the business license and bank account to help Wang Shi to conduct business. It is worth noting that no state funds were invested in this centre. Wang Shi himself was able to obtain the quota of imports and exports in order to develop the business. This centre was actually privately operated but wore a “red cap”. Without the red cap, Wang Shi said that his business would not have developed so quickly. His business faced some other troubles as a result of this “red cap” however. Wang Shi reportedly recognised that state ownership could bring extra facilities to his business, including lower entrance barriers, more resources and more protection. On the other hand, however, he also recognised the constraints of the state ownership. Therefore, when he read a government

circulation about the ownership reform experiment, he decided to carry out ownership restructuring. However it was very difficult to define the property rights of the assets of this centre because neither government funds nor SOEs funds were invested in this center. Actually, all investments in this centre came from individuals, but its trademark and brand name, as well as its bank account, came from the SOE. The Deputy Mayor of Shenzhen City put forward a plan, supported by Wang Shi, to divide the ownership of this centre between employees and the state, at the proportion of 40:60. This centre accomplished the shareholding restructuring in 1988 and became a MOE and changed its' name to the present one. Later on, Wanke Company was listed and the state shareholding proportion declined to 30%. In 1998, Shenzhen Special Zone Development Company decided to sell all of its state shares in Wanke Company but agreed the buyer could be selected by Wanke Company itself. Thus, Wang Shi had the chance to fully privatise Wanke Company by selecting a private company to buy these shares. Surprisingly, he selected another SOE, Huarun Group Company. Wang Shi himself publicly declared that he liked Huarun's background of being a SOE. According to published information, in 2008, the first largest shareholder of Wanke Company was Huarun Group Company, its shareholding proportion stood at 14.6% and the employees union held some shares. Wanke Company is a MOE now. It is fair to say that the mixed ownership of Wanke Company was the choice of Mr. Wang Shi because he recognised that the fast development of Wanke Company benefited both from SOE's advantage for business resources, and from the ability of the management. Wang Shi still decided not to fully remove the state ownership.

Another important factor of Wanke Company' opting for mixed ownership was the managers' contribution to the formation of the corporate assets, fortunately, the contribution was recognised by the government, who agreed that their contribution could be converted to individual equity shares. Although the predecessor of Wanke Company was a business department of Shenzhen Special

Zone Development Company, but Shenzhen Special Zone Development Company did not invest any funds in that department. Nevertheless, Shenzhen Special Zone Development Company facilitated the business expansion of the department by providing the license and trademark as well as bank account. The enterprises like Wanke Company, during the process of their business development, received little or no funding from the government, namely, the assets formation benefited from the successful operation of the managers instead of the input of state funds. However, the business operation of those enterprises still depended, to some extent, on the support from SOEs, especially in terms of soft assets and preferential policies. Some preferential policies such as import and export quotas proved difficult for private companies to obtain. Therefore, while launching ownership reform, the management usually asked for the compensation for their contributions to the assets formation, the government accordingly agreed to grant some shares to the management. It is fair to say, one factor driving these enterprises to become MOEs was managers' contribution to assets formation, their contribution was compensated by shares grants.

A field survey on another prominent MOE in China, Lenovo Holdings Company<sup>3</sup>, was conducted. While launching the ownership reform of Lenovo Holdings Company, the managers' contribution to the assets formation was recognised by the government and their contribution was compensated by shares grants. Established in the mid-1980s, Lenovo Holdings Company was supervised by China Science Academy. Mr. Liu Chuangzhi, the founder of Lenovo Holdings Company, and his colleagues, borrowed 200,000 RMB from China Science Academy in order to set the company up but returned the full amount in the following year. Lenovo Holdings Company was registered as a wholly-state-owned enterprise at that time. As the company developed and the assets expanded, the management appealed to China Science Academy for shares grant. The government rejected this request of shares granting, but agreed to

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<sup>3</sup> The interview with the director of Lenovo Holdings company in October 2008 .

grant the rights of claiming the dividends of 35% of the total equity. This was the first step in the transition. In 2001, the State Council eventually approved the ownership reform proposal of Lenovo Holdings Company. Then Lenovo Holdings Company became a MOE, the management and core employees bought 35% of the shares. The State Assets Management Company of China Science Academy held 65% of the total shares. The State Assets Management Company of China Science Academy did not intervene in the business affairs of Lenovo Holdings Company. The board of directors of Lenovo Holdings Company had six members at that time, one was from The State Assets Management Company of China Science Academy, and other five were the managers of Lenovo Holdings Company. Lenovo Holdings Company was controlled by the minority shareholder, instead of the majority shareholder.

A field survey of TCL Group Company<sup>4</sup>, another prominent Chinese MOE, was also conducted. This case has more meaningful implications than the Lenovo example, though they are similar. TCL Group Company was established by a few individual founders in the early 1980s. Though there was no financial investment from the government, it was registered as a wholly-state-owned enterprise at that time. To encourage the development of this enterprise, the local government struck an agreement with the management in 1997, stipulating that the management should guarantee the yearly increment ratio of the state assets of this company would not be lower than 10%, the management would get specific proportions of shares grant while the yearly increment ratio of the state assets was really higher than 10%. From 1998 onwards, management began to hold some shares, and their shareholding proportion increased over time. Since then, due to the introduction of outside strategic investors and the issuance of new stocks to the public, the state shareholding proportion declined from 100% in 1997 to 58% in 2002, 40.97% in 2003, 25.22% in 2004, and 15.22% in 2005. Since 2005, the state shareholding proportion has remained stable. There is no

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<sup>4</sup> The interview with the vice president of TCL Group company in October 2008.

government plan to decrease its shareholding proportion anymore. It seems that the mixed ownership of this example is beneficial to all sides.

Since the mid-1990s, the ownership reform of SOEs, or the so-called systematic transformation (Gai Zhi), has sped up enormously. The questionnaire survey shows that the government tended not to sell all of state shares when carrying out the systematic transformation. As a result lots of SOEs were transformed into MOEs.

The questionnaire survey covered 950 enterprises, in which 77.3% are MOEs. In many ownership-reformed enterprises, the government was not willing to sell all of the state shares. Instead, the government often opted to keep some state shares in the ownership-transformed enterprises, known as “retaining a hand”. Retaining a hand can not be fully explained by political or ideological factors.

A few field surveys were conducted with some cases. These cases illustrated why, and how, the government retains a hand. A visit was paid to a very famous private company group in China, Fuxing Group Company, and one of its subsidiaries, Nanjing Iron and Steel Company which used to be a SOE before it was taken over by Fuxing Group Company in 2003<sup>5</sup>. Fuxing Group Company was established in 1993, and has become one of the largest private companies in China, its business covers different sectors such as steel, power, finance and retailing. Its revenue exceeds 30 billion RMB in 2008. In 2003, Fuxing Group Company invested 1.65 billion RMB in Nanjing Iron and Steel Company and became its majority shareholder. Originally, Fuxing Group Company planned to take over 100% of the equity of Nanjing Iron and Steel Company, but the local government had a definite strategy of “retaining a hand”, refused to sell all of its shares. Eventually, Fuxing Group Company and the government reached an agreement. In the post-restructuring company, Fuxing Group Company held 60%

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<sup>5</sup> The interview with the vice president of Fuxing Group Company in July 2008.

of the total shares while the government and management held some shares. Nanjing Iron and Steel Company was a MOE containing private ownership, state ownership and the management ownership. In my interview, Fuxing Group Company acknowledged that the continuous existence of some state shares had been playing a positive role. Keeping some state shares was useful for the company to attain the trust of local government, and to use this trust to get the support from the power supply department, the transportation department, the land administration department, the environment administration department, the taxation department, and other governmental departments.

Since benefiting from the mixed ownership, in 2007, Fuxing Group Company selected to adopt the mixed ownership pattern when participating in the ownership reform of Hainan Iron Mine Company, who used to be a wholly-state-owned enterprise. After the take-over, Fuxing Group Company held 60% of the total shares in Hainan Iron Mine Company, the local government held 40%. In 2008, Fuxing Group Company signed an agreement with Tianjian Municipal Government to take over Tianjin Steel Company, a large SOE, and proposed a mixed ownership structure in which 47.5% of the shares would be held by Fuxing Group Company and some share would be held by the local government.

## **5.4 Why Does the Government Want to Retain Some State Shares?**

Why does the government want to retain a hand and maintain some state shares while carrying out the ownership reform of SOEs?

It is found from the field surveys, that in the late-1990s, and even at present, the ownership reform of SOEs is still politically sensitive. The ruling party and the central government do not have any clear expression of promoting privatisation.

Instead, privatisation is still an ideologically forbidden area and is regarded to be identical to capitalism and full westernization. As for the ownership reform, both the ruling party and the central government have used ambiguous words to express their intention to let go small and medium-sized SOEs. It is unclear however what the term “let go” definitely means. However, the ruling party and the central government explicitly declared that mixed ownership is fully encouraged, and the shareholding system should be the major pattern of state ownership. Therefore, selecting mixed ownership, namely, partial privatization, instead of full privatization, will undoubtedly decrease political risk.

Some SOEs however were still fully privatised. In 2007, Shuanghui Group Company, a very large and important SOE in Luohe City, Henan Province, was fully privatised. This means that not all government officials are confined by the traditional ideology and will avert political risk while carrying out the ownership reform of SOEs. The question is, whether there are other causes for the government to “retain a hand” besides ideological factor or political risk.

This issue can be illustrated by case studies. In 2004, Little Swan Company in Wuxi City, Jiangsu Province, experienced the ownership reform. A field survey was conducted and some facts were found<sup>6</sup>. Little Swan Company used to be a very large SOE in Wuxi City and owned a very famous brand name, Little Swan. The local government requested that this company should develop its business in Wuxi City instead of moving to other regions and the brand name should be kept intact after the ownership reform. The participant of the ownership reform, Siweite Company, a private company, made three no-change commitments to the government: there would be no change to the business sector or the brand name, no change to the management, and no change to the business regional location. Meanwhile, Siweite Company proposed a very ambitious plan for the post-privatisation business expansion of Little Swan Company. The revenue of

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<sup>6</sup> The interview with Wuxi SASAC officials in June 2008.

the Little Swan Company would reach 14 billion RMB in 2004, 19.5 billion in 2005 and 50.3 billion in 2008. Originally, the government planned to sell 100% of the state shares to Siweite Company, with the prerequisite of the three no-change commitments. Eventually, the government decided to retain 35% equity. Some comments pointed out the retention of this 35% state equity was because the government did not fully trust Siweite Company, a private firm (Yang, Kairan. 2004). The conclusion demonstrated the government's incomplete trust. Eighteen days later after the transfer of the shares, Siweite Company broke the commitments and changed the chairman and the deputy chairman of the board. The cause of changing the chairman and deputy chairman was the division about the development strategy. The original management argued that the company should continue to develop the existing business of home electricity apparatus, but Siweite Company argued that the company should concentrate its resources to develop IT business. IT was the major business of Siweite Company. Three years later, Siweite Company was caught in a financial crisis. As the local government retained 35% stake, it took over all the controlling powers as the second shareholder and forcibly resumed the 65% state shares from Siweite Company.

In China, the government bears the responsibilities of developing local economy. The economic development determines, to some extent, the promotion of local officials. Therefore, the government has some expectations for those enterprises after ownership reform. First, the government expects that the enterprises would not relocate after the ownership reform; second, the government expects that they would keep the original brand name; third, the government expects that the strategic investors would invest further funds in order to expand the business; fourth, the government expects that the new controlling shareholders would retain the original management and keep the employment of all workers in order to prevent social instability. However, the government does not fully trust private firms about those issues. It seems that the reality often justifies its incomplete

trust. Incomplete trust can lead to the incomplete selling of state shares, thus the government will “retain a hand”.

The government may sometimes keep a golden share. The term “golden share” refers to a single stock held by the government. The golden share provides the same voting rights as normal shares but gives the government a veto power on pre-agreed issues. The golden share highlights the government’s incomplete trust in private ownership. It is found in my field survey<sup>7</sup>, that the golden share system was adopted in the ownership reform of Huayi Electrical Apparatus Company, a famous company in Jiangxi Province. This golden share was held by the SASAC of Jingdezhen City, Jiangxi Province, and it has the rights to reject four issues of affairs: moving the business to other regions; changing the business sector; changing the placement plan of the employees; changing the plan of debts disposal. When the government holds one golden share, it implies a lack of full trust in the private investor about those four issues.

There is also another reason for the government to “retain a hand”. That is, the government is not willing to entirely give up its controlling powers and its influences on those enterprises even after the ownership reform. After the long-term radical control reform, there are less and less controlling powers left in the hand of the government, but the government still keeps some powers, say, the power of selecting senior managers. These controlling powers are very precious to the government. The government also has some influences on the SOEs. The government can still put some pressures on the enterprise to follow and to accomplish their objectives of the local development, to use the enterprises as a source of the financial income. All in all, the controlling powers can bring some benefits to the government departments and the officials. On one hand, the government recognises that SOEs need to be ownership-reformed. But on the other hand, the government is reluctant to give up its controlling powers of the

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<sup>7</sup> The interview with Jiangxi SASAC officials in September 2008.

SOEs, especially the large and important SOEs (Zhang, Delin. 2007). Introducing some non-state shares can vitalise the enterprises and enhance the budgeting constraint, but retaining some state shares will allow the government to retain some controlling powers. Therefore mixed ownership is a rational option for the government.

## **5.5 Why Do Private Enterprises Accept the Retention of Some State Shares and Why Do Private Enterprises Want to Bring in the State Ownership?**

Why do some private enterprises accept the retention of the state shares? Some private firms even proposed mixed ownership while participating in SOEs ownership reform. Moreover, some private firms actually invite state shareholding to change the wholly-private-owned firms to MOEs. The case of Tianwei Yingli Company is very convincing. Tianwei Yingli Company was established by a private firm, Yingli Group Company, and a SOE, Tianwei Baobian Company. The published document (He, Yifang. 2007) showed that Yingli Group Company wanted to develop a photovoltaic project, but the support of government funds had to be obtained. In fact, the funds were distributed by the State Development Bank, and private firms did not have any opportunities to get the funds. Due to this circumstance, Yingli Group Company transferred 60% of its equity in 1998 to Baoding Development Area Administration Commission to set up a new mixed ownership company, Yingli Stock Company. But Baoding Development District Administration Commission would not intervene in the business affairs of Yingli Stock Company. In 1999, Yingli Stock Company won a bid of a project and needed 150 million RMB, but Yingli Stock Company did not have enough funds. A SOE, Tianwei Baobian Company who had gained a large amount of funds from the stock market, bought some shares from Yingli Group Company. Beijing Zhongxing Liye Science-Technology Investment Company

also bought some shares. Baoding Development District Administration Commission exited from this company. It occurred in 2002. Within the new company, Tianwei Yingli Company, Tianwei Baobian Company held 49% of the total shares, Yingli Group Company held 45%, and Beijing Zhongxing Liye Science-Technology Investment Company held 6%. In 2004, Tianwei Yingli Company needed 400 million RMB to invest in new projects and asked Tianwei Baobian Company to provide guarantee for the borrowing from banks, but the latter proposed to absolutely control Tianwei Yingli Company. Then Yingli Group Company transferred 2% of the total equity of Tianwei Yingli Company to Tianwei Baobian Company, but reached an agreement that Tianwei Baobian Company would not intervene in the business affairs of Tianwei Yingli Company. Thus, 51% of the total equity of Tianwei Yingli Company was held by Tianwei Baobian Company. In 2005, Tianwei Yingli Company prepared to be listed in the New York Stock Exchange, but the proposal could not be approved by the government because it was a state majorly-owned company. In 2006, Yingli Group Company increased its shareholding proportion in Tianwei Yingli Company from 43% to 51% without the contention of Tianwei Baobian Company, and then was listed in the New York Stock Exchange. In 2007, The Chinese Weapon and Equipment Group Company, the parent company of Tianwei Group Company, and the grandfather company of Tianwei Baobian Company, proposed to resume the 51% shareholding proportion, and wanted to control Tianwei Yingli Company so that it could enter the photovoltaic sector through the access of Tianwei Yingli Company. The Chinese Weapon and Equipment Group Company clearly declared that if this proposal could not be accomplished quickly, it would suffocate the development of Tianwei Yingli Company.

Tianwei Yingli Company is not the only private firm who initially select the mixed ownership, the same is true for Suntech Company<sup>8</sup>. In 2001, Mr. Shi

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<sup>8</sup> The interview with Wuxi SASAC officials in June 2008.

Zhengrong, an expert on photovoltaic sector, came to Wuxi City, Jiangsu Province, to start his photovoltaic business. He lacked sufficient funds however and invited the local government to invest funds in order to set up his company. Eight SOEs, encouraged by local government invested funds, resulting in the formation of a MOE, Suntech Company. Fortunately, when Suntech Company was preparing to be listed in New York Stock Exchange, Shi Zhengrong managed to convince the government to urge the eight SOEs to withdraw their shares from Suntech Company, and he succeeded.

The cases of Tianwei Yingli Company and Suntech Company show that private firms can not enjoy the same treatment as SOEs in terms of the acquirement of government funds, project bidding, and borrowing from banks. During the business expansion, the difficulties of private firms in raising funds are much more serious than SOEs. SOEs usually have good access to funds from the domestic stock market and banks. Private firms usually have good flairs for selecting projects, finding opportunities, and making profits. In these circumstances, mixed ownership helps both SOEs and private firms.

Moreover, since the periodic business cycle and market fluctuations impose risks on enterprises, in comparison with large SOEs, private firms have poorer capability and fewer resources to tackle these risks. After the long-term gradual ownership reform, most of the small and lots of the medium-sized SOEs were sold out, nowadays SOEs are usually large-sized and are supported by the government. These large SOEs have good access to government support, and have great capability to resist the risks. In terms of obtaining assistance from government to resist the risk, private firms are still struggling to get the same national treatment as large SOEs. The cases of Xinhua Airline Holdings Company, Hainan Airline Group Company and Okair Airline Company are very good examples. In 2008, the global airline sector fell into a crisis, almost all airline companies in China faced cash flow crisis. At that time, state-owned

airline companies, such as Air China, China Southern Airlines, China Eastern Airlines, received tens of billions of RMB from the government and was able to weather the crisis as a result. In contrast, Okair Airline Company, a private firm, could not get funds from the government and stopped its business for a time. Another private airline, Dongxing Airline Company, was in a financial trouble in 2009 and was sold to Air China, a SOE. However, Xinhua Airline Holdings Company, a MOE, also got funds from government. According to Mr. Chen Feng, the chairman of this company, the government of Tianjin City and Hainan Province infused hundreds of millions of RMB to Xinhua Airline Holdings Company and its subsidiaries (Li, Meilin. 2008). The support from the government in the global financial crisis demonstrates that how significant and how correct the decision of transforming Xinhua Airline Holdings Company to a MOE was. This company was established in 2004, and the management invited Hainan provincial government to be a shareholder. In 2006, Hainan provincial government invested 1.5 billion RMB and now holds 48.61% of the total shares.

## **5.6 Summary and Discussions**

The analysis on the factors driving the emergence of China's MOEs has been conducted through empirical observations. Now it is necessary to summarize and make some discussions.

(1) The initial mixed ownership originated from the combination of the flexible operational mechanisms of private enterprises and the plentiful business resources of state-owned enterprises

The analysis illustrates that the initial mixed ownership was not an intentional strategy designed by the state. However the initial mixed ownership naturally resulted from the economic co-operation and horizontal alliance in the 1980s. Once the co-operation and the alliance started, it could not be confined to SOEs, the co-operation and alliance among SOEs and collective enterprises as well as

private firms, naturally happened. The newly-born private firms in particular had flexible operational mechanisms, and the SOEs had rich business resources. The mixed ownership enabled them to mutually supplement their advantages. In fact, the mixed ownership demonstrated its vigour in reality. The synergy of different advantages of SOEs and non-SOEs, is an important factor driving the emergence of the MOEs in China.

(2) The China Model of state owned enterprises reform catalysed a number of mixed ownership enterprises

My studies demonstrate that the China Model of SOEs reform bred mixed ownership. Radical control reform of the SOEs and gradual ownership reform are liable to lead to partial rather than full privatisation. Meanwhile, the government's incomplete trust in private ownership, the government's incomplete releasing of its controlling powers on SOEs, the prejudice about private firms from the public and the employees of SOEs, the granting of some state shares for compensating insiders' contribution to state assets formation, promoted the rise of MOEs. The unfair treatment to private firms also enhances the standing of mixed ownership.

(3) The incremental transition pattern provided the basis for the formation of mixed ownership

Without doubt, the incremental transition pattern, as defined by Wang, Mengkui. (2003), provided a firm basis for the formation of mixed ownership. This was because the rise of mixed ownership needs both SOEs and private enterprises. The incremental reform keeps the state sector for a time but encourages the development of the private sector. From time to time, the private sector will expand and more private firms will grow up. Once the opportunities arise, SOEs and private firms will collaborate and MOEs will emerge. On the contrary, in Russia and Eastern European countries, the transition pattern is not incremental,

meaning there were not enough private firms to be combined with SOEs to produce MOEs.

(4) The governmental inexperience in administering private firms favours mixed ownership

Why does not the government have complete trust in private ownership? Why does not the government want to completely release its' control of SOEs? This can not only be attributed to the interests of government departments and officials, but also to the governmental inexperience in and unfamiliarity with administering private firms. Chinese government has the customs and the tradition to keep the controlling powers and influence on economic affairs. The government is experienced in and familiar with keeping some control and guidance on SOEs, but this is not the case with private enterprises. A simple example is, when the government faces inflation or unemployment, it can instruct SOEs not to raise the price and not to fire the workers, but it does not know how to handle these issues with private firms, or it does not believe it is capable of handling the situation well. While many SOEs, especially large and important SOEs, need ownership reform, the government does not want to completely lose its controlling powers and influence. Retaining some state shares and selecting mixed ownership will decrease these worries. Many cases show that how MOEs are more liable to accept governmental influence. Of course, this is also a corporate governance issue, which will be addressed in chapters 6 and 7.

