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Change of control and the success of China's share-issue privatization ☆

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ABSTRACT

Using two newly available datasets of exchange-listed firms in China covering the period from 1994 to 2003, we test if share-issue privatization, defined here as a change of corporate control from the State to private owners rather than the IPO event used in earlier studies, improved firm performance. Our econometric analysis shows that privatization, when accompanied by a change of control, has had positive effects on profitability and the productivity of labor that are both statistically and economically significant.

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> "China is accelerating the privatization of tens of thousands of state-owned businesses that once served as pillars of Communist Party rule, and has decided to let foreign and private investors buy majority stakes in large enterprises the government had previously refused to sell, according to Chinese officials and researchers."
>
> —Washington Post, November 12, 2003

1. Introduction

Ownership structure is an essential component of economic and political institutions, and by influencing incentives can have a wide impact on the profitability and performance of business enterprises. One important shift in ownership structure occurring at unprecedented speed is the divestiture of shares in enterprises once wholly-owned by governmental units through large-scale privatizations. Since 1979, more than 100 countries, both developed and developing, have implemented privatizations. According to Gibbon (2000, p.1), the cumulative value of proceeds from these transactions surpassed $1 trillion as early as 1999, and empirical

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studies for a number of countries already provide strong evidence of positive effects on firm performance (Megginson, Nash, & van Randenborgh, 1994; Barberis, Boycko, Shleifer, & Tsukanova, 1996; Boubakri & Cosset, 1998; D'Souza & Megginson, 1999; La Porta & Lopez-de-Silanes, 1999; Frydman, Gray, Hessel, & Rapaczynski, 1999; Gupta, 2005).

China, as the world's largest developing country and indeed its second largest economy based on GDP adjusted for purchasing power parity, has also joined the global privatization wave with an incremental approach called “share-issue privatization.” This involves privatizing state-owned enterprises (SOEs) through the issuance of publicly-traded equity shares.[1] In contrast to the positive evidence for other countries, however, China's SOEs have *not* in general become more profitable after their initial public offerings (IPOs), and this makes for something of a “profitability puzzle.”[2]

In light of this, we explore the effectiveness of China's share-issue privatizations using two newly available datasets for exchange-listed firms and a new definition of the privatization “event.” We conclude that it is a change of control from the State to a private owner, rather than simply having an IPO, that best characterizes “privatization.” Using this definition, we show that Chinese firms *did* become more profitable and more productive after privatization, offering some resolution to the puzzle.

2. Background

Why have so many countries chosen to privatize their SOEs? After all, the Modigliani-Miller theory maintains that firm performance is invariant to the nature of ownership in a world with perfect competition, complete contracts, low information costs, no taxes, and no externalities. Even in the presence of externalities when perfect competition no longer holds, SOEs can still emerge as organizations capable of preventing market failures through pricing policies that take account of social costs (Shapiro & Willig, 1990). Despite the potential advantages, however, SOEs typically suffer from low operational efficiency, and the privatization literature usually points to the incompleteness of contracts and increasing information costs, which become more serious as economies grow complex and their firms more interdependent, as potential sources. This has led to the “agency view” of inefficiency. Two perspectives within this view are:

(1) The “managerial view,” which proposes that SOE managers are inadequately monitored and therefore have only weak incentives for improving operational efficiency (Vickers & Yarrow, 1988). Laffont and Tirole (1993) argue that this occurs in SOEs because there is neither an individual owner with a strong incentive to monitor nor a public share price to provide information about how the market judges the manager's actions. Further, inefficient but non-traded public sector firms lie outside of the market for takeovers;

(2) The “political view,” which asserts that political interference in SOEs leads to operational constraints and distorted objectives. For example, managers may gain political support by pursuing full employment policies at the expense of profits, and may apply soft budget constraints that end up not binding due to bailouts of the State (Kornai, 1979).[3] These distortions can result in redundant employees (Shleifer & Vishny, 1994; Boycko, Shleifer, & Vishny, 1996), employment of politically connected individuals rather than the best-qualified (Krueger, 1990), poor choices of product and location, and investment in projects with low net present values.

Agency-related factors seem to have motivated China's economic reforms since 1978. SOEs were at the core of these reforms because they have traditionally been such an important component of the economy and because weak management incentives and heavy policy burdens had long been suspected as sources of inefficiencies therein.[4]

In the 1980s, and against a background of global privatization, China did not carry out many privatizations. Instead, it consolidated enterprise property rights at the municipal government level and adopted a governance structure that stressed incentives and enterprise autonomy (Li, 1997). Specifically, China's SOE reforms from 1978 to 1992 proceeded in three stages. In the first stage (1979–83), China implemented a policy of administrative decentralization and profit retention with an eye to improving management incentives. The second stage (1984–87) saw an end to direct funding of SOEs by the government, and an expectation that SOEs would undertake expansions or other improvements via bank loans. Though it seems that the government did this to discipline SOEs by hardening their budgets, the plan was unsuccessful, mainly because the lending banks were also state-owned and thus had only weak incentives to monitor firms. At the same time, SOEs could still get “policy loans” from state banks at preferential interest rates so that budget constraints remained soft.[5]

In the final stage (1988–92), reform focused on the separation of government ownership from control of SOE operations through a “contract responsibility system” that improved incentives for managers to maximize profits. Groves, Hong, McMillan,

[1] Two methods of privatization have become common over the past 20 years. The former Soviet Union and countries of Eastern Europe have used “voucher privatization,” a method whereby citizens are given or can inexpensively purchase a book of vouchers that represent potential shares in any SOE. This has allowed countries to achieve mass privatization quickly. The second method, adopted by China and several other transition economies, is share-issue privatization. By far the largest fraction of total proceeds raised by privatizing governments has been collected through the latter method.

[2] See Sun and Tong (2003), Wei, Varela, D'Souza, and Hassan (2003), and Wang, Xu, and Zhu (2004).

[3] Berglof and Roland (1998) and Frydman, Gray, Hessel, and Rapaczynski (1999) show that soft budget constraints are an important source of inefficiency in SOEs, and Lin (1999) shows that they are prevalent in China. Bai and Wang (1999) demonstrate that soft budget constraints result in poor resource allocation decisions.

[4] For example, Lin, Cai, and Li (1998) show that even after 18 years of reform, SOEs still employed 57.4% of all urban workers and accounted for 52.2% of total investment in industrial fixed assets in 1996. They also argue that China's SOEs assume too many functions aimed at improving social welfare rather than enhancing firm performance. See also Mi and Wang (2000) on problems of incentives for management.

[5] For example, Cull and Xu (2003) observe that such “policy lending” has remained a defining characteristic of the Chinese financial system and that the responsibility to bail out poorly performing SOEs has been assumed increasingly by banks. A 2003 Ernst and Young report states that “in 2002, the non-performing loans of Chinese banks amounted to a staggering $500 billion USD, a result of over 40 years of extensive policy lending” (p.4).

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