(5) More public trust in SOEs encourages some private enterprises to accept mixed ownership

The studies show that not only the government itself selects mixed ownership, but some private firms who participate in the ownership reform of SOEs actually opt for mixed ownership. In China, although the economic transition has produced a great number of private enterprises, it is still difficult for them to

acquire enough trust from the public, customers, or banks. Even nowadays, SOEs are still regarded by the public as a more reliable kind of enterprises. While SOEs face efficiency problem, private firms face trust problem. The causes are complicated. Besides the long-history of social prejudice, private firms are often criticised. Indeed, they may be excessively lucrative, may neglect morals, and may defy social rules in certain circumstances. Since facing trust problem, private firms may select mixed ownership while participating in SOEs ownership reform and expanding their business. Mixed ownership may help them acquire more trust and facilitate their business.

(6) The poor access to business resources makes some private firms select mixed ownership

SOEs can acquire more business resources of many kinds than private firms. The major cause why private firms are unable to acquire enough business resources is that many business resources are still controlled by the government and it is liable to exercise preferential policies to SOEs. On the other hand, SOEs are more likely to follow government instructions on local economic and industrial development strategy and bear more social responsibilities, they have more reasons to attain these business resources from the government. Selecting mixed ownership can help private firms acquire more business resources from the government.

(7) The governmental assistance and protection for SOEs may push some private enterprises to become MOEs

The belief of “governmental protection may save state ownership from market hit” is a major factor driving private firms to accept mixed ownership. Market hit sometimes knock down firms. But SOEs are more likely to obtain funds or other kinds of supports from the government when market hit happens to them, then avoid the fate of collapse. Although SOEs are usually less efficient than private

firms and that is why SOEs need to be ownership-reformed, but SOEs have more connections with the government and are liable to resort to many kinds of supports from the government. Generally speaking, business partners and customers may have more confidence in SOEs because people believe SOEs are backed by the government. In the global financial crisis of 2008, even in the US some private giants managed to be supported by the government including obtaining state ownership in order to avoid the possible collapse. In China's market economy, lots of people believe that "governmental protection may save state ownership from market hit". In reality, it can be found that lots of private firms collapsed in the circumstances of market hit and cash shortage. As for those SOEs in difficulties, they usually can not be closed or go bankrupt, the government is likely to infuse funds and other resources to maintain their running as long as they can be saved. In comparison with private firms, it is more possible for MOEs to acquire funds and other business resources from the government when they are in difficulties. The case of Xinhua Airline Holdings Company who got the support from Hainan Provincial Government and Tianjin Municipal Government in 2008 crisis is a good example. In China, the collapse of the enterprises has another cause. Every few years, the government will carry out a round of industrial restructuring, some firms will be forced to close their business, and private firms tend to be the victims. Selecting mixed ownership will help enterprises to avoid this fate.

(8) More lawful protection for SOEs leads some private enterprises to mixed ownership

China currently is not a mature rule-of-law country. SOEs can usually get more lawful protection than private firms. This will attract some private enterprises to become MOEs.

(9) Mixed ownership can alleviate SOEs insiders' resistance to ownership reform to some extent

Mixed ownership is also a good way to alleviate SOEs insiders' resistance to ownership reform. It seems that in lots of countries, privatisation is resisted by SOEs employees. SOEs employees want to hold firmly the iron rice bowl. In China, generally speaking, SOEs employees are reluctant to become the employees of private firms because their iron bowl may become an earth bowl under ownership reform, and they think private ownership can not bring them the sense of naturalisation. It is found that in the survey that in most of the fully-privatised enterprises, the employment status of their workers was usually transformed, namely, the workers did not have the standing of permanent employment any more. In many MOEs, however, the employment status of their workers usually was not transformed. Besides, it is more feasible for MOEs to set up party organisations and that will give traditional employees more of the sense of naturalisation.

#### (10) Mixed ownership contains the traditional Chinese culture

The rise of the mixed ownership in China is related to the traditional Chinese culture of adaptation, balance and fusion. As stated by Wu, Xinxin. (2005), the development of the MOEs in Ningbo City, Zhejiang Province, has something to do with the regional cultural traditions such as the openness, innovation, and pragmatism. The culture in Ningbo is also a part of Chinese culture. It is found that many people who participated in SOEs ownership reform often emphasised the doctrine of adaptation, and recognised the philosophy of "overrunning will not run". Mr.Lin,Yutan. (2000) held that the major traits of Chinese people are roundness, flexibility, enduring, balance, and adaptation. He argued that these traits make Chinese people sensible and rational, and they are likely to select the approach of compromise and compatibility. Although the characteristics of adaptation, flexibility, roundness, enduring, and balance may not only belong to Chinese traditional culture, many other countries possibly have similar cultural traits, the rise of China's mixed ownership is indeed related to Chinese traditional

culture in the background of the great economic transition and the certain ideological constraint.

Selecting the mixed ownership means to share the controlling powers and the profits among the state shareholders and the non-state shareholders. Therefore, how to allocate the controlling powers and how to distribute the profits become very critical issues. Meanwhile, the existence of the state ownership makes the government-enterprise relationship more complicated. Mixed ownership may enhance the naturalisation sense for the enterprise employees and may maintain their iron bowl, but insiders' interests may conflict with private shareholders' interests. All these issues are related to corporate governance. The corporate governance of MOEs may be more complicated than the emergence of the MOEs in China. Therefore, the studies on the corporate governance of China's MOEs should be conducted in the following chapters.

## **5.7 Concluding Remarks**

This chapter analyses why the mixed ownership emerged in China. Some findings have been presented. In the 1980s the early mixed ownership resulted in the horizontal co-operation and business alliance, the SOEs' advantage for business resources and the non-SOEs' advantage for flexible operational mechanisms were combined in mixed ownership, and the positive synergy was created. Since the mid-1990s, many SOEs were ownership-reformed. Due to the ideological constraint, the granting of some shares for the insiders' contribution to the formation of the state assets, mixed ownership was selected by lots of enterprises. Meanwhile, the government is willing to maintain some state shares to retain a hand. It is also found that private firms have poor access to business resources, and face more difficulties in obtaining the trust of the government, the public, banks and customers. That also favours mixed ownership. Furthermore, Chinese traditional culture expedites the rise of MOEs.

## **Chapter 6**

# **Understanding the Corporate Governance of the Mixed Ownership Enterprises from the Perspective of Institutional Arrangements**

### **6.1 Introduction**

The analysis of the major factors driving the emergence of China's MOEs has been conducted. MOEs are becoming important in the market, it is necessary to know more about them, especially about their corporate governance. Chapter 6 probes into corporate governance from the perspective of institutional arrangements, and set up a basic framework for the analysis of the corporate governance of China's MOEs.

### **6.2 Different Models of Corporate Governance**

As discussed in chapter 2, the term of corporate governance usually refers to the roles of board of directors, management, owners, stakeholders, and to corporate transparency as well as the independence of corporate business. Actually, this term is often deemed as the function of board of directors, shareholder rights, information disclosure and executive compensations (OECD, 2004).

Corporate governance has been intensively discussed in the past 30 years. But there are different models of corporate governance because of different market environments, different juridical systems, and different cultural traditions. Vives (2000) stated that corporate governance can be usually distinguished into market-oriented model versus bank-oriented and relations-based model. Vives (2000) described the models. The former is also called Anglo-Saxon model. Large companies in Anglo-Saxon countries are usually listed in stock

markets, the ownership are dispersed among many institutional and many individual investors, the ownership concentration is modest, the companies are controlled by managers. The latter is also called continental European model. In continental countries, especially in Germany, the large companies usually have long-term and close relations, and then banks play very important role in corporate governance. The public corporations over 500 employees usually have a two-tier system board. Furthermore, in many continental countries and some Asian countries, most large-sized enterprises are private, even the ownership of many listed corporations is quite concentrated, but the market for corporate control in these countries is weak. Pyramidal control can be found in these companies. In Japan the main bank system is in place and the main banks play important role, the main bank usually holds some shares of the firm and they can intervene in corporate business affairs, and the management usually controls the firm. Hansman and Kraakman (2004) argued that in the most time of the 20<sup>th</sup> century, the corporate governance in the US can be called the manager-oriented model, the corporate governance in Germany can be called the labour-oriented model, the corporate governance in France and in Japan can be called the state-oriented model, and the shareholder-oriented model is highly recommended, this model is not only applicable to Anglo-Saxon countries, but also applicable to continental and many other countries. Therefore, corporate governance is addressed intensively in relation to issues such as: taking single-tier board system and introducing independent directors or outside directors, enhancing information disclosure and promoting corporate transparency, encouraging shareholder lawsuit, and developing a take-over market.

These models of corporate governance describe the features of corporate governance in different market economies quite well, but do not cover the case of China. China is a former planning economy and currently is still halfway in the process of economic transition. China even did not have its company law before 1993. Some economists (La Porta et al, 1998) argued that corporate governance

model is related to law system. Common law countries dominate continental civil law countries in terms of legal protection the interest of stockholders (La Porta et al, 1997). China enacted its first company law in 1993, this law was basically developed from the UK corporation law with a lot references to the Japanese corporation law and Germany corporation law, therefore China's corporate law is a mixed system of the UK and the continental countries. Its securities law enacted in 1998 is a continental-style law. But unlike Japan and Germany, banks do not hold equity in firms and play poor role in corporate governance in China. China's company law says corporation takes two-tier board system, but the supervisory board in China's corporations is not the same as in Germany, it is not a decision-making board but a monitoring organ. As a matter of fact, the supervisory board in China's corporations is usually a flower vase and plays no role. In addition, the ownership structure for many large enterprises in China is quite different from in the US, the UK, and other capitalist countries. Many large enterprises in China are still SOEs or MOEs. The ownership structure is usually concentrated. Furthermore, the managers and workers in SOEs and in many MOEs have strong connection with the government, they may not follow law clauses but follow government documents.

Allen and Gale (1999) argued that the effectiveness of company board, the juridical system, and the market for corporate control, is quite exaggerated by many people. In fact, internal and external governance mechanism could not play very good and expected role in overcoming the principle-agency problem. They pointed out the competition in goods market is critical to improve corporate governance and to promote corporate performance. But more literature emphasized the importance of board of directors and corporate transparency as well as lawful protection of shareholders. Hermalin and Weisbach (1991) found that board of directors is generally favourable to improve corporate performance. Denis and Sarin (1999) analysed board structure and found out in many American listed companies the board structure was from time to time under

change, and the introduction of independent directors was helpful to promote shareholder value. Rezaee (2007) stated that information disclosure, corporate transparency, and rigid regulations of securities market are very important to recover the trust from investors.

In different models, the improvement of corporate governance faces different critical issues. In Anglo-Saxon countries, outside directors or independent directors are usually recommended to improve the governance of large-sized companies in response to the unchecked managerial abuses of the controlling powers and payments of excessive compensations, because these large-sized companies are usually listed in securities market and their ownership structure is quite dispersed among institutional investors and many individual investors. The insiders control is very common, outside or independent directors are expected to act as a check against managerial powers (Lin, 1996). John and Senbet (1998) argued that the external mechanisms such as the market for corporate control are also important while the internal mechanisms including the board effectiveness and auditing system do not work very well. Aguilera (2005) also discussed the role of independent directors in different countries, and found that independent director system could still be relied on as a check mechanism though the independence of these directors was sometimes questionable. But in Germany, the banks and holding companies are recommended to sell stocks in order to decrease the ownership concentration and to increase the openness of shareholding structure, and the market for corporate control should be developed (Gilson, 1992). In Japan, since cross-shareholding is very common and main banks play an important role in enterprise groups (Kerretsu), one of the major solutions to improve the corporate governance of these enterprise groups is to enhance the corporate transparency. Furthermore, the liquidity of the equity of these enterprise groups is also important to improve the governance (Ramseyer, 2004). In emerging markets and Eastern Asian countries, Josnson et al. (2000) argued that tunnelling and expropriation were very serious problems. They found

many instances of looting of firms by their controlling shareholders in these countries, good assets were sometimes transferred out of companies, profits might be siphoned off in purpose to escape creditors. Therefore, the critical issue of improving corporate governance for these countries is how to restrict the controlling powers of controlling shareholders instead of professional managers, and to prevent them from assets and profit tunnelling.

However, corporate governance is still in change and under reform across countries in the past 10 year. In the late 1990s and the early 2000s, corporate scandals of Enron, Tyco, and WorldCom shocked the market, and then Sarbanes-Oxley Act (SOX) was passed in the US in 2002. SOX unprecedentedly emphasizes the internal control and the auditing system for listed companies in the US stock market. CEO is held responsible to the credibility and reliability of the internal control and the auditing system. Moreover, government regulations form Securities Exchange Commission (SEC) plays a more important role (SEC, 2002). Studies show that SOX helps with promoting internal control, information disclosure and corporate transparency (Hermalin and Weisbach, 2007). But Romamo (2005) criticized SOX and regarded SOX as quack corporate governance because it was enacted in a specific political environment and market atmosphere. In general, SOX is a milestone of corporate governance, it brings about the corporate governance revolution with influence on accounting, internal control, executives responsibility, corporate transparency, and the culture of stock although there have been disputes and criticism (Rezaee, 2007).

While different models and best practices of corporate governance are widely discussed, it is worthy to ask how to identify the critical issues of the corporate governance in China. The ownership structure for many companies in China is quite different from Anglo-Saxon countries and continental European countries, it is easy to find the controlling shareholders, and the ownership concentration is usually very high. But unlike Germany and Japan, banks play a weak role in the

corporate governance of China's companies. Instead, the government has a big influence both in SOEs and in many non-SOEs (Xu, Dianqing., 2000). Many instances of tunnelling can also be found in China, but it seems that the companies with large state shareholders face much less serious problem of expropriation than the companies controlled by private shareholders (Tenev, and Zhang, 2002). Especially, most of the listed companies in China have the state largest shareholders, the corporate governance in China is undoubtedly influenced by the strong government. Therefore, the enterprise-government relationship should be carefully taken into account. That is one of the most critical issues while analysing the corporate governance in China. In addition, the ownership reform of China's SOEs often causes a big change in ownership structure and control structure, that also increases the complication of the corporate governance reform in China.

### **6.3 The Corporate Governance of the State-Owned Enterprises and Private Enterprises in China**

As mixed ownership comes from the combination of SOEs and private enterprises, it is necessary to have a basic analysis on the corporate governance of the SOEs and the private firms in China before conducting studies on the corporate governance of MOEs.

Throughout the past thirty two years, the governance of China's SOEs has changed hugely. Some basic rules however, especially the rules of selecting managers by the ruling party, have not changed. Although the term of corporate governance had not been introduced to China before the early 1990s, in the 1960 the Ordinance on State Enterprises Operation was circulated by the Chinese government which determined the relationship between the government and SOEs. This ordinance set up a preliminary governance framework for SOEs and stipulated that SOEs should be supervised by the party committee and managed

by the factory chief. In 1979, the Ordinance on Expanding SOEs Operational Autonomy stipulated that SOEs should be supervised by the party committee, managed by the factory chief, and monitored by the congress of workers. In 1984, the Ordinance on Further Expanding SOEs Operational Autonomy clearly stipulated that the factory chief and the secretary of the party committee should be appointed by the government or the party department, but the deputy factory chief and deputy secretary could be nominated by the factory chief and party secretary, and the mid-level managers meanwhile could be appointed by the factory chief himself. In 1986, the State Council circulated the Ordinance of Factory Chief Mandates of SOEs, the Ordinance of Factory Party Committee Mandates of SOEs and the Ordinance of Factory Workers Congress Mandates of SOEs. These three ordinances stipulated that the factory chief should take the overall responsibility for the business operation of SOEs and he or she was the only legal representative. Factory chief was to be appointed by the government or the party department and the position was to have a term of between three and five years. In 1988, China enacted the State-Owned Enterprise Law, stating again that the factory chief should take the overall responsibility for the business operation of SOEs, and that he or she was to be the only legal representative of the enterprise. In reality however, struggles between the factory chief and the party secretary often occurred. In 1993, the first Company Law in China was enacted in which there was a chapter about solely-state-owned company. This law stipulated that shareholders' meeting, board of directors, and board of supervisors, should be set up. In reality however, conflicts among the "new three committees" and the "old three committees" arose. The new three committees are the board of directors, the board of supervisors, and the shareholders meeting while the old three committees are the party committee, the workers congress, and the trade union.

Many SOEs, especially the large SOEs, have not re-registered as corporations until now, but they do not maintain the old system in which the factory chief

takes overall responsibility. Some have tried to establish the system of board of directors since the mid-1990s, and in these circumstances the only legal representative is not the factory chief but the chairman of the board. This means the factory chief is not so powerful a person and the chairmen have become much powerful.

Almost in all SOEs, especially in the large ones, the three important positions (president, chairman and party secretary) are still grabbed by the government or the party departments. Although some SOEs have established the board of directors and the president should be selected by the board according to the company law, as a matter of fact, the nominee has to be internally selected by the government or the party department before the appointment.

The field surveys with Baosteel Group Company<sup>9</sup>, and Baotou Steel Group Company<sup>10</sup>, were informative. It is found that the positions of chairman, president and party secretary in these companies are still controlled by the party department, but the party department often honours the opinions of the insiders while doing the appointments. Since 2003 the central government and local governments have established their SASACs, the power of selecting the leaders of SOEs has been gradually transferred to SASACs. The selection of the leaders of some important large SOEs is still in the hand of party department though. Since 2004, the central SASAC has been trying to set up a new board system in central SOEs, Baosteel Group Company pioneered this trial in 2005. The new board of Baosteel Group Company consists of nine members, five are outside directors and one is an employee director. The trial has expanded to more than thirty SOEs administered by the central SASAC as of the end of 2009. It has to be pointed out however, the ultimate power of selecting the leaders in these SOEs is still in the hand of the party department.

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<sup>9</sup> The interviews with the strategy department head of Baosteel group Company in July 2008 and the monitor board members in May 2009.

<sup>10</sup> The interview with the vice president and general economist of Baotou Steel company in August 2008.

As the selection of high-level managers is still decided by the government, or the party, their status and compensations can not be fully marketised. Nowadays, the chairpersons, presidents and party secretaries of SOEs still hold the status of state cadre. It is the same case even in listed SOEs. The government, or the party, will exercise periodic examinations on their business performance and political performance, their compensations are also managed by the government, or the party. A field survey of the central SASAC<sup>11</sup> showed that the compensations of SOEs executives began to be connected with the performance of the enterprises they manage. In late 2003, the central SASAC circulated the ordinance of performance examination. The examination targets include both basic targets and unique targets, the former are the assets appreciation ratio and ROE while the latter are determined separately by the SASAC according to the specific conditions of each SOE. The SASAC officials expressed that the compensations of SOEs' executives ought to be controlled by SASAC, otherwise the gap between their compensation and the salaries of workers would soar and the public may not accept it. It is found that the CEO's compensation of CNOOC, a listed company in overseas stock market, to be seemingly very high. But as a matter of fact, the published compensation is only nominal, while the actual compensation was determined by the central SASAC according to the achievements of the targets and was much lower than the published compensation.

It is very important to point out the seriousness of the insiders control and insiders sharing in China's SOEs, which should be highly considered when studying their corporate governance. During the progress of delegating powers and conceding profits, the implementation of the SOEs' autonomous powers was very important for the SOEs to get rid of the planning economic system and the governmental intervention at that time. However, the autonomy was actually an unclear concept. In reality, insiders' sharing and insiders' control are very serious

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<sup>11</sup> The interview with performance monitor department officials in March 2009.

in SOEs though the government and the party still hold some ultimate powers.

The corporate governance of China's private enterprises appears much simpler than SOEs. The appointment of managers and their compensations have nothing to do with the governmental control, the government does not intervene in the daily operation of private enterprises. However, private enterprises also face their own problems of the corporate governance. China has a very short history of private sector, most private enterprises are family firms, and the decision-making system is very simple: the founder of the firms, or the most influential member of the family, is the ultimate decision-maker. Even if these enterprises are a registered corporation which should run according to company law, as long as the majority equity is owned by family members, the decision-making system is the same. However, while some shares are owned by outside people, the governance becomes much more complicated. If all shareholders belong to the same circle, such as the classmates circle, the village mates circle or the friends circle, the circle relations and circle culture impact heavily on corporate governance. When all shareholders do not belong to the same circle, the fighting for controlling powers is very critical.

The basis of the combat for controlling powers is the struggle for majority shareholding among the various parties. The majority shareholding brings the corresponding lawful voting rights and allow the controlling party to obtain the position of chairman and enough seats in the board of directors, as well as the positions of president and chief financial officer (CFO). In China's company law, the chairman has the decisive power, while the president and CFO are also powerful people. It is found in the surveys that acquiring majority shareholding is the primary target for most important shareholders in private companies. In general, the founding shareholder, or the existing majority shareholder, absolutely hates to lose the standing of holding the majority shares. A field

survey was conducted with Shanshan Group Company<sup>12</sup>, a famous private company in China, founded by Mr. Zhen Yonggang who holds the majority shares. In 2009, he introduced a Japanese company, Yitengzhong, as a strategic investor to participate in his company. During ownership structure negotiation, he clearly expressed that if Yitengzhong wanted to obtain the majority shares there would be no need to proceed further. It is a clear statement of his intent to keep the controlling powers. Eventually, Yitengzhong acquired 28% of the total shares. However, if corporate shares are dispersively distributed in many shareholders, the combat for controlling powers will be very fierce. It is found in the field survey of Sina Company<sup>13</sup>, the combat for the controlling powers had been very fierce due to its shares being dispersively distributed. Since 2001 to present, Sina Company has seen four chairmen and four CEOs. During the struggle, insiders, instead of large shareholders, gradually obtained the controlling powers. The case of Sohu Company provides an opposite example<sup>14</sup>. Sohu Company is another famous internet company in China. Mr. Zhang Chaoyang, the company founder, holds the majority shares. He has been successfully maintaining the position of the chairman.

While there are many small shareholders, the controlling shareholder is liable to abuse the controlling powers to harm the interests of small shareholders through related-parties transactions and tunnelling. These transactions are more common in private enterprises. Studies (Li, Zengquan. et al, 2005; Chen, Xiao., Wang, Kun. 2005) show that the abuse of the controlling powers by majority shareholders and the conveyance of interests, are a headache in China. Sun, Zhaobin. (2006) found that the probability of tunnelling by controlling shareholders is very high in China's private companies. Tang, Qingquan. et al. (2005), Xu, Xiaodong., and Chen, Xiaoyuan. (2003), found that the largest shareholder often exploits other people's interests through the transactions of

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<sup>12</sup> The interview with the president of Shanshan Group Company in June 2009.

<sup>13</sup> The interview with the vice president of Sina Company in June 2008.

<sup>14</sup> The interview with the president of Sohu Company in January 2009.

related parties. Bai, Chong'en. et al. (2005) conducted studies on China's listed companies, finding unbalanced ownership structure to be liable to cause tunnelling transactions. Su, Qilin., and Zhu, Wen. (2003) conducted studies on family-controlled listed companies in China, finding that family interests may conflict with company interests very often. Zhao, Jingwen., and Yu, Zengbiao. (2005) pointed out that corporate shareholding structure is very critical, and an appropriate shareholding structure is helpful to exercise the check and balance function.

The emergence and development of China's stock market have been favouring the reform and the improvement of the corporate governance of both SOEs and private companies. Shanghai Stock Exchange was established in 1990 and Shenzhen Stock Exchange was established in 1991. Until the end of 2009, more than 1800 companies have been listed in Shanghai Stock Exchange and Shenzhen Stock Exchange, about 65% of them have the state majority shareholder (Li Yang, 2010). China passed its first company law in 1993 and first securities law in 1998. All listed companies have to establish board of directors and board of supervisors according to the company law and the securities law while most of state-wholly-owned enterprises do not have their board of directors. Furthermore, China Securities Regulatory Commission (CSRC) introduced an independent director system to China's listed companies by executing the Principles of the Corporate Governance of Listed Companies published by CSRC in 2002, which stipulates that the members of independent directors in any listed company should exceed one third of the total seats in the board of directors. The second edition of China's company law passed in 2005 stipulates that any listed company must have independent directors in the board. CSRC also published lots of ordinances about the information disclosure, the auditing and reporting, the rules of general meeting and the board of directors, and the voting system of listed companies. Once a company gets listed in the stock market, its

transparency, its decision-making regularity, and its checking mechanism, will be enormously promoted regardless of a SOE or a private company.

But listed companies still face some similar governance problems to non-listed companies. For listed SOEs, the conflicts among the “new three committees” and “old three committees” are still there, and they can not escape the intervention from the government although the influence may be more cryptic. Listed companies additionally face their own specific governance problems. One of the serious problems is the tunnelling and expropriation. The ownership structure of listed companies in China is very concentrated, and pyramidal shareholding structure is quite common. In this circumstance, large shareholders are liable to transfer assets or profits from listed companies to their own non-listed firms, some parent companies even baldly embezzle and employ the funds of their listed subsidiaries. The camouflage way of infringing on the interests of listed companies is related-parties transaction. Accounting fraud and financial manipulation are other serious problems. In order to overcome these problems, the function of board of directors should be enhanced, especially independent directors should play more important role, and regulations by CSRS and stock exchange houses should also be emphasized (Qiu Yonghong, 2008).

Some Chinese companies have been listed in overseas stock markets including Hong Kong stock market and the US stock market. The overseas listing is more helpful to improve the corporate governance of those companies because overseas stock markets have longer history, more rigid rules and more advanced juridical system. Most of Chinese overseas listed companies are in the US market, therefore SOX also has impact on some large Chinese companies. China Mobile Corporation is a state-owned company listed in New York Stock Exchange. The chairman, Mr. Wang Jianzhou, said in 2006 that China Mobile Corporation had been working hard to establish a strong internal control system and an independent auditing system in order to meet the requirements of SOX, and he

recognised this work would promote the transparency of China Mobile Corporation and earn more trust from the global investors (Gong, Weifeng., 2006). But it should be noted that the overseas listing can not solve the problem of the “new three committees” and the “old three committees”, and the problem of the governmental selection of executives. The appointment and the retirement of Mr. Wang Jianzhou himself are of course determined by the government, the function of the board of directors is like paperwork.

Generally speaking, although a big progress has been made in improving the corporate governance in China, there are still some serious problems. For China’s SOEs, the power of selecting managers and determining their compensations is still in the hand of the government or the ruling party. The conflicts among the “new three committees” and the “old three committees” actually reflect the complicated and unclear relations among the government, the enterprise, the management, and the labour. The underdevelopment of the market of managers makes these issues very difficult to deal with, the management and the labour have strong and complex connections with the government, which gives the excuse for the government to intervene and hold the government responsible to impose influence on SOEs governance. For China’s private companies, the selection of managers and their compensations are not critical issues, and they do not face the conflicts of the “new three committees” and the “old three committees”, but the fighting for majority shareholding proportion and controlling powers are very critical while there are two or more large shareholders in a company. This means that the relations among different shareholders should be highly concerned while looking at their corporate governance, the shareholding structure and the control structure will be decisive. But in many circumstances, the distribution of controlling powers depends not only on shareholding structure but also on some informal institutions and customs, such as the family authority structure. Moreover, looting transactions may happen very often in listed private companies.

Therefore, using the common framework to analyse the corporate governance of China's companies is not sufficient. The corporate governance of China's companies, especially China's SOEs, of course primarily refers to the board of directors, the corporate transparency, and the regulations from securities market. However, it would be difficult to catch the other side of the corporate governance of China's enterprises if the issues of the enterprise-government relationship, the relationship among different block shareholders, the relationship among the management and the workers as well as the government, and the arrangements of the controlling powers, were not probed into. Probing into those issues needs the analysis from the perspective of institutional arrangements on the basis of new institutional economics. Especially, in the circumstance of mixed ownership, it is more necessary to look at the corporate governance from the perspective of institutional arrangements because the introduction of the other kind of ownership attribute will make the institutions of corporate governance more complicated.

#### **6.4 Understanding Corporate Governance from the Perspective of Institutional Arrangements**

According to Williamson (2000), social analysis can be divided into four levels in the new institutional economics. Actually he developed this analytical framework in 1998 (Williamson, 1998). Williamson (2000) described that the first level is embeddedness: informal institutions and customs; the second level is institutional environment: formal rules of the game; the third level is governance: play of the game, especially contract; the fourth level is resources allocation and employment. The new institutional economics is concerned with level 2 and level 3. He discussed the connections between governance structure and property rights, regulations, bureaus, contracts, and markets. He stated that the firm should be considered as a governance structure in which internal structure has an economic purpose and effect. He admitted that the attributes of mixed ownership

modes (alliances, joint ventures, franchising, and the like) as well as the mechanisms for supporting credible contracting between autonomous firms are incompletely worked. His analytical framework of four levels is very enlightening to my research, though his concept of governance structure is not identical to corporate governance.

Roe (2004) discussed corporate governance in detail from the perspective of the institutions in his paper “The Institutions of Corporate Governance”. He means the relationships at the top of the enterprise by corporate governance: the board of directors, the senior managers, and the shareholders. And by institutions he means those repeated mechanisms that allocate authority among the board of directors, the senior managers, and the shareholders. He argued that core corporate governance institutions respond to two very important and distinct problems which should not be avoided: the vertical governance and horizontal governance, the institutions interact as complements and substitutes. He also listed the basic governance institutions of listed companies in securities markets: markets (product market, equity market, managerial labour market); the board of directors; information distribution and gate-keeping; coalescing shareholders; executive compensation; professionalism and norms; corporate lawsuits; capital structure; bankruptcy; complements and substitutes. He also pointed out that the institutions of corporate governance could sometimes be affected by political institutions. The political pressures would lead enterprises to have more concentrated ownership so that managers of enterprises could be more directly controlled. He also analysed the corporate governance institutions in their setting, such as contract, property rights, and control rights. His studies on the institutions of corporate governance is very shrewd, especially his analysis of ten issues is very helpful.

Posner (2010) also did some analysis on corporate governance from the perspective of new institutional economics. He stated that the corporate

governance of business companies is quite weak and the agency problem should of course be overcome, and argued that the judiciary of common law is regarded very helpful. But regrettably, his discussions focused on legal systems. Allen (2005) discussed the corporate governance in emerging economies by using the new institutional economics approach, and argued that it is not always sufficient to focus on the issue whether the legal framework and institutions ensure that firms are run in the interests of shareholders. His conclusions are interesting, but also focus on legal system.

Corporate governance of course is related to corporate ownership. According to Grossman and Hart (1986), ownership can be regarded as a system of control rights, the appropriate assignment of property rights is determinative from the view of new institutional economics. A study by Fama (1980) is also widely acclaimed. He emphasized the deep significance of the arrangements of controlling powers, and pointed out that the board itself works as a controlling tool. Consequently, some economists studied corporate governance from the perspective of controlling powers. Tirole (2001) conducted a systematic analysis on the importance of the controlling powers in corporate governance by using the new institutional economics approach, and argued that the structure of controlling powers has a decisive impact on corporate governance. Dyck and Zingales (2004) also did analysis on corporate control, and pointed out that the transfer of controlling powers is a significant issue in corporate governance. Becht et al. (2002) reviewed the theoretical and the empirical studies on the main mechanisms of corporate control in their paper "Corporate Governance and Control", discussed the main legal and regulatory institutions in different countries. They found a fundamental dilemma about the role of the controlling shareholders.

Aoki(2001)pointed out that corporate governance is actually a set of institutional arrangements, and institutions are the system of shared beliefs that defines how

games will be exercised. The rules of game are formed by the participants during the game process, these institutions are then self-enforced. It is very shrewd to regard corporate governance as a set of institutions and the rules of game. North (1990) also conducted deep analysis on institutions and the rules of game, although he did not conduct studies on corporate governance. He argued that institutions are actually the rules of game, and the rules of game can be divided to two categories: formal rules, such as law and formal contracts; and informal rules, such as customs and traditions. On the basis of the above analysis, corporate governance can be regarded as a set of mechanisms handling the relations of different parties and the power structure which are forged during the process of conflicts and frictions among different parties. This understanding of corporate governance is significant to my studies on the corporate governance of MOEs.

In the process of conflicts and frictions among different parties a balance will be created, known as the corporate political mechanism (Pound, 2001). Hellwig (2000) conducted the studies on corporate governance from the perspective of political economics, arguing both shareholders and stakeholders strive to achieve the best possible outcome. Their activities lead to complicated game situations of corporate governance, in which the management are usually found to hold the advantageous standing. Hart and Moore (1989) also pointed out that different parties will struggle to achieve their own interests. The results of these struggles determine the distribution of their interests. The studies by Roe (1990, 1994, and 2003) are very interesting. He analysed, in detail, how the corporate governance of American companies is influenced by the social politics, and explored how managers and workers employ the public opinions and the requirements of the politicians in order to protect their own interests and to strengthen their own standing. He argued that corporate governance is often influenced by political factors.

Thus, looking at corporate governance from the perspective of institutional arrangements on the basis of new institutional economics give me deep understanding of corporate governance. The institutional arrangements of corporate governance should include the following issues: company ownership and property rights arrangements; corporate controlling powers arrangements; contracts; markets (product market, equity market, managerial market and labour market); regulations from bureaus and political mechanisms; relations between owners and the management, relations among shareholders; and of course the role of the board of directors, information disclosure, executive compensation, corporate lawsuits. For non-publicly-traded companies, the issues of information disclosure, executive compensation, and corporate lawsuits are usually less concerned. Since mixed ownership in China results from the gradual transition and the institutional evolution of China's economy, taking the perspective of the institutional arrangements to study the corporate governance of MOEs is more helpful to catch the institutional relevance of China's enterprises reform. While discussing the corporate governance of MOEs from the perspective of institutional arrangements in next chapter, the focus will be the following issues: ownership; controlling powers and the board of directors; contracts; markets (especially the manager market and labour market); regulations from bureaus and political mechanisms; relations between owners and management, relations among shareholders. The issues of information disclosure, executive compensation, and corporate lawsuits will not be discussed because the MOEs this thesis is concerned about are not the publicly-traded companies, while the corporate governance of publicly-traded companies in China is regulated by specific laws and specific ordinances, and the existing literature on the corporate governance of publicly-traded companies in China is affluent.

## **6.5 The Institutional Arrangements of the Corporate Governance of the Mixed Ownership Enterprises: Literature Discussions and Empirical Observations**

Existing literature has pointed out that the corporate governance of MOEs is distinctive (Lin, 2000). The critical difference between MOEs and SOEs, as well as between MOEs and private enterprises, is that there are both state shares and private shares in MOEs. Namely, they have a distinctive shareholding structure. From the perspective of the institutional arrangements of MOEs' corporate governance, shareholding structure is critical. On the issue of the relationship between shareholding structure and corporate governance, existing literature shows big disputes. Morck et al. (1998) found that while management shareholding proportion increases to an appropriate level, the consistency and compatibility of managers' interests and other shareholders' interests will increase. The study by McConnell and Servaes (1995) shows that Tobin's Q is strongly correlated to the shareholding proportion of insiders. Some other studies, however, show that corporate governance and corporate value have nothing to do with shareholding structure. Holderness and Sheehan (1988) compared the dispersive-ownership companies with concentrated-ownership companies and found that corporate performance was not correlated to shareholding structure. It is regrettable that these papers do not look at MOEs. Hansmann (1996) conducted studies on the corporate governance of companies with numerous shareholders, and found the difference in interest orientations and business styles among various shareholders were very common. He claimed this would cause mutual distrust and poor cooperation among these shareholders. In comparison with common firms, the corporate governance of multi-shareholders companies is more complicated. Boubakri et al (2005) did studies on the post-privatisation corporate governance and discussed the role of ownership structure. They used a

sample of 209 privatised enterprises from 39 countries over the period of 1989-2001, and found that the ownership tended to concentrate over time.

Existing literature has also studied the conflicts of the interests among different shareholders. Some studies (Bai et al. 2005; Friedman et al. 2003; Johnson et al. 2000; Michaell et al. 2003) found that large shareholders may abuse their controlling powers in order to embezzle corporate resources and exploit other shareholders' interests. Some studies (Maury and Pajuste, 2005; Pagano and Roe, 1998) also found that a few large shareholders may check and balance each other and sometimes prevent tunnelling transactions to some extent. They found that the existence of several large shareholders often leads to the increase of corporate value. These papers explored the circumstance in which there are several shareholders. While these shareholders have high shareholding proportions or their shares are difficult to negotiate, the interests of these large shareholders are usually inconsistent. In general, large shareholders may abuse their controlling powers to embezzle corporate resources and exploit other shareholders' interests, but if there are several large shareholders, they may play a role of check and balance. These studies pointed out the distinctiveness of the corporate governance of multi-shareholder companies, but it is regrettable that they did not touch upon the multi-shareholders situation with different ownership attributes.

As for the corporate governance of China's enterprises, Clarke (2003) conducted a simple analysis, and pointed out that China's political system might destroy successful governance. Bai et al. (2004) conducted further studies on the corporate governance of China's enterprises, but their focus was only on the listed companies and their market value. Liu (2006) pointed out China's enterprises were often short of transparency, the government-enterprise relationship was unclear. Fan and Wong (2007) studied the corporate governance of partially-privatised SOEs, and found that they were still largely controlled by

the government. These findings are very valuable to my research, but regrettably their studies only focused on listed companies. The OECD (2006) also touched upon China's enterprises while studying corporate governance in emerging countries, and found that a lack of transparency and a problematic government-enterprise relationship. Pistor and Xu(2005) found the independence of the boards of listed companies in China was poor. Shirley and Xu(2001) found that the effectiveness of the performance contract between the government and SOEs often decreased if the government-enterprise relationship was unclear. Aivazian et al.(2005) studied the corporatisation of China's SOEs, and found that the corporatisation without ownership transformation might improve their corporate governance, but the sustainability of the improvement was dubious.

Some studies on the corporate governance of privatised enterprises are interesting. Gupta (2005) analysed the performance of privatised enterprises. Estin and Wright (1999) compared the privatisation patterns of Ukraine and Russia. They pointed out that voucher privatisation was not helpful in establishing good corporate governance. Brada (1996) found that similar ownership reform might lead to different corporate governance. Studies by Caves (1990) found that the improvement of corporate governance was much more complicated than ownership reform itself. Boycko et al. (1996) found that the successful restructuring of SOEs needs not only ownership transfer, but also power transfer, in order to promote the commercialisation of those enterprises. Again, it is regrettable that the above papers do not touch upon the corporate governance of MOEs.

In summary, existing literature does have studies on corporate governance from the perspective of shareholding structure, but the definition of shareholding structure in the existing literature is the shareholding proportion of insiders, or the shareholding concentration. The existing definition of shareholding structure and the research findings do not refer to mixed ownership. Lots of papers have

studied the corporate governance of China's enterprises, but largely focused on listed companies and their market value. Much literature on the corporate governance is related to the privatised enterprises, but not related to MOEs' corporate governance.

In reality, China's MOEs in the early 1980s developed different governance from traditional SOEs although the term of corporate governance was not used by people at that time. One of the most material changes was the presence of board of directors. The State Light Industry Ministry (1986) recorded the case of Zhanjiang Home Electricity Apparatus Company. When this company became a MOE from a SOE, the board of directors was established. In contrast, the SOEs were having the system of factory chief responsibility and party secretary supervision. The board of directors was a brand-new thing in China at that time and was of course brought about by mixed ownership. Almost all MOEs emerging in the 1980s and 1990s adopted the system of board of directors although China did not have its company law in the whole 1980s and the early 1990s. Meanwhile, dividend distribution became common in China's MOEs, which was exactly the case in Zhanjiang Home Electricity Apparatus Company.

However, it is not clear how the seats of board of directors should be distributed. It is found in my field survey of Wake Company<sup>15</sup> that at the early stage of its mixed ownership, the state shareholding proportion and non-state shareholding proportion were 60% and 40% respectively, but most of the board seats, and the position of chairman, were controlled by the management. In the case of Lenovo Holdings Company, though the state shareholding proportion was 65% while the management shareholding proportion was 35%, the position of chairman and the majority of the board seats were controlled by the management. Even if the board seats are distributed appropriately according to the shareholding proportions of different shareholders, they may fight for the positions of the chairperson and

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<sup>15</sup> The interview with the vice manager of HR department of Wanke Company in September of 2008.

core managers. A published case of Zhongshan Group Company (Wang, Chengbo, 2004), is a good case to analyse the fighting for important positions in MOEs. This company was transformed from a wholly-state-owned enterprise into a MOE in 2003, the non-state shareholding proportion was 90% and state shareholding was 10%. The board of Zhongshan Group Company had nine seats, six members were designated by the new private controlling shareholder, Tian'an Investment Company. Tian'an Investment Company also held the position of the chairman. The previous senior managers however, all retained their positions according to the ownership restructuring agreement. But the new controlling shareholder wanted to restrict the power of the previous management through the board of directors. However, most of the senior manager were the former bureau-level cadres, and did not treat the decision of the board of directors seriously. When the new controlling shareholder decided to designate a new CFO to the company through a decision by the board of directors, the president refused to make the nomination. Obviously, not only the director seats and chairman position, but also the office of core managers, are important. The complexity of the distribution of MOEs' control powers is far beyond the distribution of the board seats and the office of core managers. The distribution of controlling powers is related not only to the distribution of board seats and management office, but also to the state-cadre status of the managers and to the ownership restructuring agreement.

A field survey was conducted with Wujiang Hydropower Company and one of its subsidiaries, Qianyuan Power Company<sup>16</sup>. It was found that the combat for the controlling powers, and for board seats, was interwoven with the combat for management posts. It was also found that the actual controlling powers were more important than nominal controlling powers. Although Wujiang Hydropower Company was not a MOE, it had two state shareholders, China Huadian Group Company who held 51% of total shares and Guizhou Provincial SASAC who

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<sup>16</sup> The interview with the president of wujiang Hydropower Company in April 2009.

held 49%. There were seven members in the board of Wujiang Hydropower Company, Huadian Group Company had four seats and Guizhou Provincial SASAC had three. Although the two shareholders were both state organisations, their interests and business preferences were quite different. Guizhou Provincial SASAC asked Wujiang Hydropower Company to invest more funds in the local area and develop diversified business in order to promote local economic development. Huadian Group Company on the other hand, asked it to expand its hydropower business to other areas of China. Meaningfully, Huadian Group Company had a fully-owned business branch in Guizhou Province in the coal power business. Although Huadian Group Company held 51% of the total equity of Wujiang Hydropower Company, it had an agreement with Guizhou Provincial Government that the selection of the chairman and the president of Wujiang Hydropower Company should be mastered by Huadian Group Company, but the appointment had to be agreed by Guizhou Provincial Government, and Huadian Group Company must select local people to be the chairman and the president. Qianyuan Power Company was a typical multi-shareholders company and a MOE. Its corporate governance was quite complicated. In 2008, Huadian Group Company held 13.3% of the total shares, Wujiang Hydropower Company held 12% and the combined shareholding proportion of Huadian Group Company and Wujiang Hydropower Company was 25.5%. These two companies were the first and second largest shareholders. But another SOE, State Development Investment Company, held 12.9%. A group of individuals held 4%. Thus the control arrangements of Qianyuan Power Company were very complex. It had been actually controlled by the management, though Huadian Group Company and the State Development Investment Company had been fighting to grab the controlling powers. Huadian Group Company even decided to urge Qianyuan Power Company to issue new shares to Wujiang Hydropower Company in order to increase its shareholding proportion and then to achieve the firm control of this company. Apparently, in addition to shareholding proportion, the office of core managers is very critical in the control powers arrangements.

Interestingly, it is found that the corporate governance of MOEs is not always based on shareholding proportions and company law clauses. I found many shareholders of MOEs had agreements among the shareholders about their concerned issues, these agreements might be written, and might be oral or even cryptic. The government would often join in those agreements. Zhanjiang Home Electricity Apparatus Company was a good example (State Light Industry Ministry, 1986). There was an agreement that stipulated that the employees could buy shares of the company and the company must pay annual dividends. Furthermore, the agreement stipulated that the employees had the rights to sell back their shares to the company and they were entitled to get refunds. These clause, were of course not fitting to the common rules or laws. In fact, at that time, China did not have company law. Some local governments, such as Jiangxi province, struck the agreements to let the governments hold a golden share, again there was no lawful basis for that in China.

The agreements concern the issues of selling shares, dividend payments, and the golden share. Actually, these agreements are covenants covering a wide range of issues. The case of Tianwei Yingli Company is very informative (He, Yifang, 2007). Its non-state shareholder and state shareholder had the covenant stipulating that the state shareholder, as the first largest shareholder, would not intervene in the corporate business affairs of the MOE. The shareholding structure could be changed though there were additional conditions for the change in order to accomplish specific goals (such as getting listed in the stock market). It is found in my field survey of Fuxing Group Company<sup>17</sup> that while participating in the ownership reform of SOEs, it usually struck covenants with the management and local government, covering the issues of the original and future shareholding structures, the successive engagement plan of the previous management and their incentives program, the distribution of controlling powers,

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<sup>17</sup> The interview with the vice president of Fuxing Group Company in July 2008.

the commitments to local economic and social development, and government preferential policies.

There are a few reasons for the government to join in the covenants. On one hand, the government itself is the owner of SOEs, while on the other hand, it is the administrator of local public affairs. The government aims to promote the development of ownership-transformed enterprises and local economy by setting-up the agreements. In the case of Little Swan Company<sup>18</sup>, the local government stipulated strictly that Little Swan Company must maintain its original major business, original brand name, original management, and original registration location unchanged after its ownership reform. These clauses might overrun the boundary of its interests as the state shareholder, but did help the government maintain social stability and promote local economic development. These clauses can be regarded as governmental special regulations. The case of Tianwei Yingli Company is another example (He, Yifang., 2007). Although the agreement between the non-state shareholder and the state shareholder stated that the latter would not intervene in the business affairs of Tianwei Yingli Company, there were other clauses between Tianwei Yingli Company and the local government stipulating that Tianwei Yingli Company must exercise the strategy of developing photovoltaic business in Baoding City, Hebei Province. This clause put a very tight constraint on Tianwei Yingli Company. If Tianwei Yingli Company swung away from this strategy, the government would intervene. However, the government may give some preferential policies and support to MOEs, particularly when MOEs were facing difficulties. The preferential policies and governmental supports can be found in the case of Xinhua Airline Holdings Company and Hainan Airline Company. Obviously, looking at the special regulations and the covenants helps to understand the institutional arrangements of MOEs corporate governance as they may determine the corporate strategy and define the government-enterprise boundary.

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<sup>18</sup> The interview with Wuxi SASAC officials in June 2008.

It is also found that not only the relationship between government and MOEs, but the relationship between MOEs and their employees, is very special. Most of China's MOEs originated from ownership-reformed SOEs. Ownership reform is also called systematic transformation. The systematic transformation itself may cause the change in employment status of workers. It is found that the employment status of the workers in fully-privatised enterprises was usually transformed by paying compensation fees. In these fully-privatised enterprises the employment status changed from permanent employment to contractual and marketable employment, and the retirement treatment was pensioned and medical treatment was socialised. However, the circumstances were much more complicated in MOEs. There may be many types of employment status in MOEs. Many MOEs, especially those with state majority shareholders, have not achieved the employment status transformation. Moreover, many previous executives may still maintain the state cadre status, though the status of other managers designated by non-state shareholders is usually contractual. And, the employment status of newly-employed workers also tends to be contractual. It is found in the field survey of Fuxing Group Company<sup>19</sup> that it signed an agreement with Tianjin Municipal Government to prepare the systematic transformation of Tianjin Steel Company, a traditional SOE. The agreement stipulated that all executives would retain their posts, and their state cadre status would be maintained for two years. After two years their status would be re-considered. In addition, in many MOEs the management and the workers held shares, in this case their employment status is more complex because they are employees on one hand, but on the other hand they are shareholders. In this circumstance they may have a conflict of interest: as employees they may want to increase salaries, while as shareholders they may want to decrease salaries in order to control the cost and to increase the profit. Therefore, their thoughts and their activities have a big impact on enterprise operation. All in all, analysing the

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<sup>19</sup> The interview with the vice president of Fuxing Group Company in July 2008.

employment status of managers and workers in MOEs, helps clarify the special relationship among the managers, the workers, the enterprises, and the governments.

## **6.6 An Analytical Framework for the Institutional Arrangements of the Corporate Governance of Mixed Ownership Enterprises**

Since the analysis of the institutional arrangements of MOEs corporate governance in China is a new task, it is necessary to establish a basic analytical framework. It is not strange to establish an analytical framework for a specific research task. Roe (2004) put forth a research framework for the studies of the institutions of corporate governance that includes ten issues. Williamson (2000) established a specific framework to analyze the new institutional economics he described as four levels and drew a figure to show the logics of the four levels. Gillan (2006) also established a framework to depict corporate governance, he described the balance sheet model of the firm and the corporate governance framework, and the beyond balance sheet model and the corporate governance framework. All those analytical frameworks are based on theoretical discussions and empirical observations. I hereby put forth the basic analytical framework of the institutional arrangements of MOEs corporate governance in China from the viewpoint of my theoretical discussions and empirical observations in 6.2, 6.3, 6.4, and 6.5.

It is found through my empirical observations that the institutions of MOEs corporate governance are quite distinctive. The shareholding structure is particularly distinctive and results in a different pattern of controlling powers distribution. The allocation of board seats, the positions of chairman and core management posts, such as president and CFO, are very critical. Since the entrance of non-state shareholders, the conveyance of interests and tunnelling

seem to occur more often, meaning the prevention of conveyance of interests and tunnelling is an important issue. The government's role in MOEs is also a very important issue. The employment status of employees in MOEs is very complicated and that should be deeply considered. According to these facts, I put forth hereby the basic analytical framework for the institutional arrangements of MOEs corporate governance. This analytical framework comprises the following five issues.

(1) Shareholding structure

The shareholding structure has become an important research issue in corporate governance. In this thesis the shareholding structure of MOEs refers to the state shareholding proportion and non-state shareholding proportion. It is the basis of studying the corporate governance of MOEs.

(2) Covenant among different shareholders and the government

MOEs are governed not only according to the shareholding structure and company law but also, in many circumstances, according to the covenant struck by different shareholders and government. This involves the issues of original and future shareholding structure, the distribution of controlling powers, successive engagement program of the original management, the incentives program, the corporate strategy and local economic development.

(3) Office of the core managers

Shareholding structure impacts heavily upon the distribution of corporate controlling powers, the analysis of shareholding structure can not, however, substitute for the analysis of controlling powers distribution. The analysis of controlling powers distribution of MOEs should include not only the distribution of board seats, but also, the distribution of management posts, especially the office of core managers such as president and CFO. Since the chairman in

China's company law is usually the only legal representative, his or her office is the pivot in the controlling powers system. Thus, the office of core officials such as chairmen, president and CFO, is very determinative in the control structure of MOEs.

#### (4) Special regulations

Since there are still state shares in MOEs, the government-enterprise relationship in MOEs is very complex. Analysing the special regulations imposed by the government is crucial in clarifying the government-enterprise relationship. Although the special governmental regulations are sometimes connected with the covenant, the regulations are still regard as an independent issue in this thesis. The analysis of the regulations should be helpful to judge the commercialisation as well as the independence of MOEs.

#### (5) Employment relations

Employees are the stakeholders of MOEs. The resorts of their interests are very complicated due to the complex employment status of employees in MOEs. The employment status of the workers in MOEs depends not only on state shareholding proportion, but also on covenants. Through studying employment status, people can truly understand the relationship between the employees and the MOEs.

Shareholding structure, covenant, office of core managers, regulations, employment relations, are the 5 key issues of the institutional arrangements of MOEs' corporate governance. The combinative word of the first letters of these five phrases is SCORE. Therefore, SCORE is the basic analytical framework for the institutional arrangements of MOEs corporate governance in China.

## **6.7 Concluding Remarks**

In this chapter, the understanding of corporate governance is deepened through literature review and theoretical discussions. Especially, corporate governance is discussed from the perspective of new institutional economics. The corporate governance of SOEs and private companies in China are also discussed. The key issues of the institutional arrangements of MOEs' corporate governance are identified, and then a basis analytical framework for the institutional arrangements of MOEs corporate governance is established. It is the SCORE analytical framework. The next chapter will use the SCORE framework to conduct studies.

## **Chapter 7**

# **The Studies on the Institutional Arrangements of the Corporate Governance of Mixed Ownership Enterprises: Some Findings**

### **7.1 Introduction**

Since most of the MOEs are not listed companies, my analysis on the institutional arrangements of MOEs' corporate governance in this chapter do not focus on the common issues listed companies usually face, such as the regularity of meetings, board composition and independent directors, information disclosure, internal control and accounting fraud. Actually, it is stressed in chapter 1 that the definition of the MOE in this thesis refers to the enterprise with the state block shareholder and the non-state block shareholder, and those listed state-controlled companies without non-state block shareholders are not my concern because the corporate governance of the common listed companies is regulated by specific laws and ordinances. This chapter uses the SCORE framework to intensively study the institutional arrangements of the corporate governance of China's MOEs. A generalised analysis on the board of directors of China's MOEs is conducted first. Afterwards the studies on the shareholding structure of the MOEs, the covenant, the office of core managers, the special regulations, and the employment relations are conducted. Lastly, some findings are presented and some discussions about the major features of the corporate governance of China's MOEs are made.

## **7.2 The Board of Directors**

Since any MOE should be a registered corporation, according to Chinese company law, a corporation must either establish its board of directors or set up the post of executive director if the corporation is a limited liabilities company. As Jensen (1993) pointed out, the board of directors is charged with advising and monitoring management and has the responsibility to select, replace and compensate the senior management team. With a fiduciary duty to shareholders, and the responsibility to provide strategic direction and monitoring, the role of board of directors in corporate governance is the cornerstone. Warther (1998) also regarded the role of board of directors as the monitor of, and the adviser to, corporate management. John and Senbet (1998) pointed out that the effectiveness of board of directors is the basic measurement of corporate governance. But Larcker et al. (2005) found that “cosy” relationship between board of directors and management will limit effective monitoring, so that the independence of board of directors is very important to enhance the role of board of directors and to improve the corporate governance. The board of directors in Chinese company law has the powers about the following issues: 1) convene the general meeting of shareholders and report to the general meeting; 2) execute the decisions of the general meeting; 3) decide the business plan and investment program; 4) formulate the annual fiscal budgeting and the final account; 5) formulate the dividend payment plan; 6) formulate the recapitalization plan; 7) formulate the restructuring plan; 8) decide the organizational structure; 9) appoint the managers and decide their compensation; 10) formulate the basic management systems; 11) other issues authorized the general meeting of shareholders.

In the questionnaire survey, 950 enterprises provided the requested information, one issue of the requested information is the set-up of the board of directors. In these 950 enterprises, 813 enterprises, accounting for 85.6% of the total 950 enterprises, established their board of directors, and the other 137 enterprises,

accounting for 14.4% of the 950 enterprises, did not establish board of directors. It is not known why those 137 enterprises did not set up the board of directors, one guess is either each of those 137 enterprises has few shareholders, or those 137 enterprises are small-sized enterprises, which has no need to establish board of directors according to the Chinese company law. Since at least 77.3% of the 950 enterprises are MOEs, the conclusion can be drawn that most of the MOEs in the 950 sampled enterprises have their board of directors.

Table 7-1 Whether Or Not the Enterprise Set Up the Board of Directors  
(Sample: 950 Enterprises)

The Number of The Enterprises Which Have the Board of Directors	The Number of The Enterprises Which Do Not Have the Board of Directors
813	137

One of the statutory powers for board of directors is to appoint managers. But as stated in 6.4, the management in some MOEs is still selected by the government. Especially, the post of chairman of the board may be decided by the government or the ruling party instead of by the board of directors. According to Chinese company law, the chairman of the board of directors usually is the only legal representative of a corporation, and then has more influential power than other directors. It is imaginable that the post of the chairman is often contested by state shareholders and non-state shareholders. Therefore, the covenant among the shareholders and the government are often used to tackle the allocation of the important posts and the controlling powers, which will be further addressed in 7.4.

### 7.3 The Shareholding Structure

Jensen and Meckling (1976) defined shareholding structure as the shareholding proportions of insiders, especially the management, against outside investors. Later literature then accepted this definition. Demsetz (1983) defined shareholding structure as shareholding concentration, his definition is also accepted by many economists. However, the definition of shareholding structure in this thesis is the comparison of the state shareholding proportion and the non-state shareholding proportion.

The basis of controlling powers is shareholding structure, though the former is not absolutely corresponding to the latter. A study by Gomes and Novaes (1999) showed if there were a few large shareholders in an enterprise, they would check and balance each other. Bennedsen and Wolfenzon (2000) found while several large shareholders co-controlled an unlisted enterprise, the corporate value would be increased. Wang (2005), and Wei et al. (2003), studied the changes in performance of ownership-transformed enterprises in China, and found that shareholding structure matters. Anderson and Reeb (2003), Sraer and Thesmar (2004), also studied the impact of shareholding structure upon controlling powers and corporate performance. They found that the shareholding structure and control structure of family companies were relatively stable, and the stable structure had a positive impact on corporate performance. A study by Block and Hedge (2001) demonstrated that when there were a few large shareholders in an enterprise, they tended to fight for the controlling powers, which often caused corporate instability. However, the fighting for controlling powers might prevent, to some extent, the problem of the conveyance of interests and tunnelling.

The field survey<sup>20</sup> showed that, in order to fight for the controlling powers, the shareholders, regardless of their ownership attribute, would strive to acquire

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<sup>20</sup> The interview with Yunnan SASAC officials in December 2008.

more shares. Kuming Pharmaceutical Company was a listed MOE and its first largest shareholder was Huali Group Company, a famous private company in China. The second largest shareholder was Yunnan State Assets Management Company, and its third largest shareholder was another SOE, Hongta Group Company. Their shareholding proportions in 2008 were 24.3%, 12.5% and 9.5% respectively. In 2007, the shareholding proportion of Yunnan State Assets Management Company was only 7.4%, it silently bought stocks in the securities market, resulting in the increase of its shareholding proportion to 12.5% in 2008. Interestingly, Huali Group Company also increased its shareholding proportion by 1% through buying stocks in securities market. The purpose of accumulating shares in the securities market was to change the shareholding structure. Of course, they all wanted to control the company.

Not every shareholder however has the ability to lift its shareholding proportion. I found that some MOEs were more willing to accept a balanced shareholding structure. A survey of Ping'an Group Company, one of the largest MOE in China<sup>21</sup>, was conducted. Its shareholding structure was very unique. In 2008, HSBC, a British company, held 16.7% of the total shares. These shares were divided between its two subsidiaries, HSBC Insurance Company, holding 8.3%, and Shanghai HSBC, holding 8.4%. The management and employees of Ping'an Group Company held 9.8%, but these shares were divided into two holding vehicles, Shenzhen Xinhaoshi Investment Company, holding 5.3%, and Shenzhen Jing'ao Industrial Company, holding 4.5%. Shenzhen Investment Management Company, a SOE, held 7.7%, while Yuanxinhang Investment Company, a domestic private company, held 5.2%. The remaining shares were negotiable stocks. It is found that this shareholding structure was intentionally designed by these shareholders. The balanced shareholding structure was good to diminish the qualms of different shareholders and to allow them to check and

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<sup>21</sup> The interview with the vice chairman of Ping'an Group company is in January 2009.

balance each other. However, the dispersive shareholding structure was favourable for the management to control the company.

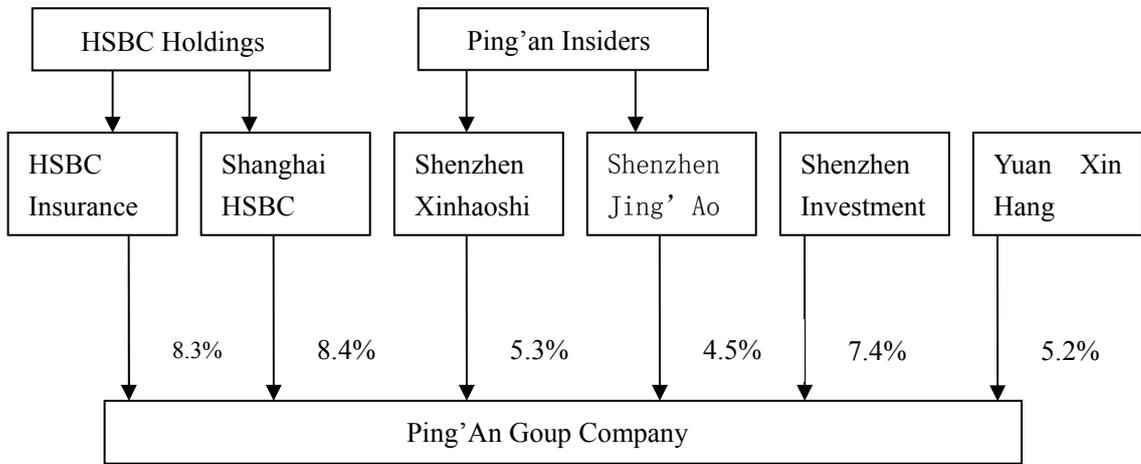


Figure 7-1 The Shareholding Structure of Ping'An Group Company

Generally speaking, different shareholders have different interest appeals. Their ways and means of realising their own interests could be very different. Large shareholders often have more advantages to realising their interests, they may also abuse the controlling powers in order to loot the interests of small shareholders. A study by Burkart et al. (1997) demonstrated that when there was a controlling large shareholder in a company, it had the motivation to enhance its own inappropriate interests. A study by La Porta et al. (1999) demonstrated that in many countries large shareholders were liable to loot the interests of small shareholders.

There are 42 MOEs in the 300 companies of Shanghai-Shenzhen Component Index. In 33 of them, the state shareholding proportion is higher than the non-state shareholding proportion. Within the top 10 shareholders of these 33 MOEs, the mathematical average shareholding proportion of the state shareholders is 33.1%, while the mathematical average shareholding proportion of the non-state shareholders is 19.6%.

In the 950 surveyed enterprises, there are 486 enterprises in which a SOE is the majority shareholder, and the mathematical average shareholding proportion is 63.6%. These 486 enterprises are all MOEs. The detailed shareholding structure of these 486 MOEs is in the table below.

Table 7-2 The Second and Third Largest Shareholders and Their Average Shareholding Proportions  
(Sample: 486 Enterprises)

The Second Largest Shareholder Is:	The Number of the Enterprises (The Percentage in the 486 Enterprises)	The Average Shareholding Proportion(%)	The Third Largest Shareholder Is:	The Number of the Enterprises (The Percentage in the 486 Enterprises)	The Average Shareholding Proportion(%)
Government	7 (1.4%)	24.0	Government	5(1.0%)	19.0
State Assets Company	20 (4.1%)	23.4	State Assets Company	26(5.3%)	11.4
State-owned enterprise	126 (25.9%)	16.2	State-owned Enterprise	124(25.5%)	10.1
Private Firm	42 (8.6%)	24.0	Private Firm	59(12.1%)	8.6
Management	6 (1.2%)	37.6	Management	2(0.4%)	4.0
Employees	157 (32.3%)	34.8	Employees	61(12.6%)	16.1
Individual	48 (9.9%)	21.7	Individual	124(25.5%)	8.2
Foreign Firm	17 (3.5%)	33.9	Foreign Firm	12(2.5%)	14.2
Collective Firm	28 (5.85)	13.3	Collective Firm	17 (3.5%)	19.7
Others	35(7.2%)	24.0	Others	56 (11.5%)	7.5

From the above table, it can be found that in the MOEs with a state first largest shareholder, there are 157 enterprises whose second largest shareholder is the employees, the mathematical average shareholding proportion is 34.8%; there are

126 enterprises whose second largest shareholder is another SOE, the mathematical average shareholding proportion is 16.2%; there are 48 enterprises whose second largest shareholder is individual, the mathematical average shareholding proportion is 21.7%; there are 42 enterprises whose second largest shareholder is private firm, the mathematical average shareholding proportion is 24.0%; there are 17 enterprises whose second largest shareholder is foreign company, the mathematical average shareholding proportion is 33.9%; there are 6 enterprises whose second largest shareholder is the management, the mathematical average shareholding proportion is 37.6%.

It is also found that there are 64 MOEs with a private first largest shareholder. In 9 of them, the second largest shareholder is state assets management company, the mathematical average shareholding proportion is 25.6%; in 11 of them, the second largest shareholder is SOE, the mathematical average shareholding proportion is 34.8%.

According to the above analysis, many MOEs in China have state majority shareholders and non-state minority shareholders.

## **7.4 The Covenant**

Shareholding structure provides the basis for corporate governance, but it is only one of the numerous factors impacting on corporate governance. Judging corporate governance only on the basis of shareholding structure may be misleading. In many circumstances, covenant may be made between the shareholders of the MOEs and the government. Even in the US, covenants can be found in controlling powers arrangements and interests arrangements. Kaplan, and Stromberg(2003, 2004) studied the corporate governance of those companies in which venture capital funds had invested, and found that covenants among the funds and the company promoters, as well company managers, were very popular. The clauses of the covenants include the shareholding proportion and the

conditions to change the shareholding proportion, the distribution of voting rights, and the exit arrangements. The studies by Lerner and Malmendie (2004) demonstrated that shareholders sometimes strike covenants with strategic business partners to share the powers and profits and to acquire critical support.

In the case of Zhongshan Group Company (Wang, Chengbo. 2004), Tian'an Investment Company, a private firm, became the first largest shareholder and obtained six of the nine seats in the board of directors. According to the company law, it is expected that Tian'an Investment Company should control the MOE. But there was a covenant among itself and the local government as well as the previous management that stipulated the previous management would retain their positions for five years. As a result, Tian'an Investment Company could not realise their control of the MOE, and the CFO designated by Tian'an Investment Company was expelled out by the previous management. Furthermore, the previous management refused to execute the decisions made by the board if these decisions were deemed to be against the covenants or the interests of the previous management. It is clear there were severe conflicts between the company law and the covenant in this case.

Generally speaking, covenant is usually designed to distribute controlling powers and exercise monitoring. The studies by Cremer (1995), Aghion and Tirole (1997), demonstrated how excessive monitoring could hurt the initiatives of the management, while the failure of monitoring could cause the loss of the interests of some shareholders. MOEs often try to tackle this problem by striking covenants, however it is not easy to find a balance point. A field survey was conducted with Fuxing Group Company. When participating in the ownership reform of Nanjing Steel Company in 2003, the management struck an agreement with the local government and Fuxing Group Company. According to the covenant, the management would not only keep their original positions but also

buy some shares at a preferential price in order to enhance the incentives<sup>22</sup>. In 2008, Fuxing Group Company agreed to restructure Tianjin Steel Company into a MOE, the agreement stipulated that Fuxing Group Company would hold 47% of the total shares, Tianjin Municipal Government would hold 48%, Xin'Ao Company would hold 5%. Moreover, Fuxing Group Company and Tianjin Municipal Government could not purchase any shares from Xin'Ao Company and Tianjin Steel Company could not issue any new shares to Fuxing Group Company or Tianjin Municipal Government. Meanwhile, it stipulated that the board of the post-restructuring Tianjin Steel Company would have five seats, two would be occupied by Fuxing Group Company, two by the management, and one by Xin'Ao Company, while Tianjin Municipal Government would not occupy any seats but would have the power to select the chairman. The president would be selected by Fuxing Group Company, but it was agreed that the president would be the original one. The CFO would also be selected by Fuxing Group Company. Obviously, it was a complicated but well-designed covenant.

In the 950 surveyed enterprises, most of them have covenants between the non-state shareholders and the government, as well as the management. The contents of these covenants include the successive engagement program of the previous management, the re-employment program of workers, and others.

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<sup>22</sup> The interview with the vice president of Fuxing Group Company in July 2008.

Table 7-3 Whether the Enterprise Had Covenant about the Re-employment of Workers and the Successive Engagement Program of the Original Management  
(Sample: 950 Enterprises)

How Many Enterprises Answer “Yes”		How Many Enterprises Answer “No”	
Enterprises Number	The Percentage in the Sample	Enterprises Number	The Percentage in the Sample
530	55.8%	420	44.2%

However, some enterprises do not have any covenants, especially those in financial sector and listed in stock market usually do not have any covenants. Many shareholders in those companies are financial investors instead of strategic investors, their aim is to sell shares at a higher price in secondary market. Beyond this, they tend not to care about the long-term arrangements of controlling powers or interests.

## 7.5 The Office of Core Managers

Hart and Moore (1989) studied the distribution of corporate powers among different shareholders, and found that different interest groups, often fought with each other. Aghion and Bolton (1992), and Hart (1995), studied the controlling powers in corporate governance. They argued that the arrangements of corporate powers were very critical because of the incomplete contract. Aghion and Tirole (1997), and Lerner et al. (2003), studied the issue of multi-control, and found it was possible to distribute different classes of powers to different parties. For example, the controlling power of financial affairs, the controlling power of sales affairs, and the controlling power of strategic affairs, could all be allocated to different managers or board members. Harris and Raviv (1989) argued if a shareholder was not the true claimant of economic surplus, or was unable to truly

obtain the surplus, its voting rights would not be fully exercised. The state shareholder is applicable to this argument. Moreover, the state shareholder is liable to be influenced by the political system. Therefore, the decisions made by the state shareholder may deviate from commercial norms. If the state shareholding proportion is high and the state shareholder can easily acquire the office of core managers, the government-enterprise boundary probably is not clear, which will jeopardize the business independence of MOEs.

According to China's company law, the board chairman is usually the only legal representative of the company, and the convener of board meetings. Usually, the board chairman has the ultimate power to decide corporate affairs. Thus the chairman is in fact a core official, the president is another core official. The position of CFO, also a core official, may in fact be more critical than the position of president. The office distribution of these core officials should be analysed

It is found that in the 950 surveyed enterprises, more than 60% of them did not change legal representatives or CFO after the ownership reform. Only 38% changed their legal representatives while 32% changed CFO.

Table 7-4 How Many Enterprises Changed Legal Representative and CFO  
(Sample: 950 Enterprises)

	"Yes" Answer		"No" Answer	
	The Number of the Enterprises	The Percentage in the Sample	The Number of the Enterprises	The Percentage in the Sample
Did You Change Legal Representative	360	37.9%	590	62.1%
Did You Change CFO	300	31.6%	650	68.4%

However, even if the management is able to maintain their original positions, it is still possible for new private shareholders to obtain some positions of core managers. Fuxing Group Company successfully occupied the CFO position and the position of one deputy president in all of the MOEs in which it held shares<sup>23</sup>. In 2008, Fuxing Group Company signed an agreement to participate in the ownership reform of Tianjin Steel Company, stipulating the CFO would be designated by Fuxing Group Company after the ownership reform, although Fuxing Group Company would be the second largest shareholder. It is clear that obtaining the office of core managers is sometimes more important than the majority shareholding proportion. It is found that in the field survey of Yili Resources Group Company<sup>24</sup>, just how important the office of core managers could be. In those MOEs co-owned by Yili Resources Group Company and various SOEs, the shareholding proportions of the private shareholders and the state shareholders tended to be very close, meaning the role of the office of core managers was crucial. Initially, when establishing those MOEs, Yili Resources Group Company usually negotiated with its state partners about the distribution of the core management positions. In everyday business the situation was often different from the original design however. Yili Resources Group Company found if the core managers were designated by state shareholders, it would be difficult to cooperate well. Struggles for powers and interests, as well as disputes regarding strategy and business affairs, often happened. As a result, Yili Resources Group Company withdrew the core managers and allowed the state shareholders to manage these MOEs alone.

If both state and non-state shareholders fail to strike a cooperation plan, they may take legal procedures in order to fight for the office of core managers. A published case is Jingu Forest Industry Company (Li, Hui., 2009). Jingu Forest Industry Company was a listed company, and in the middle of 2009 its largest

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<sup>23</sup> The interview with the vice president of Fuxing Group Company in July 2008.

<sup>24</sup> The interview with the president of Yili Group company in June 2009.

shareholder, holding 24.42% of the total shares, was a SOE, Jingu Senda State Assets Management Company. The second largest shareholder was a private enterprise, Taiyue Guarantee Company, who used to be the largest shareholder from 2004 to early 2009. Since their shareholding proportions were very close, their combat for the office of core managers had been very severe since 2008. In May 2009, the state shareholder tried to take over the position of the chairman which had been occupied by the non-state shareholder since 2004. The non-state shareholder managed to use its position as chairman to block the proposal of holding a special board meeting to change the board members and chairman. This case demonstrates that the office of core managers actually determines the control structure.

## **7.6 The Special Governmental Regulations**

The field surveys and the data analysis show that many MOEs are subject to special governmental regulations, though these regulations may not be long-term. It is found that the government imposed special regulations on the Little Swan Company while 65% of its shares was transferred to Siweite Company in 2004<sup>25</sup>. The regulations included three “no changes” involving the original brand name, the original management and the original registration location. The regulations also included an agreement regarding business expansion that stipulated the sales of Little Swan Company would reach 14 billion RMB in 2004, 19.5 billion RMB in 2005, and 50.3 billions RMB in 2008. It is regrettable, however, the expansion plan was not achieved.

The major cause of the special governmental regulations is, the government can not avoid its responsibilities to the safety and smoothness of the ownership reform and the post-reform development. Roe (1994) analysed the circumstances of ownership transfer and control transfer of American enterprises, and found

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<sup>25</sup> The interview with Wuxi SASAC officials in June 2008.

even in the US, employees, creditors, suppliers, community residents were all concerned about and afraid of the transfer, and might resist the transfer. The government might impose pressure on the politicians to interfere. Furthermore, anti-transfer stakeholders might form an alliance to stop the transfer. Their arguments would include seemingly noble reasons such as social justice and public rights. The Chinese government is more liable to interfere in business transactions. While restructuring SOEs to MOEs, the government is usually concerned about the stability of the enterprises and society, as well as the interests of the stakeholders including employees and suppliers. Furthermore, the government wants to attract more funds to invest in local areas through ownership restructuring in order to promote local economic development. Therefore the government is in favour of setting up special regulations regarding the above issues. While the government is still one of the owners in a MOE, these special regulations help supervise corporate operation and the activities of private shareholders. Studies by Bottazzi et al.( 2005), Casamatta (2003), Kaplan et al. ( 2003), Lerner and Schoar (2005), Schmidt (2003), showed that these kind of regulations and monitoring could help the economic development, but might also cause conflicts. The long-term effects of the special regulations still need to be further observed.

The government usually wants to attract more funds to invest in local areas. Regarding the financing of companies, existing literature is abundant. Studies by Borio (1990), Corbett and Jenkinson (1994), Eckbo and Masulis (1995), Kojima (1994), Kotaro (1995), Rajan and Zingales (1995, 2003), showed that corporate financing had different patterns in different countries. Since the capital market is underdeveloped in China, it is a reasonable choice for the government to attract more funds by promoting mixed ownership.

It is found from the questionnaire survey that more than half of the 950 surveyed enterprises made commitments to the government to ensure that the major

business would remain unchanged after the ownership reform. In addition, some enterprises made commitments not to move to other regions. Commitments not to sell the shares to third parties were also made.

Table 7-5 How Many Enterprises Had the Special Regulations on the Following Issues  
(Sample: 950 Enterprises)

The Commitment	The Number of the Enterprises Making the Commitment	The Percentage in the Sample
Not Moving to Other Regions	713	75%
Not Changing the Major Business	616	58%
Increasing Funds Input	304	

However, the private shareholders in MOEs are intelligent. While the government set up the special regulations, non-state shareholders often co-operate. But at the same time, they will negotiate with the government to acquire preferential support, often in the form of price discount, land grant, and pre-emptive rights of contracting large public construction projects.

It is still questionable however, whether these special regulations are effective or not. Studies by Mako and Zhang (2003) demonstrated how similar special regulations were adopted during the process of SOEs reform in other countries, but the government was difficult to monitor the effectiveness of the regulations and to punish those who were against the regulations.

## 7.7 The Employment Relations

According to the theory by Blair (1995), employees are the important stakeholders in enterprises, their interest orientation and interest protection will impact upon corporate governance. The employment status of SOEs workers in

China is inherited from the planning economy. In MOEs, the entrance of private shareholders will bring a shock to the original employment status and produce new employment relations, which has a huge impact on the corporate governance of MOEs.

While restructuring SOEs to MOEs, the new private shareholders usually ask the government and the SOEs to transform the employment status of the workers. However, the transformation of employment status has its cost. Employees have to be paid with the compensation fees.

The questionnaire survey showed that in the 950 surveyed enterprises, the transformation of employment status was very prevalent when private shareholders were the majority shareholders. In the enterprises with the non-state shareholder as the first largest shareholder, 70.2% of them transformed the employment status by paying the compensation fees, 13.2 % of them did not transform the employment status but made commitment to guarantee the re-employment, 16.6% of them did not supply information about this. In the enterprises with the state shareholder as the first largest shareholder, only 13.6% of them transformed the employment status by paying compensation fees.

Table 7-6 How Many Enterprises Transformed the Employment Status  
of Their Workers  
(Sample: 950 Enterprises)

	The Percentage in the Enterprises Whose First Largest Shareholder Is a Non-state Shareholder	The Percentage in the Enterprises Whose First Largest Shareholder Is a State Shareholder
Transformed by Paying Compensation Funds	70.2%	13.6%
Not Transformed but Committed to Guaranteeing Re-employment	13.2%	41.0%
Others	16.6%	45.4%

Since the entrance of private shareholders may cause employment status transformation and threaten the positions of the original management, the workers and the management sometimes unite to resist the entrance of private shareholders. Studies by Cespa and Ceston (2002), Pagano and Volpin (2005), found that both management and workers did not like the entrance of new large shareholders from the outside and might establish an alliance to resist. It is true in China. Therefore, in order to dissolve this alliance or diminish the obstruction, the new shareholders and the government may negotiate with the management and the workers, usually resulting in the commitment to the future employment and future position retaining.

In the 950 surveyed enterprises, 55.8% of them made re-employment commitments. The table below shows the contents of these commitments. In the companies who made the re-employment commitments, 68.0% committed to re-employ more than 80% of the workers, 19.1% committed to re-employ 50% to 80% of the workers, and 12.9% committed to re-employ less than 50% of the

workers. Furthermore, in the companies who made re-employment commitments, 80.3% committed not to fire any re-employed workers in 3 years, and 3.6% committed not to fire any re-employed workers in 5 years.

Table 7-7 The Re-Employment Commitments  
(Sample: 950 Enterprises)

Commitment 1	Re-Employ More Than 80% Workers	How Many Enterprises Made the Commitment	Percentage in the Sample
		646	68.0%
	Re-Employ 50%-80% Workers	How Many Enterprises Made the Commitment	Percentage in the Sample
		181	19.1%
Commitment 1	Re-Employ Less Than 50% Workers	How Many Enterprises Made the Commitment	Percentage in the Sample
		123	12.9%
Commitment 2	Agreeing Not to Fire Re-Employed Workers in 3 Years	How Many Enterprises Made the Commitment	Percentage in the Sample
		763	80.3%
	Agreeing Not to Fire Re-Employed Workers in 3-5 Years	How Many Enterprises Made the Commitment	Percentage in the Sample
		153	16.1%
Commitment 2	Agreeing Not to Fire Re-Employed Workers in Five Years	How Many Enterprises Made the Commitment	Percentage in the Sample
		34	3.6%

Most of the sampled enterprises whose first largest shareholders were private shareholders transformed the employment status by paying compensation fees, but most of the enterprises whose largest shareholders are state shareholders did not transform the employment status, the employees in the latter enterprises could still hold iron rice bowl. In those MOEs whose employees still hold iron rice bowl, one of the key task of improving the corporate governance is how to enhance the protection of shareholders' interests because the iron bowl may erode the regular interests of shareholders. Especially, when the managers of those MOEs still enjoy the iron chair, the entrance of new private shareholders

may not shake the entrenchment of them, and the control structure may not be restructured according to the new shareholding structure.

In the MOEs whose employment status is transformed, their corporate governance faces other challenges. One possible challenge is that the prevalent employees' shareholding will lead to the confusion of the employees' role. In the enterprises whose employment status was transformed in the 950 enterprises, 75% paid cash for the compensation fees, and 21% paid the shares as the compensation funds. That means lots of MOEs with the employment status transformation contain employees shares. Employment status transformation on one hand promotes the commercialisation of the enterprises, but on the other hand produces lots of employee shareholders, which makes the institutional arrangements of MOEs corporate governance more complicated than those enterprises without any employee shareholders and may jeopardize the commercialisation of the corporations.

## **7.8 The Findings and the Discussions**

On the basis of the above analysis, some findings can be drawn as follows.

First, the largest shareholder in most of the MOEs is still a state shareholder, meaning most MOEs are still state-controlled enterprises. In the 950 surveyed enterprises, there are 652 enterprises whose first largest shareholders are state shareholders, accounting for 68.6%. In the 42 MOEs out of the 300 listed companies in the Shanghai-Shenzhen Component Index, the average state shareholding proportion of the top 10 shareholders is 34.7% while the average non-state shareholding proportion is only 17.3%.

Second, the control structure sometimes fails to correspond to the shareholding structure, thus the controlling powers system and the liabilities system can deviate from the normal situation, which may cause contradictions and conflicts

among shareholders and insiders. Then the enterprises may be in an unstable position. The unstable position may cause government intervention.

Third, the employment status transformation, on one hand can rectify the enterprise-employee relationship, but on the other hand may produce more complex enterprise-employee relations if the compensation fees are paid in form of shares instead of cash.

Fourth, special governmental regulations are common, the intention of these regulations is understandable but the effects need to be observed because the agreements and commitments are difficult to monitor. These regulations are difficult to execute, increase the governmental discretionary power and provide an excuse for governmental intervention in the operation of MOEs.

Based on the above findings, it can be concluded that the institutional arrangements of the MOEs' corporate governance in China has some marked features. The first feature is that most MOEs have a state majority shareholder instead of non-state majority shareholder. Therefore the traditions inherited from the SOEs are influential, the government still maintains some interventions, the management is somewhat bureaucratic, the labour force is not marketized enough. And some outdated governance mechanisms are not completely replaced yet, the "old three committees" still play their roles and often have conflicts with the "new three committees", some senior managers are still selected by the government in the bureaucratic manners, and the government tends to interfere in the business disputes between managers and shareholders instead of encouraging them to appeal to lawful system. The second feature is the insiders control is interwoven with large non-state shareholders control. Insiders control often contradicts with large non-state shareholders control, but neither the board of directors nor the general meeting has become the effective platform for resolving those contradictions although most MOEs have set up their board of directors. Moreover, covenants are often used to complement and amend the control

structure. It is fair to say that the control arrangements of the MOEs have an interim and mixed structure which is not stable. The third feature is the marketization of the management and the labour force is taking place, but the progress is slow and unbalanced. In some MOEs, managers are appointed by the board of directors and their compensations are marketized, but in other MOEs I see the opposite. In some MOEs the employment status is transformed and the workers have the market-styled contract with the enterprises, but in other MOEs, workers still enjoy the planning-economy-styled iron rice bowl. The fourth feather is that the special regulations from the government are strong, but it is difficult to make the assessment of it. In China, the special regulations probably are positive because the legal system is still immature.

All in all, the corporate governance of China's MOEs is in a mixed, transitional, and unstable situation. This situation can be named the incomplete commercialisation of the corporate governance. By the commercialisation of corporate governance I mean the governance mechanisms are based on commercial laws, common business rules, and profound marketization. Apparently, the improvement of the MOEs' corporate governance in China needs more commercialisation. Fortunately, most of the MOEs have established the regular platform, namely, the board of directors, and are practising the rules of the board of directors. Therefore I believe China's MOEs is in the correct direction to better corporate governance.

In the past thirty two years, China's SOEs have achieved a great extent of operational commercialisation. That means their business operation is run on the basis of commercial laws, common business rules, and profound marketization. However, the governance commercialisation is far behind the progress of the operational commercialisation. Developing mixed ownership is a very important step to promote governance commercialisation, but is not the last step. The covenant, the successive engagement program of the previous management, and

the complicated employment relations, all are in favour of the original management and the workers to entrench their posts. If private shareholders' penetration to the office of core managers causes conflicts with the original management and the existing governance framework does not provide a solution, then governmental intervention is highly possible. The government may use special regulations to interfere in MOEs' business strategy and corporate operation, which increases the difficulties in clearly defining the government-enterprise boundary. It is fair to say, the corporate governance of MOEs is in an immature state, the MOEs have not established sustainable corporate governance. In the future, the critical task for China's MOEs is undoubtedly to promote the commercialisation of their corporate governance.

## **7.9 Concluding Remarks**

The shareholding structure of MOEs, the covenant among shareholders and the government, the office of core managers, the special governmental regulations, and the employment relations are analysed in this chapter. In most Chinese MOEs, the state is still the majority shareholder, and their corporate governance can not immediately wipe out the colour of SOEs. The corporate governance of China's MOEs is in the situation of incomplete commercialisation.

# Chapter 8

## Do Mixed Ownership Enterprises Outperform Others? ---Empirical Estimation

### 8.1 Introduction

Since the major factors driving the emergence of the mixed ownership in China have been explored and the institutional arrangements of MOEs' corporate governance have been studied, a further issue to investigate is the performance of the MOEs. Are they performing better or worse than wholly-owned enterprises (non-MOEs)? Is there a significant performance difference between MOEs and non-MOEs? This chapter takes the listed companies in China's stock market as the sample to conduct the analysis on the performance of the MOEs and non-MOEs.

### 8.2 The Sample and the Identification of Mixed Ownership Companies

#### 8.2.1 The Sample and the Data

In order to conduct the comparative analysis on the performances of MOEs and non-MOEs, I use the data of China's listed companies. In the early 1990s, China established both Shanghai Stock Exchange and Shenzhen Stock Exchange. China Centre for Economic Research (CCER), Peking University, developed a database of the listed companies, which contains the accounting information and shareholding information of listed companies during 1998-2007. It is a panel data set. The number of those companies is 1087. In these 1087 companies, 517 were listed in Shanghai Stock Exchange and 570 were listed in Shenzhen Stock

Exchange. These 1087 listed companies are the sample of the performance studies carried out in this chapter. There are a total of 8089 observations made on these 1087 companies, which I use in the analysis along with some accounting data and shareholding data from both Shanghai Stock Exchange website<sup>26</sup> and Shenzhen Stock Exchange website<sup>27</sup> in order to supplement the necessary information missing from the CCER database.

Therefore, there is a different data set of companies in chapter 8 from the data set in chapter 4. The reason for using listed companies as the research sample in this chapter is that all listed companies have to publish both their accounting information and their shareholding information. This information reveals the identity and the ownership attribute of the first to tenth largest shareholders. The data based on the questionnaire survey used in prior chapters can not provide a panel data set over 10 years and covering thousand of companies. Actually, no other databases than the database of the listed companies can do that. Some other authors, such as Xu, Xiaonian. and Wang, Yan. (1999), Chen, Xiao. and Wang, Kun. (2005), also used the data of listed companies to conduct the performance analysis and ownership structure analysis of China's enterprises.

## **8.2.2 Identifying Mixed Ownership Companies and Wholly-Owned Companies**

All these sampled companies published the information of the first to tenth largest shareholders, including the identity of those shareholders. In order to identify the MOEs and non-MOEs, I first need to identify the ownership attribute of the shareholders. All shareholders can be divided into 2 categories, one is the state shareholder category and the other is non-state shareholder category.

Furthermore, all sampled companies are classified into 2 groups, one is

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<sup>26</sup> <http://www.sse.com.cn/>

<sup>27</sup> <http://www.szse.cn/>

wholly-owned enterprise, or called non-MOE, the other is MOE. In this chapter, the wholly-owned enterprise, or called the non-MOE, is defined as the listed company whose first largest, second largest, and third largest shareholder are all state shareholders, or are all private shareholders. Other enterprises excluding the wholly-owned enterprises are MOEs. Of course, the first, the second and the third largest shareholders in any wholly-owned enterprises have the same ownership attribute, either private or state ownership attribute. On the contrary, the ownership attribute among the first, the second, and the third largest shareholders in each of the MOEs, is different. The code 0 is given to wholly-owned enterprise group, and the code 1 is given to mixed ownership enterprise group. The definition of MOE in this chapter is slightly different from the definition in chapter 4. The definition of MOE adopted in this chapter simplifies the identification of listed mixed ownership companies because a listed company may have too many small shareholders.

In this sample, there are totally 8089 observations, in which 59.77% are the mixed ownership and 40.23% are the whole ownership. It is worth noting that state ownership is dominant both in the mixed ownership group and in the whole ownership group. 91.42% in the whole ownership group are state-owned enterprises (accurately speaking, state-controlled enterprises, because there must be tradable shares held by individuals in these companies), and only 8.76% in the whole ownership group are private enterprises (accurately speaking, private-controlled enterprises, because there may be some smaller state shareholders in these companies). In the mixed ownership group, 92.37% have the state majority shareholder, only 7.63% have the private majority shareholder.

Table 8-1 The Percentage of Whole Ownership and Mixed Ownership

Code	Whole Ownership (0)		Mixed Ownership (1)	
	0_0(Private)	0_1(State)	1_0 (Private)	1_1 (State)
Observations	285	2969	369	4466
Percentage	8.76%	91.24%	7.63%	92.37%
Total	3254		4835	
Total percentage	40.23%		59.77%	

## 8.3 Methodology

### 8.3.1 The Grouping of the Companies

The grouping should be done first and then the comparative studies on the performance among different groups can be conducted. Firstly, all companies in the sample are grouped into 2 classes: wholly-owned enterprise (whole) and mixed ownership enterprise (mixed). Secondly, the wholly-owned enterprises can be classified into 2 sorts: state whole ownership enterprise (whole-state) and private whole ownership enterprise (whole-private). It is still worth noting that the so-called whole ownership is not truly wholly-owned by the state or by a private owner because there must be some other individual stockholders in these listed companies. Thirdly, the mixed ownership enterprises can also be classified into 2 sorts: the mixed ownership enterprise with a state majority shareholder (mixed-state) and the mixed ownership enterprise with a private majority shareholder (mixed-private).

### 8.3.2 Measurement Indicators

I use return on assets (ROA), return on equity (ROE), Tobin's Q, sales growth rate (SGR) to measure the performance of different groups of companies.

## 1. ROA

$$r_{ROA} = \frac{NI + IE - IT}{ATA}$$

Where  $r_{ROA}$  = return on assets

NI = net income

IE = interest expense

IT = interest tax saving

ATA = average total assets

## 2. ROE

$$r_{ROE} = OP \times AT \times DEMR = \frac{NIAT}{TR} \times \frac{TR}{ATA} \times \frac{ATA}{ASE} = \frac{NIAT}{ASE}$$

Where  $r_{ROE}$  = return on equity

OP = operating performance

AT = asset turnover

DEMR = debt-equity management ratio

NIAT = net income after tax

TR = total revenue

ATA = average total assets

ASE=average shareholders' equity

### 3. Tobin's Q

Tobin's Q is a ratio of the corporate market value against the replacement cost of corporate assets. While Tobin's Q is between 0 and 1 (low Q), it indicates the replacement cost of corporate assets is higher than the corporate market value. While Tobin's Q is above 1 (high Q), it indicates the corporate market value is higher than the replacement cost of corporate assets.

$$Q = \frac{TMV}{TAV}$$

Where Q= Tobin's Q

TMV=total market value

TAV= total assets value

### 4. Sales growth rate

$$g_{sales} = \frac{S_t - S_{t-1}}{S_{t-1}}$$

Where  $g_{sales}$  = sales growth rate

$S_t$ =sales in this year

$S_{t-1}$ =sales in last year

### 8.3.3 Control Variable

Controlling variables in regression analysis is very important, because one small overlooked factor may result in a big difference. While controlling variables, four factors are introduced. The four factors are net margin (NM), earnings before interest and taxes (EBIT), sales growth rate (SGR), and total cost (TC).

Net Margin:

$$NM = \frac{NP}{OR}$$

Where NP=Net Profit

OR=Operating Revenue

EBIT:

$$EBIT=OP+II+NOI-OE+PYIA$$

Where OP= operating profit

II= investment income

NOI= non-operating income

OE= operating expenses

PYIA= prior year income adjustment

## **8.4 Hypotheses and Model**

### **8.4.1 Hypotheses**

There are six hypotheses that I believe cover all possible performance scenarios.

The six hypotheses are as follows.

#### **Hypothesis 1:**

There is no relationship between mixed ownership and corporate performance.

#### **Hypothesis 2:**

There is a negative relationship between mixed ownership and corporate performance.

#### **Hypothesis 3:**

There is a positive relationship between mixed ownership and corporate performance.

#### **Hypothesis 4:**

The transformation from whole ownership to mixed ownership is helpful to improve corporate performance.

#### **Hypothesis 5:**

The transformation from whole ownership to mixed ownership is harmful to improve corporate performance.

#### **Hypothesis 6:**

The transformation from whole ownership to mixed ownership is neutral to

improve corporate performance.

## 8.4.2 Model

The multivariate regression is used to test the above hypotheses. It is a common way to use the multivariate regression to check the relations between the corporate performance and the concerned factors, such as ownership structure, or ownership transfer. It is also very common to use the indicators of ROE, ROA, and Tobin's Q to measure corporate performance. In order to control variables, net margin (NM), earnings before interest and taxes (EBIT), sales growth rate (SGR), and total cost (TC) must be introduced. That is helpful to get more reliable results.

There are three regressions. Regression 1 is used to test hypothesis 1, 2, and 3. In regression 2, a *Dmixed<sub>it-2</sub>* dummy is used to test these hypotheses further, that helps understand the relationship in more detail. Regression 3 is used to test hypotheses 4, 5, and 6.

### Regression 1:

$$y_{it} = \alpha + \beta_0 Dmixed_{it-1} + \beta_1 TC_{it}(-1) + \beta_2 TA_{it}(-1) + \beta_3 NM_{it} + \beta_4 TC_{it}(-1) + \beta_5 N1\_share_{it} + \beta_6 EBIT_{it} + \varepsilon_{it}$$

### Regression 2:

$$y_{it} = \alpha + \beta_1 Dmixed_{it-2} + \beta_2 TC_{it}(-1) + \beta_3 TA_{it}(-1) + \beta_4 NM_{it} + \beta_5 TC_{it}(-1) + \beta_6 N1\_share_{it} + \beta_7 EBIT_{it} + \varepsilon_{it}$$

### Regression 3:

$$y_{i,t} = \alpha + \beta_1 Dmixed_{i,t-3} + \beta_2 TC_{i,t}(-1) + \beta_3 TA_{i,t}(-1) + \beta_4 NM_{i,t} + \beta_5 TC_{i,t}(-1) + \beta_6 N1\_share_{i,t} + \beta_7 EBIT_{i,t} + \varepsilon_{i,t}$$

Where  $y_{i,t}$  is a measurement of performance in year t for company i. Return on assets (ROA), return on equity (ROE), Tobin's Q and sales growth rate (SGR) are used to measure corporate performance.

$ROA_{i,t}$ ----- return on assets for company i in year t.

$ROE_{i,t}$ -----return on equity for company i in year t.

$Q_{i,t}$  ----- Tobin's Q for company i in year t.

$SGR$ ----sales growth rate.

$\alpha$  is constant,  $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$  are correlation coefficients and

correspond with  $Dmixed_{i,t}, TA_{i,t}, NM_{i,t}, SGR_{i,t}$  and  $EBIT_{i,t}$ .

$Dmixed_{i,t-1}$ ----- a dummy variable that takes a value of 1 if company i has mixed ownership and 0 otherwise.

$D_{mixed_{i,t-2}}$ ---- a dummy variable that takes a value of 1 if company i has whole state ownership and 0 otherwise.

$D_{mixed_{i,t-3}}$ ---- a dummy variable that takes a value of 1 if company i is transformed from whole ownership to mixed ownership and 0 otherwise.

$N1_{share_{i,t}}$ ----the shareholding percentage of the first largest shareholder for company i in year t.

$TA_{i,t}(-1)$ ----total assets lagged one period for company i in year t.

$NM_{i,t}$ ----net margin for company i in year t.

$TC_{i,t}(-1)$ ---- total cost lagged one period for company i in year t.

$EBIT_{i,t}$ ---- earnings before interest and taxes (EBIT) for company i in year t

$\varepsilon_{i,t}$ ----the residuals in this regression for company i in year t.

These three regressions are common ways of correlation analysis.

## 8.5 Data Analysis

### 8.5.1 All Variables

In this section the performance of each group is presented and the comparative analysis on the data is conducted.

Table 8-2 presents the minimum and maximum values for each variable, the mean and the standard deviation, the obviations, the shareholder's identity (ID), and their ownership attribute. There were some uncommon minimum and maximum values for variables, thus the outliers with extraordinary values were removed when running models in STATA software.

Table 8-2 The Values of All Variables  
(Sample: 1087 Companies)

Variable	Obviations	Mean	Std. Dev.	Min	Max
Year	10870			1998	2007
ID	10870			2	601991
Nx1	9285			10	21
Nx2	8089			10	21
Nx3	8089			10	21
DUM_Mixed	8089			0	1
DUM_State	8089			0	1
Total assets	9546	3.66E+09	2.47E+10	222849.1	9.94E+11
Total cost	9553	2.20E+09	1.95E+10	-3412904	1.01E+12
Tobin's Q	7944	2.015502	1.962812	0.1376041	47.86974
Return on assets	9528	0.142767	0.102418	-0.2116036	0.966565
Return on equity	9529	0.339887	1.025284	-41.27379	61.74834
Net profit	9572	2.11E+08	2.96E+09	-3.72E+09	1.36E+11
EBIT	9572	6.09E+08	6.48E+09	-1.19E+09	2.84E+11
Sales growth rate	8459	0.882992	41.54487	-4.411048	3782.713
Net margin	9555	-30.0057	2944.027	-287764.3	1999.105

Note: NX1, 2, 3 denote the first to third largest shareholders, DUM\_Mixed and DUM\_State display dummy variables.

## 8.5.2 Correlation Analysis

Table 8-3 presents the correlation matrix for a group of variables or for the coefficients of their most recent estimations. It is found that EBIT is strongly related to both total assets and total cost as the correlation coefficients are 0.9618 and 0.7705. They are close to 1. Similarly, the total assets and the total cost have a pairwise correlation coefficient of 0.8471, that means these two variables are highly correlated. Therefore, I introduce the total cost and the total assets lagged by one period into the model. Other variables have very small pairwise correlation coefficients.

Table 8-3 All Pairwise Correlation Coefficients

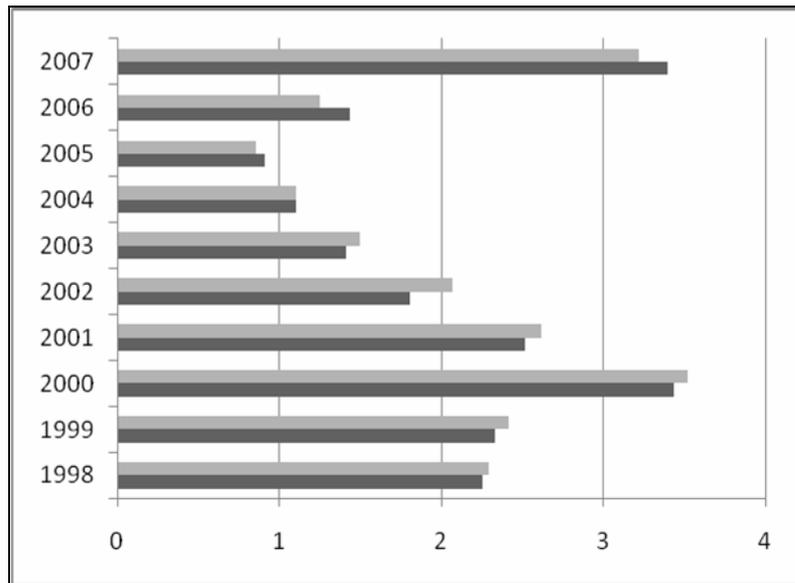
	Dum1	Dum2	TA	TC	Q	ROA	ROE	EBIT	SGR	NM
Dum1	1									
Dum2	0.0203	1								
<b>TA</b>	<b>0.0127</b>	<b>0.0273</b>	<b>1</b>							
TC	0.0148	0.0169	0.8471	1						
Q	-0.0041	-0.074	-0.0303	-0.0255	1					
ROA	-0.0595	-0.0779	0.0519	0.0564	0.1586	1				
ROE	-0.0082	-0.0393	0.0265	0.0371	0.0034	0.2077	1			
EBIT	0.0164	0.0157	0.9618	0.7705	0.0006	0.0858	0.0197	1		
SGR	-0.0152	0.0032	-0.0006	-0.0009	-0.0014	-0.001	0.0027	-0.0008	1	
NM	-0.0091	-0.0033	0.0011	0.0012	0.0094	0.0143	0.0034	0.001	0.0005	1

Note: When the correlation coefficient is close to 1, the relationship between the variables is strong. Dum1: mixed and whole dummy variable, 1 for mixed ownership and 0 for whole ownership; Dum 2: state and private dummy variable, 1 for state ownership and 0 for private ownership; TA: total assets; TC: total cost; Q: Tobin's Q; ROA: return on assets; ROE: return on equity; EBIT: earnings before interests and tax; SGR: sales growth rate; NM: net margin.

## 8.5.3 Tobin's Q

Figure 8-1 presents the average value of Tobin's Q for both the mixed ownership group (mixed) and the whole ownership group (whole) between 1998 and 2007. It can be found that the Tobin's Q of mixed ownership group is higher than the

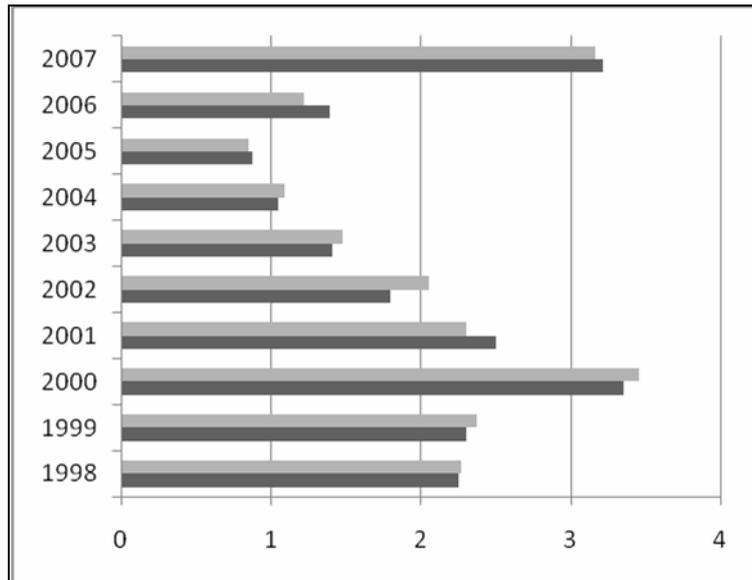
Tobin's Q of the whole ownership group between 1998 and 2003. Interestingly, it is then lower for the period between 2005 and 2007. But the differences between the mixed group and the whole group are not marked, and the differences are not consistent during the period of 1998-2007 and the period of 2005-2007. It is clear from these illustrations that Tobin's Q is not strongly related to mixed ownership.



■ Q mixed  
■ Q whole

Figure 8-1 Tobin's Q of the Mixed Group versus the Whole Group

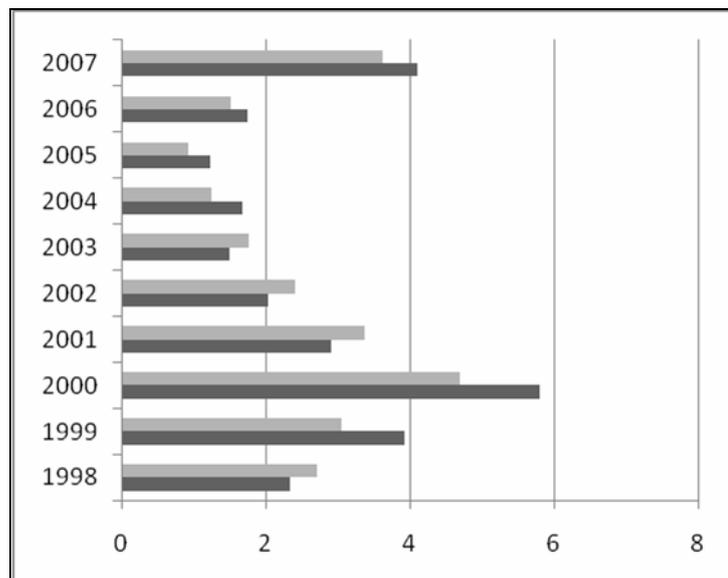
Figure 8-2 presents Tobin's Q of the group of mixed ownership with the state majority shareholder (mixed-state) and the group of the whole state ownership (whole-state). It is found that there is no significant differentiation between the two groups.



■ Q Mixed-State  
 ■ Q Whole-State

Figure 8-2 Tobin's Q of the Mixed-State Group versus the Whole-State Group

Figure 8-3 presents the Tobin's Q of the group of the mixed ownership with the private majority shareholder (mixed-private) and the group of the whole private ownership (whole-private). The Tobin's Q has no significant differentiation between the two groups although it is sometimes higher for the latter group and sometimes higher for the former group.



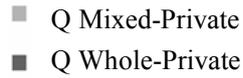


Figure 8-3 Tobin's Q of the Mixed-Private Group versus the Whole-Private Group

### 8.5.4 ROA

Figure 8-4 presents the mean value of ROA of mixed ownership group (mixed) and whole ownership group (whole). It is easy to find that the ROA of the whole ownership group is higher than mixed ownership group in most years, but the differentiation is not significant.

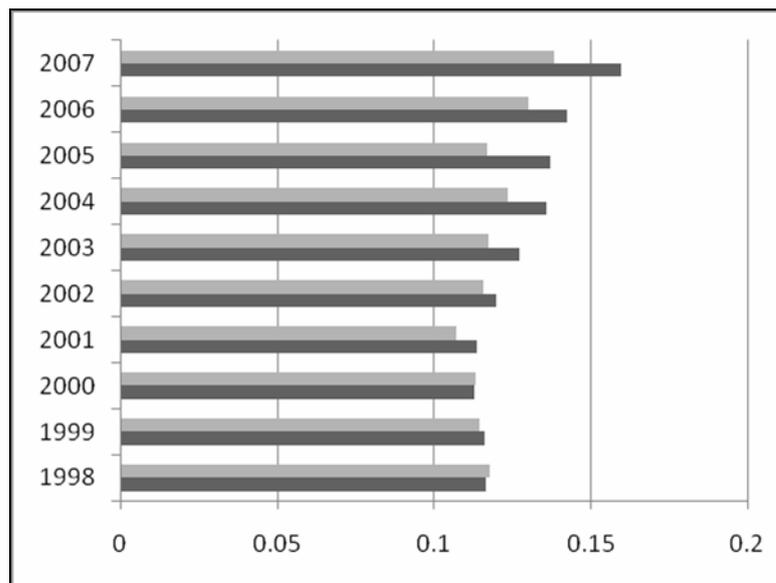


Figure 8-4 ROA of the Mixed Ownership Group versus Whole Ownership Group

Figure 8-5 presents ROA of the group of the mixed ownership with the state majority shareholder (mixed-state) and the group of the whole state ownership

(whole-state). It seems the ROA of the latter tends to be higher than the former, though again the differentiation is also insignificant.

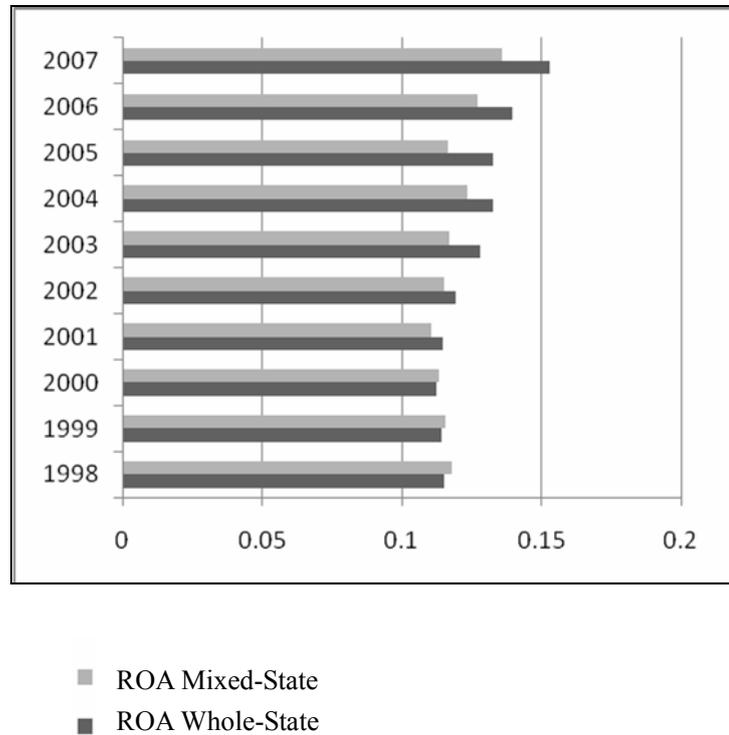


Figure 8-5 ROA of the Mixed-State Group versus the Whole-State Group

Figure 8-6 presents ROA of the group of the mixed ownership with the private majority shareholder (mixed-private) and the group of the whole private ownership (whole-private). In most years the ROA of the latter is much higher than the former.

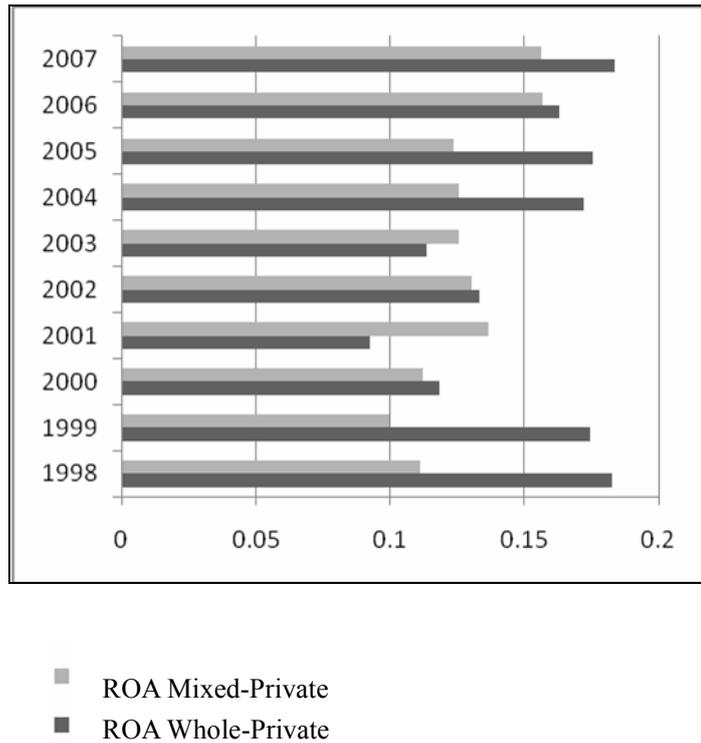
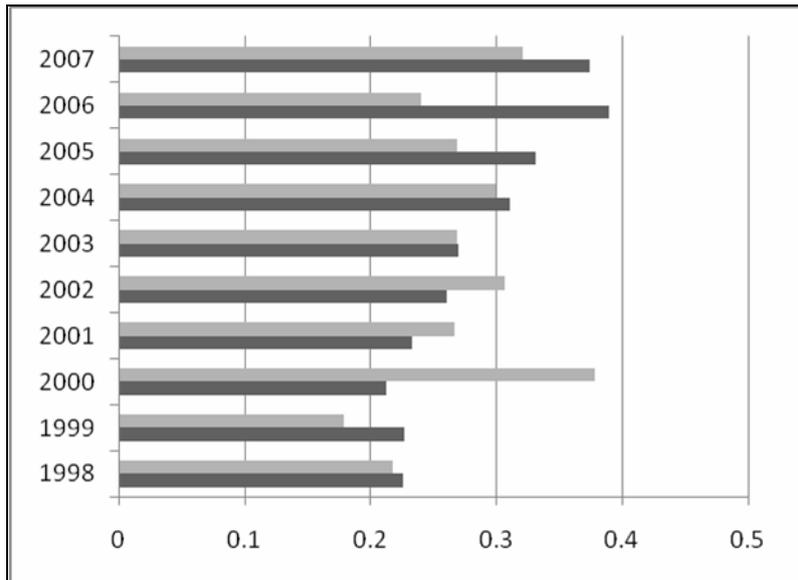


Figure 8-6 ROA of the Mixed-Private Group versus the Whole-Private Group

### 8.5.5 ROE

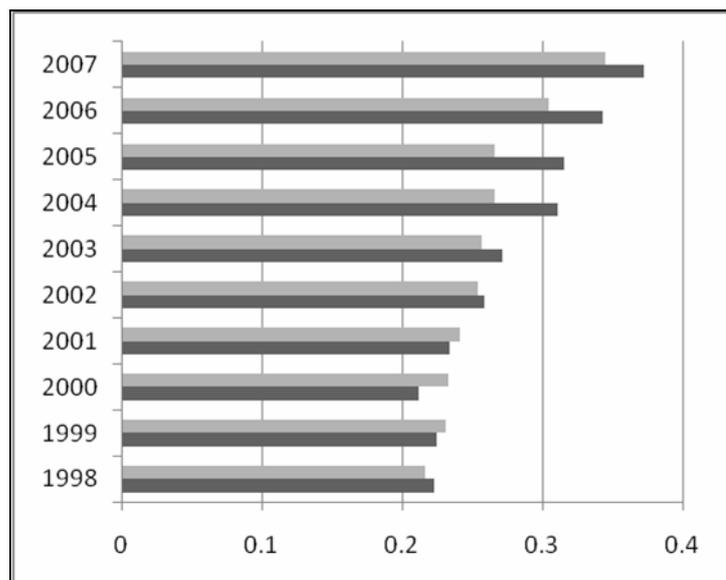
Figure 8-7 presents the mean value of ROE for the whole ownership group (whole) and for the mixed ownership group (mixed). It can be found the ROE for the mixed ownership group is higher than the ROE for the whole ownership group between 2000 and 2003, but lower between 1998 and 1999, and between 2004 and 2007.



- ROE Mixed
- ROE Whole

Figure 8-7 ROE of the Mixed Ownership Group versus the Whole Ownership Group

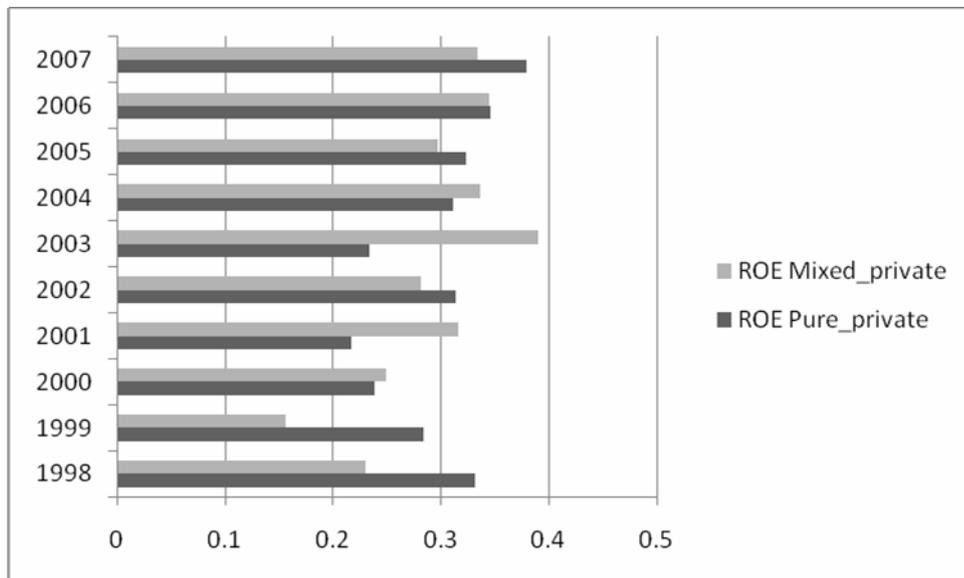
Figure 8-8 presents ROE of the group of the mixed ownership with the state majority shareholders (mixed-state) and the group of the whole state ownership (whole-state). It can be found in most years the former is lower than the latter.



- ROE Mixed-State
- ROE Whole-State

Figure 8-8 ROE of the Mixed-State Group versus the Whole-State Group

Figure 8-9 presents ROE of the group of the mixed ownership with the private majority shareholder (mixed-private) and the group of the whole private ownership (whole-private). It can be found that in most years the former is lower than the latter. But in 2000, 2001, 2003 and 2004, the former is higher than the latter.



- ROE Mixed-Private
- ROE Whole-Private

Figure 8-9 ROE of the Mixed-Private Group versus the Whole-Private Group

Based on the above comparisons, it is fair to say there is no solid evidence showing the performance of mixed ownership companies is higher than the performance of whole ownership companies or vice versa. Sometimes, the performance of whole ownership companies is higher than the performance of mixed ownership companies, but the differences are not very noted. In general, it

is difficult to find the relationship between the corporate performance and the ownership structure.

## **8.6 Empirical Test Results**

### **8.6.1 Empirical Test Approach**

In this section the empirical tests on regression 1, 2, and 3 are conducted. The results of the empirical tests are shown in the following tables.

Table 8-4, 8-5, 8-6, 8-7 present estimated the results of different groups. Firstly, the sample is totally analysed through the introduction of a mixed dummy variable. Secondly, the sample is divided into the whole ownership group and the mixed ownership group, and then the performance correlation with the ownership structure is checked. Thirdly, the relationship between the corporate performance and the transformation from whole ownership to mixed ownership is checked. A variable, the shareholding percentage of the first largest shareholder, is introduced to the regression.

### **8.6.2 ROA Empirical Test**

Table 8-4 presents ROA empirical test results of different groups. The first column shows the total sample results of five variables, all the variables are significant at the 95% confidence interval, with the exception of the net margin variable. The dummy variable coefficient for mixed ownership group and the whole ownership group is -0.0081068, that tells the dummy variable of mixed ownership group has a significant negative relationship with ROA. This means the whole ownership group has better performance than the mixed ownership group. Besides the dummy variable of mixed ownership group, EBIT is positively and significantly related to ROA.

Moreover, the dummy variable is used to analyze the relationship between ownership structure and corporate performance.

In the whole ownership group, all variables are significant except net margin, dummy variable and EBIT of the companies with the state majority shareholder have positive coefficient. Thus, the whole state ownership group (whole-state) has better performance than the whole private ownership group (whole-private). The shareholding percentage of the first largest shareholder shows negative significance both in the total sample and in the whole ownership group.

In the mixed ownership group, the dummy variable of the companies with the state majority shareholder (mixed-state) shows positive insignificant relationship with corporate performance. EBIT still plays a positive and significant role, however, the variable of the shareholding percentage of the first largest shareholder is no longer significant at 5% level.

Further, the issue whether the transformation from whole ownership to mixed ownership affects corporate performance, should be studied. Since lots of wholly-owned enterprises were transformed to MOEs during 2002 to 2007, I consider the period of 2002 to 2007 in the model. In the column of 2002-2007, dummy variable of ownership transformation shows positive but insignificant relationship with corporate performance. While singling out those companies in which the shareholding percentage of the first largest shareholder is higher than 40%, the test result presents a positive significance on the dummy variable. That means even an ownership transformation occurs, the proportion of transferred equity matters very much. Low proportional equity transfer usually does not affect corporate performance, but high proportional equity transfer does. That implies the controlling powers and the shareholding structure matter in terms of improving performance. It is fair to say that the change in corporate governance is far more important than the ownership transformation itself. To prove this result more accurately, the robust testing can be applied.

Table 8-4 Dependent Variable: Return on Assets

	Total	Whole	Mixed	2002-2007	2002-2007>40%	2004-2007	2004-2007>40%	2006-2007	2006-2007>40%	2004-2005	2004-2005>40%	2002-2003	2002-2003>40%
dum_mixed	-0.0081068 (0.000)	-	-	-	-	-	-	-	-	-	-	-	-
dum_state	-	<b>.1561075</b> (0.000)	<b>.0019354</b> (0.465)	-	-	-	-	-	-	-	-	-	-
d_mixed	-	-	-	.0053045 (0.167)	.0130825 (0.011)	.0084656 (0.093)	.0197662 (0.016)	.0054664 (0.385)	<b>0.23785</b> (0.005)	.0026923 (0.689)	.0073567 (0.426)	.000614 (0.917)	.0041711 (0.565)
total assets	-3.18e-12 (0.000)	-5.08e-12 (0.000)	-3.69e-12 (0.000)	-3.12e-12 (0.000)	-1.50e-12 (0.084)	-2.91e-12 (0.037)	-1.54e-12 (0.366)	-7.66e-12 (0.000)	-6.41e-12 (0.000)	-1.01e-11 (0.000)	-9.35e-12 (0.000)	-6.62e-12 (0.035)	-5.12e-12 (0.202)
total cost	-1.61e-12 (0.000)	-4.62e-12 (0.000)	-6.31e-13 (0.012)	-3.90e-12 (0.003)	-3.88e-12 (0.010)	-1.38e-12 (0.577)	-1.09e-12 (0.746)	-1.01e-13 (0.935)	3.33e-13 (0.777)	5.15e-12 (0.194)	4.87e-12 (0.366)	5.23e-12 (0.195)	7.57e-12 (0.118)
net margin	1.93e-07 (0.266)	-1.42e-05 (0.408)	1.93e-07 (0.235)	-1.04e-05 (0.533)	.000084 (0.230)	.0000151 (0.393)	-.0017149 (0.037)	.0384033 (0.008)	.0991885 (0.000)	.0034064 (0.269)	-.0000684 (0.000)	.0049801 (0.000)	.004392 (0.003)
EBIT	1.94e-11 (0.00)	5.53e-11 (0.000)	1.43e-11 (0.000)	4.05e-11 (0.000)	2.24e-11 (0.000)	2.62e-11 (0.000)	1.52e-11 (0.004)	5.25e-11 (0.000)	3.82e-11 (0.000)	1.52e-10 (0.000)	1.36e-10 (0.167)	3.48e-11 (0.001)	2.52e-11 (0.260)
NI_share	-0.0221688 (0.002)	-7.66e-02 (0.000)	.00232 (0.829)	-.0569032 (0.003)	-.0350033 (0.299)	-.0533631 (0.062)	.0131173 (0.815)	.0625158 (0.154)	.1956662 (0.030)	.0438464 (0.239)	.1049703 (0.659)	.0324908 (0.458)	.1248632 (0.562)
observation	7472	2077	3851	1378	645	864	375	673	290	616	362	595	371
R <sup>2</sup>	0.0198	0.0245	0.0015	0.1560	0.0652	0.1495	0.1417	0.2173	0.0869	0.1512	0.1526	0.2749	0.1539

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Note: The table in brackets is the p-value of t-statistic. Total assets, total cost and EBIT are lagged one period. Dum\_mixed is used to compare the performance of the mixed ownership group and the whole ownership group, Dum\_state is used to compare the performance of the companies with the state majority shareholder and the companies with the private majority shareholder. D\_mixed is used to compare the performance of the companies with ownership transformation from whole ownership to mixed ownership and other companies. N1\_share is the shareholding percentage of the first largest shareholder.

### **8.6.3 ROE Empirical Test**

Table 8-5 presents the empirical test results for ROE of different groups. The dummy variable of mixed ownership group and whole ownership group is negatively significant at the 95% confidence interval. This shows the performance of whole ownership group is better than mixed ownership group. While the first largest shareholder owns more than 40% of the total equity after the ownership transformation, the ownership-transformed companies from whole ownership to mixed ownership are positive and significant at the 5% level in the period of 2002-2007, 2004-2007 and 2006-2007. Other groups have positive insignificant relationship with the performance. ROE test results are similar to ROA test results.

Table 8-5 Dependent Variable: Return on Equity

	Total	Whole	Mixed	2002-2007	2002-2007>40%	2004-2007	2004-2007>40%	2006-2007	2006-2007>40%	2004-2005	2004-2005>40%	2002-2003	2002-2003>40%
dum_mixed	-0.0097583 (0.237)	-	-	-	-	-	-	-	-	-	-	-	-
dum_state	-	.3742461 (0.000)	.0205602 (0.057)	-	-	-	-	-	-	-	-	-	-
d_mixed	-	-	-	.0337059 (0.099)	.0766564 (0.002)	.035953 (0.160)	.1170968 (0.000)	.0408094 (0.243)	.1332606 (0.000)	.0086674 (0.843)	.0236843 (0.743)	.0225786 (0.460)	.0086336 (0.629)
total assets	-8.80e-13 (0.536)	-8.98e-12 (0.000)	-1.20e-12 (0.600)	-7.91e-12 (0.075)	-4.06e-12 (0.343)	-8.43e-12 (0.234)	-1.67e-12 (0.779)	-1.83e-11 (0.012)	-2.20e-11 (0.000)	-9.54e-12 (0.436)	-1.09e-11 (0.580)	9.42e-12 (0.560)	8.53e-12 (0.387)
total cost	-7.03e-12 (0.000)	-1.51e-11 (0.000)	-6.13e-12 (0.000)	-1.39e-12 (0.843)	-7.86e-12 (0.288)	1.08e-13 (0.993)	-1.14e-11 (0.338)	6.49e-13 (0.927)	-9.30e-13 (0.858)	7.56e-12 (0.761)	1.30e-11 (0.757)	4.82e-12 (0.817)	1.10e-11 (0.357)
net margin	4.66e-07 (0.566)	-8.36e-06 (0.900)	4.62e-07 (0.487)	.0000362 (0.686)	.000354 (0.310)	-0.000106 (0.907)	-0.0086125 (0.003)	.0000317 (0.758)	-1.901098 (0.000)	-0.0001109 (0.783)	-0.0000985 (0.851)	.003639 (0.606)	.0014896 (0.679)
EBIT	5.08e-11 (0.000)	1.66e-10 (0.000)	4.69e-11 (0.000)	1.17e-10 (0.000)	8.91e-11 (0.000)	8.69e-11 (0.000)	5.97e-11 (0.001)	1.45e-10 (0.003)	1.54e-10 (0.000)	2.61e-10 (0.006)	2.33e-10 (0.097)	4.56e-11 (0.376)	2.73e-11 (0.313)
NI_share	-1.1854165 (0.000)	.3560211 (0.000)	-.1477546 (0.001)	-.1423103 (0.166)	-.2901866 (0.077)	-.1131745 (0.432)	.0145481 (0.940)	.4091295 (0.105)	1.179629 (0.004)	.1247185 (0.605)	.0715525 (0.904)	.0513555 (0.803)	.7430536 (0.007)
observation	7493	2107	3864	1404	694	882	387	730	302	638	369	605	375
R <sup>2</sup>	0.0067	0.0375	0.0306	0.0930	0.0709	0.1144	0.0469	0.0744	0.1057	0.0582	0.0256	0.0228	0.0114

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Note: The table in brackets is the p-value of t-statistic. Total assets, total cost and EBIT are lagged one period. Dum\_mixed is used to compare the performance of mixed and whole ownership group; dum\_state is used to compare the performance of companies with the state majority shareholder and the companies with the private majority shareholder. D\_mixed is used to compare the performance of the companies with the transformation from whole ownership to mixed ownership and other companies. N1\_share is the shareholding percentage of the first largest shareholder.

#### **8.6.4 Tobin's Q and Sales Growth Rate Empirical Test**

Tobin's Q in table 8-6 also shows that the dummy of the mixed ownership group has negatively significant relationship to corporate performance. However, the dummy of the group with the state majority shareholder and the group with the private majority shareholder is not significant in the whole ownership group but is significant for the mixed ownership group. These findings differ from the analysis for ROA ROE. And the dummy variable for the companies with transformation from whole ownership to mixed ownership is positively significant for the period of 2002-2007, 2004-2007, 2006-2007. This is also true for the companies whose first largest shareholder holds more than 40% of the total equity for these periods. This implies that the group with transformation from whole ownership to mixed ownership has better performance than those without ownership transformation in recent years.

The test result on sales growth rate is similar to the results for ROA and ROE. The dummy variable of the mixed ownership group is not significant in the total sample. The dummy variable of the ownership-transformed group is positively significant only in those ownership-transformed companies whose first largest shareholder owns more than 40% the total equity after the transformation in the period of 2002-2007, 2004-2007, 2006-2007.

Table 8-6 Dependent Variable: Tobin's Q'

	Total	Whole	Mixed	2002-2007	2002-2007>40%	2004-2007	2004-2007>40%	2006-2007	2006-2007>40%	2004-2005	2004-2005>40%	2002-2003	2002-2003>40%
dum_mixed	-1.1084312 (0.023)	-	-	-	-	-	-	-	-	-	-	-	-
dum_state	-	.7045646 (0.352)	.1505946 (0.034)	-	-	-	-	-	-	-	-	-	-
d_mixed	-	-	-	.2472373 (0.006)	.4180974 <b>(0.042)</b>	.9192072 (0.000)	1.129463 <b>(0.002)</b>	1.430904 (0.000)	1.035706 (0.014)	-1.1431807 (0.061)	-1.1523994 (0.081)	-1.3589472 (0.002)	-1.1369622 (0.184)
total assets	-6.48e-11 (0.000)	-9.70e-11 (0.000)	-8.33e-11 (0.000)	-9.85e-11 (0.000)	-6.65e-11 (0.065)	-1.18e-10 (0.004)	-1.05e-10 (0.170)	-6.70e-11 (0.192)	-1.43e-11 (0.826)	-3.29e-11 (0.122)	-5.96e-11 (0.012)	-1.10e-10 (0.064)	-1.05e-10 (0.047)
total cost	-4.00e-12 (0.416)	-5.30e-11 (0.020)	1.13e-11 (0.090)	3.62e-11 (0.224)	-4.08e-11 (0.512)	1.75e-10 (0.017)	1.05e-10 (0.488)	-1.34e-11 (0.787)	-3.15e-12 (0.956)	-3.91e-11 (0.365)	2.34e-11 (0.643)	-4.09e-11 (0.591)	1.52e-11 (0.812)
net margin	4.56e-06 (0.326)	-.001311 (0.123)	4.62e-06 (0.287)	-.0011005 (0.126)	.0018561 (0.527)	-.0016273 (0.079)	.0028675 (0.938)	-.0013587 (0.275)	1.511776 (0.517)	.0007867 (0.262)	.0007449 (0.237)	-.041022 (0.363)	.0058071 (0.869)
EBIT	2.07e-10 (0.000)	8.45e-10 (0.000)	1.49e-10 (0.000)	9.14e-10 (0.000)	1.00e-09 (0.000)	8.06e-10 (0.000)	8.78e-10 (0.000)	1.07e-09 (0.003)	6.36e-10 (0.158)	2.77e-10 (0.093)	2.83e-10 (0.093)	4.06e-10 (0.032)	2.48e-10 (0.088)
NI_share	1.423278 (0.000)	.4520685 (0.313)	1.740212 (0.000)	-2.488114 (0.000)	-4.865488 (0.000)	-3.437227 (0.000)	-6.080009 (0.015)	-.9579719 (0.585)	-5.489715 (0.209)	.9781333 (0.020)	3.38137 (0.000)	1.037536 (0.175)	-.0629238 (0.966)
observation	7377	2096	3841	1618	693	857	385	677	290	636	368	593	354
R^2	0.113	0.0186	0.0065	0.0122	0.0434	0.0052	0.0093	0.0008	0.0002	0.0861	0.0116	0.0475	0.0378

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Note: The table in brackets is the p-value of t-statistic. Total assets, total cost and EBIT are lagged one period. Dum\_mixed is used to compare the performance of the mixed ownership group and the whole ownership group; dum\_state is used to compare the performance of the companies with the state majority shareholder and the companies with the private majority shareholder. D\_mixed is used to compare the performance of the companies with the transformation from whole ownership to mixed ownership and other companies. N1\_share is the shareholding percentage of the first largest shareholder.

Table 8-7 Dependent Variable: Sales Growth Rate

	Total	Whole	Mixed	2002-2007	2002-2007>40%	2004-2007	2004-2007>40%	2006-2007	2006-2007>40%	2004-2005	2004-2005>40%	2002-2003	2002-2003>40%
Dum_mixed	-.169707 (0.301)	-	-	-	-	-	-	-	-	-	-	-	-
dum_state	-	.5653078 (0.019)	.0368609 (0.185)	-	-	-	-	-	-	-	-	-	-
d_mixed	-	-	-	.0236834 (0.534)	.117751 <b>(0.040)</b>	.0571557 (0.255)	.1883411 <b>(0.039)</b>	.0848181 (0.260)	.2140582 (0.165)	-.0465587 (0.653)	.0430683 (0.743)	.0117289 (0.895)	.0679817 (0.390)
total assets	-1.11e-11 (0.000)	-1.59e-11 (0.017)	-1.87e-11 (0.001)	7.20e-12 (0.385)	3.57e-11 (0.001)	1.61e-12 (0.907)	5.12e-11 (0.014)	-1.61e-11 (0.312)	-1.89e-11 (0.434)	-1.29e-11 (0.657)	-2.14e-12 (0.952)	-6.35e-12 (0.892)	6.27e-13 (0.988)
total cost	-1.50e-11 (0.000)	-4.79e-11 (0.000)	-8.55e-12 (0.001)	-7.60e-11 (0.000)	-5.89e-11 (0.001)	-9.38e-11 (0.000)	-5.91e-11 (0.110)	1.40e-12 (0.926)	8.47e-12 (0.693)	2.31e-11 (0.659)	-9.61e-12 (0.901)	1.19e-10 (0.051)	9.78e-11 (0.064)
net margin	3.36e-06 (0.036)	-0.00084 (0.633)	3.36e-06 (0.049)	.0000198 (0.907)	.0010279 (0.214)	.0000468 (0.808)	-.0191255 (0.070)	-.0000521 (0.808)	.3811346 (0.665)	.0001688 (0.860)	.0001711 (0.857)	.0690725 (0.001)	.0521352 (0.001)
EBIT	1.20e-10 (0.000)	3.19e-10 (0.000)	1.01e-10 (0.000)	2.21e-10 (0.000)	-1.89e-10 (0.013)	2.63e-10 (0.000)	-2.39e-10 (0.094)	2.11e-10 (0.048)	1.72e-10 (0.293)	3.17e-10 (0.159)	3.13e-10 (0.219)	-1.26e-10 (0.400)	-1.34e-10 (0.261)
N1_share	.0849696 (0.209)	.003969 (0.00980)	.3883634 (0.001)	.1098001 (0.564)	.5485507 (0.149)	.2870156 (0.305)	1.030908 (0.090)	.8590385 (0.109)	3.645301 (0.031)	1.38956 (0.016)	1.942162 (0.082)	-.3074362 (0.609)	-.3009447 (0.803)
observation	7456	2100	3869	1397	690	875	383	695	297	636	367	604	375
R <sup>2</sup>	0.0024	0.0349	0.0075	0.0108	0.0721	0.0088	0.0803	0.0421	0.0143	0.0170	0.0171	0.0342	0.0390

Note: The table in brackets is the p-value of t-statistic. Total assets, total cost and EBIT are lagged one period. Dum\_mixed is used to compare the performance of the mixed ownership group and the whole ownership group; dum\_state is used to compare the performance of the companies with the state majority shareholder and the companies with the private majority shareholder. D\_mixed is used to compare the performance of the companies with the transformation from whole ownership to mixed ownership and other companies. N1\_share is the shareholding percentage of the first largest shareholder.

## **8.7 The Explanations and Discussions**

Although it is a difficult task to justify the mixed ownership from the perspective of performance, it is still necessary to compare the performance of the MOEs and non-MOEs in terms of the empirical results. In this chapter, I use the companies listed in China's stock market during the period of 1998-2007 as the sample to do the comparative analysis on the performance of MOEs and non-MOEs. It is found that there is no significant relationship between mixed ownership and performance, although there might be a tendency for the whole ownership group to exhibit better performance than the mixed ownership group, but the correlation is weak and the results are very inconsistent. Sometimes the mixed ownership group has better performance than the whole ownership group, but this result only covers a few time periods and contains few indicators. To summarise, hypothesis 1 is supported by the empirical estimation, but hypothesis 2 and 3 are rejected.

Corporate performance is decided by various complicated factors, ownership structure is only one of them. Besides, the capability of management, the effectiveness of board of directors, the business opportunities, the market power, the R&D ability, the brand name influence, and the access to obtain funds and other resources, are all important to corporate performance. Ownership structure may have impact on the above factors, but it takes time. As for private ownership itself, it may bring vigour to SOEs, but the ownership restructuring may make the corporate governance more complicated, say, tunnelling may happen after the entrance of the private controlling shareholder and the profit may be transferred away.

However, the establishment of good corporate governance is more difficult than the ownership restructuring itself and needs more time. As cited in 5.5 of this thesis, Little Swan Company, a very famous company in China, became a MOE

from a SOE in 2004, while a private company, Siweite Company, became the controlling shareholder of Little Swan Company. But afterwards Siweite was accused of embezzling funds from Little Swan, and Little Swan was caught in a financial distress. Apparently, mixed ownership did not bring better performance to Little Swan. Business strategy may also have an impact on corporate performance. While a company makes intense investments, its financial performance may drop down for a period. Usually the investments are very intense for lots of MOEs after the ownership restructuring. Moreover, more business opportunities, stronger market power, higher R&D ability, better brand name influence, and smoother access to obtain funds and other business resources, are not always corresponding to mixed ownership, sometimes the real circumstances are the opposite. Anyway, it takes long time and enormous effort for a MOE or any other kind of enterprise to establish high R&D ability, good brand name influence, smooth access to obtain business resources, strong market power, even if the MOE has a good management team and good corporate governance.

All in all, the entrance of new non-state shareholders and the accomplishment of mixed ownership do not necessarily mean outperforming the whole ownership, but as stated in chapter 5, there are indeed strong factors to drive the emergence of mixed ownership in China, and mixed ownership is favourable to combine the advantages of state ownership and private ownership. The most important thing which should be kept in the mind is, mixed ownership is rapidly rising in China because of some strong driving factors rooting in China's economic transition and China's social environment. It is extremely necessary to know more about it and its corporate governance, in order for the MOEs to be treated properly, to be assessed well, to be led to improve the corporate governance, to be encouraged to establish high R&D ability, good brand name influence, strong market power, unimpeded access to obtain business resources, and eventually to have good performance.

The sample in this chapter for the data analysis of the corporate performance is different from the sample in chapter 4 and 6 for the analysis of the commonness degree and mixture degree of mixed ownership as well as the analysis of the institutional arrangements of MOEs' corporate governance. It is understandable that the different samples are used. Since most of the MOEs originate from the ownership transformation, I have to check how many ownership-transformed enterprises have become MOEs so that I can assess how prevalent the partial privatization is in China. Therefore, I conducted the questionnaire survey that gives me the sample of 950 systematically-transformed enterprises. The questionnaire survey provides not only ownership structure information but also other useful information, such as the changes of the legal representative and CFO, and the establishment of board of directors because I intentionally designed the questionnaire to satisfy my analysis of the corporate governance of the enterprises. Consequently, I use the sample of 950 enterprises to study the institutional arrangements of MOEs corporate governance. But while doing the comparative analysis of the performance of MOEs and non-MOEs, the sample of 950 questionnaire-surveyed enterprises is not appropriate. This sample does not provide the performance data for a period of quite a few years because it is impossible to receive enough well-answered questionnaires if the questionnaire design is too complicated. The best way of conducting the comparative analysis is to use the national statistical data collected by the State Statistics Bureau of China, but as a matter of fact it is impossible. Firstly, the data of the State Statistics Bureau contains millions of enterprises, so that the data processing will be very difficult. Secondly, the data of the State Statistics Bureau does not contain the information of shareholding structure and shareholder's ownership attribute I need to identify the MOEs and non-MOEs. The data of China's listed companies is good and convenient to conduct the comparative performance analysis because the data provides the information of financial indicators and shareholding structure as well as shareholder's ownership attribute. The analysis results of the comparative performance by using the sample of the listed

companies may deviate from the analysis if the national data of the State Statistics Bureau can be used, but this is a common problem of using samples. For corporate performance analysis, using the data of listed companies is very common and a feasible choice.

This chapter has a meaningful finding. The transformation from whole ownership to mixed ownership promotes the corporate performance while the first largest shareholder owns more than 40% of the total ownership after the transformation. Namely, hypothesis 4 is supported empirically, but with a very important precondition of more than 40% of shareholding proportion of the first largest shareholder. Hypothesis 5 and 6 are rejected. The significance of the 40% shareholding proportion is found by a few trials. This signifies the higher shareholding proportion is material to make changes of the corporate performance in response to the ownership transformation. That is to say, even if an enterprise is transformed from whole ownership to mixed ownership, its performance may not have a noted change if the new first largest shareholder own less than 40% of the equity of the company. Why 35% and below do not show the noted change of the performance is unknown, one possible explanation is that the 40% shareholding proportion may be the lowest threshold to effectively control a listed company in regular circumstances and then to impact on corporate performance. Usually, it is well-know that 51% shareholding proportion will lead to the control of a non-listed company in regular circumstances, but for listed companies, the 40% shareholding proportion seems a threshold for the control of the business because there are a number of tradable stocks in the market besides.

From the perspective of corporate governance, the 40% shareholding proportion reflects the importance of corporate control. That signifies the transfer of corporate controlling powers is very important for the transformed companies from whole ownership to mixed ownership to improve the performance. As

stated in chapter 6 and 7, the transformation of corporate governance of MOEs is more important than ownership transformation itself. Therefore, the critical task in the future for China's MOEs is to transform the institutional arrangements of corporate governance and to establish good corporate governance, although that will take a long period of time.

## **8.8 Concluding Remarks**

This chapter checks the performance of MOEs and non-MOEs in China, and it is found that there are usually no notable performance difference between MOEs and non-MOEs. Corporate performance is determined by a set of factors. It is not appropriate to expect soon better performance after the transformation from whole ownership to mixed ownership. The critical issue is to encourage the MOEs to improve the corporate governance in the future.

# Chapter 9

## Conclusions and Further Thinking

### 9.1 Introduction

Mixed ownership is a result of China's economic transition. Little English literature on China's MOEs can be found. However, the existing literature on firm theory, economic transition, ownership reform, new institutional economics, and corporate governance, is enlightening. This thesis has studied the driving factors of the emergence of China's MOEs, their corporate governance, and their performance, and some findings have been drawn.

### 9.2 The Summary of This Research and the Major Findings

Since most of the MOEs in China originate from SOEs' ownership reform, this thesis first analyses the background, the policies, the progress, and the characteristics of China's SOEs reform. On this basis, the China Model of SOEs reform is generalised, which refers to the combination of the radical control reform and the gradual ownership reform, the strong path dependence, the exploitation of ever-growing private sector, and the dual transformation mode. The discussions about the path dependence and the employment status transformation as well as the cost payment are original. Mixed ownership is rooted deeply in the China Model. A large scale questionnaire survey covering 950 ownership-transformed enterprises is conducted, then the commonness degree of mixed ownership and the mixture degree are analysed. It is found that in the 950 ownership-transformed enterprises, 77.3% are MOEs, and in the 300 listed companies in Shanghai-Shenzhen Component Index, 14% are MOEs. Mixed ownership is quite common in China.

The driving factors of the emergence of China's MOEs have been explored. It is found in the 1980s, the mixed ownership budded in the economic co-operation and horizontal alliance, and it combined SOEs' advantage of obtaining business resources and non-SOEs' advantage of flexible operational mechanisms. The mutual supplement of different advantages achieved good synergy in mixed ownership. Since the mid-1990s, lots of SOEs have been restructured to MOEs instead of fully-privatised enterprises. The government's incomplete trust in private ownership, the government's incomplete releasing of its controlling powers on SOEs, the granting of some shares to SOEs' insiders, the unfair treatment to private enterprises, and the Chinese traditional culture, promoted the emergence of China's MOEs. In comparison with SOEs, China's private enterprises have more difficulties in obtaining business resources and acquiring the trust of the government, banks, customers and the public. China is still not a country ruled by law, as a result private firms are not confident in acquiring the protection from the authorities. The government is very powerful and controls lots of business resources. These are also the factors driving the rise of China's MOEs.

The institutional arrangements of MOEs' corporate governance in China have been studied. From the perspective of new institutional economics, the institutional arrangements of corporate governance should include quite a few issues such as ownership structure, control arrangements, contracts, markets, regulations, and a set of relations. After taking some theoretical discussions and empirical observations, a basic analytical framework for the studies of the institutional arrangements of MOEs' corporate governance is established, namely, the SCORE framework. It includes five issues: shareholding structure, the covenant, the office of core managers, the special governmental regulations, and the employment relations. Based on the SCORE analysis for the institutional arrangements of MOEs' corporate governance, it is found that most of the MOEs have the state majority shareholder, and many of the MOEs have the covenants.

In the control structure of the MOEs, insiders have big advantages and privileges, they maintain noted powers and rights even after the entrance of new large private shareholders. Nevertheless, the new private shareholders can gradually penetrate the office of core managers. The government often sets up special regulations on MOEs in order to guarantee the stable operation of the MOEs and to promote local development, though these regulations may not be as effective as expected. The employment relations in MOEs are quite complicated, some employees still enjoy their iron rice bowl. Meanwhile, many employees hold shares in the enterprises they work for. Generally speaking, the corporate governance of China's MOEs is in an unstable and immature situation, and is not commercialised enough.

The comparative analysis on the performance of MOEs and non-MOEs has also been conducted. The five hypotheses about the performance of different groups of enterprises were tested empirically. One major finding is that the ownership transformation from whole ownership to mixed ownership promotes the corporate performance with a precondition that the first largest shareholder owns more than 40% of the total ownership in the company after the ownership transformation. That signifies the transfer of corporate controlling powers is meaningful for the improvement of the performance.

### **9.3 Contributions**

The contributions of this research are as follows.

First, the comprehensive analysis on the background, the policies, the progress, and the characteristics of China's SOEs reform has been conducted, the distinctiveness of China's SOEs reform has been explored, the China Model of SOEs reform has been generalised and explained. Although lots of similar research results and arguments are present in the existing literature, this research still have some particular analysis and discussions, say, the path dependence of

China's SOEs reform, the insiders' mastering in the ownership reform, and the employment status transformation. Mixed ownership is rooted deeply in the China Model of SOEs reform.

Second, the commonness degree of the mixed ownership in China and the mixture degree have been analysed. Though the calculations of these two indicators are not very sophisticated, the analysis is still necessary. The analytical results show that the mixed ownership is indeed quite common in China, and the mixture degree is quite high. Therefore, the mixed ownership in China deserves more research attention. Furthermore, the large scale questionnaire survey covering 950 ownership-reformed enterprises is very informative and provides lots of data for the following studies.

Third, the driving factors of the emergence of mixed ownership in China have been studied in this research. These factors are meaningful. My studies show that the mixed ownership can combine SOEs' advantage of obtaining business resources and non-SOEs' advantage of the flexible operational mechanisms, and private enterprises are still treated unfairly in China. That means there still a long way to go for China to establish the market system. Furthermore, mixed ownership also reflects the moderate and balanced philosophy of Chinese traditional culture.

Fourth, the SCORE analytical framework was established to conduct the studies on the institutional arrangements of MOEs corporate governance. This analytical framework is original although I draw on a lot from the works by Roe (2004) and Williamson (2000). It is found that the corporate governance of China's MOEs is unstable and immature, and is not commercialised enough. It is an important conclusion.

Fifth, the comparative analysis on the performance of MOEs and non-MOEs is meaningful. It is found that there is no noted relationship between corporate

performance and mixed ownership, but the transformation from whole ownership to mixed ownership with a precondition that the first largest shareholder owns more than 40% of the total equity promotes the corporate performance. It implies that the transfer of corporate controlling powers is critical for the ownership-transformed companies to improve the performance.

## **9.4 Academic Value and Policy Implications**

The findings about the mixed ownership commonness degree and the mixture degree, about the driving factors of the rise of China's MOEs, about the comparative performance analysis, bring value to the existing literature of the studies on the Chinese economy, and enrich the existing literature of the studies on economic transition. The establishment of the basic analytical framework of SCORE is original, and the analysis findings are meaningful.

This thesis also brings policy implications. Promoting mixed ownership is a strategy determined by China's central government and the ruling party. More and more MOEs are expected to rise in China because there still are many SOEs expected to take ownership restructuring. As the strategy is clear, mixed ownership will persist in China for long time. Therefore, understanding and improving their corporate governance is undoubtedly very important. This research tells people that more attention should be paid to the corporate governance of MOEs than to mixed ownership itself. My studies present that the corporate governance of China's MOEs is in an unstable, immature situation, and is not completely commercialised. The covenants and the special regulations may be helpful in the smooth ownership transformation in the short term, but is not helpful in the regular transfer of the controlling powers to new shareholders. The entrenchment of the original management obstructs the market-based selection of managers. Special regulations will be difficult to be enforced and will obscure the government-enterprise boundary line. The complex employment relations,

especially the maintenance of the iron rice bowl, are harmful to the future development of MOEs. The maintenance of the state cadre status of some managers obstructs the normal change of their positions and the marketisation of their selections and their compensations. Therefore, the MOEs need to establish sustainable and completely commercialised corporate governance. First, the special regulations should fade out. Second, the employment status should be transformed to the largest possible extent. Third, the normal transfer mechanism of the controlling powers and the normal replacement mechanism of the managerial positions should be established to the largest possible extent. In the past thirty two years, China's SOEs have almost achieved the commercialisation of their operation, but China need to push forward the commercialisation of the corporate governance of the MOEs for the next step. By commercialisation of corporate governance, I mean that the governance mechanisms are set up on the basis of commercial laws, common business rules, and profound markets. I think the most urgent task in the future is to gradually decrease the state shares in MOEs, allowing more and more MOEs to become the companies whose major shareholders are of private ownership attribute. This work will promote the commercialisation of MOEs corporate governance. Only the commercialisation of the corporate governance of MOEs is realised, the stable, and then the sustainable corporate governance can be established.

## **9.5 Concluding Remarks**

Although mixed ownership has been emerging in China for many years, it is still new in comparison with the typical private ownership and the typical state ownership. My research on China's MOEs is only a start. China's MOEs, as a new group of enterprises, will becoming more and more active, their activities and their corporate governance will attract more and more attention. I hope my research will open the curtain for further discussions and studies on MOEs. I am looking forward to more, and better, studies to surface in the future.

# Appendix

## The Questionnaire of Systematic Transformation (Gai Zhi)

Definition: The systematic transformation (Gai Zhi) is defined as the transaction that introduces non-state equity to SOEs through selling existing state shares or issuing new shares to private investors, then accomplishes full privatisation or partial privatisation.

Name of the enterprise:

Name of the head of the enterprise: \_\_\_\_\_, His or her position: \_\_\_\_\_.

Has the enterprise implemented Gai Zhi: Yes \_\_\_\_\_, No \_\_\_\_\_.

Please proceed if the answer is Yes.

1. Gai Zhi happened in the year of \_\_\_\_\_.

2. The size of the enterprise at the time of Gai Zhi (enter “√” in the selections):

Large \_\_\_\_\_, Medium \_\_\_\_\_, Small \_\_\_\_\_.

3. The major proposer of the Gai Zhi (enter “√” in the selections):

(1) The government \_\_\_\_\_.

(2) The parent company \_\_\_\_\_.

(3) The management of the enterprise \_\_\_\_\_.

(4) The workers of the enterprise \_\_\_\_.

(5) The outside investor \_\_\_\_.

(6) Others \_\_\_\_.

4. The pattern of the Gai Zhi (enter “ √ ” in the selections) :

(1) Selling the existing state equity \_\_\_\_.

(2) Introducing additional non-state capital \_\_\_\_.

(3) The combination of (1) and (2) \_\_\_\_.

5. The information of the first, second, and third largest shareholder.

The category of the shareholder status	The shareholding proportion

The categories of shareholder status are as follows:

(1) The government

(2) State assets management company

(3) State-owned enterprise

(4) State-participated enterprise

(5) Non-profit organization

(6) Collective enterprise

(7) Private firm

(8) Foreign company

(9) The management

(10) The workers

(11) Financial institute

(12) Individual

(13) Others

6. Whether or not the legal representative of the enterprise was changed after the Gai Zhi(enter “ √” in the selections): (1) Yes\_\_\_\_, (2) No\_\_\_\_\_.

7. Whether or not the CFO of the enterprise was changed after the Gai Zhi(enter “ √” in the selection): (1) Yes\_\_\_\_, (2) No\_\_\_\_\_.

8. The distribution channel of the information of the Gai Zhi proposal (enter “ √” in the selections):

(1) Distributed among the insiders\_\_\_\_\_.

(2) Published in nationwide newspapers\_\_\_\_\_.

(3) Published on internet\_\_\_\_\_.

(4) Published in property exchanges\_\_\_\_\_.

9. Whether or not the enterprise (or the controlling shareholder) made commitments about the post-Gai Zhi employment of the workers(enter “ √” in the selection): Yes\_\_\_\_, No\_\_\_\_. If the answer is Yes, in how many years\_\_\_\_(enter the number) the enterprise will not fire the workers, and the proportion\_\_\_\_% of the total workers will be retained in the enterprise.

10. Whether or not the enterprise (or the controlling shareholder) made commitments about the following issues (enter “ √” in the selections):

(1) The enterprise will not move to other places\_\_\_\_\_.

(2) The enterprise will not change the major business\_\_\_\_\_.

(3) The enterprise or the controlling shareholder will make further investment \_\_\_\_.

11. Whether or not the enterprise (or the controlling shareholder) get preferential policies from the government based on the commitments of question 9, and 10 (enter “ √” in the selections) :

(1) Yes \_\_\_\_.

(2) No \_\_\_\_.

Please specify the preferential policies if the answer is Yes:

(1) \_\_\_\_\_.

(2) \_\_\_\_\_.

(3) \_\_\_\_\_.

12. The economic compensations for the employment status transformation of the workers (enter “ √” in the selections):

(1) The enterprise become non-SOE (the state is the minority shareholder or there is no state equity), all workers transformed their employment status and received the economic compensations \_\_\_\_.

(2) The enterprise become non-SOE( the state is the minority shareholder or there is no state equity), all workers are guaranteed for further employment but received no economic compensations \_\_\_\_.

(3) The enterprise is still state-controlled enterprise after the Gai Zhi, all workers transformed their employment status and received the economic compensations \_\_\_\_.

(4) The enterprise is still state-controlled enterprise after the Gai Zhi, the employment contracts of all workers were changed, and all workers received no economic compensations\_\_\_\_\_.

(5) The enterprise become a company with a non-state majority shareholder, all workers transformed the employment status and received the economic compensations\_\_\_\_\_.

(6) The enterprise become a company with a non-state majority shareholder, the workers did not transform the employment status\_\_\_\_\_.

(7) Others (please specify)\_\_\_\_\_.

13. The proportion\_\_\_\_% of the total workers left the enterprise after the Gai Zhi.

14. The average economic compensation is\_\_\_\_\_RMB for one person.

15. The ways of economic compensations (enter “ √” in the selections):

(1) Cash\_\_\_\_\_.

(2) The stocks of the enterprise\_\_\_\_\_.

(3) The debt to the workers.

16. Has the enterprise established the board of directors (enter “ √” in the selections):

(1) Yes\_\_\_\_\_.

(2) No\_\_\_\_\_.

17. The redundant workers in the enterprise after the Gai Zhi (enter “√” in the selections):

(1) None\_\_\_\_\_.

(2) Few\_\_\_\_\_.

(3) Many\_\_\_\_\_.

**Thank You!**

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