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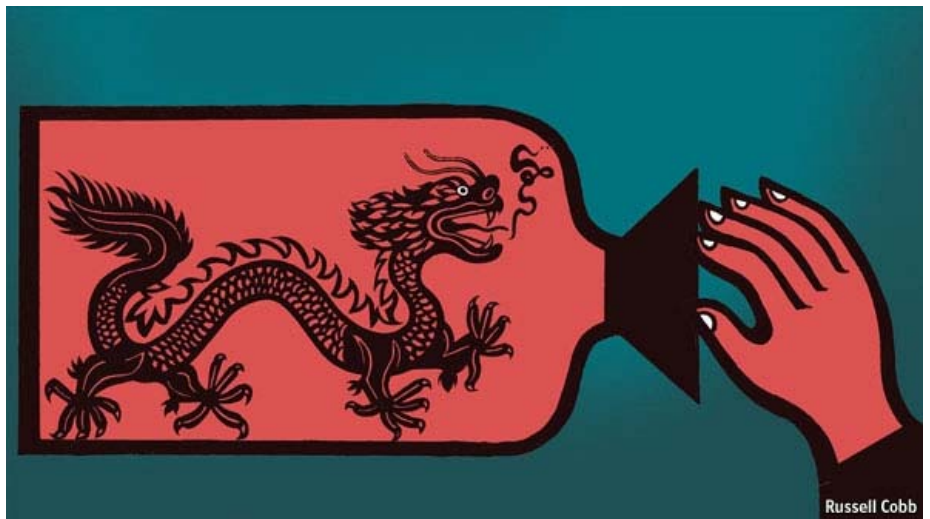
## Privatisation in China

# Capitalism confined

**Chinese companies, like companies everywhere, do best when they are privately run. In China, however, the state is never far away**

Sep 3rd 2011 | BEIJING | from the print edition

IN 1992 two Chinese cities, one just south of Beijing, the other just north of Hong Kong, were in desperate shape even by the standards of a desperately poor country. Their municipally run companies were in danger of bankrupting not only themselves but the cities too. Zhucheng, near Beijing, was best known as the birthplace of Jiang Qing, Mao Zedong's despotic, doctrinaire fourth wife, who died in jail in 1991. Two-thirds of its revenues were being eaten by corporate losses. Shunde, a small city in Guangdong, was buried in debt.



Meanwhile, the authorities in Beijing were becoming concerned that the state banking system, already creaking under the weight of bad debt, would be unable to bear even more. With the quiet acquiescence of the central government, Zhucheng and Shunde ignored doctrine, old laws and 40 years of failed policies in search of a better approach.

In a carefully constructed phrase subsequently endorsed, in 1993, by the all-powerful State Council, the two cities engaged in *gaizhi*, which means "changing the system" and implies the diversification of ownership. Put more simply, in words that even now the Chinese government cannot bring itself to utter, they started to privatise many of their companies. They thus began one of the Chinese state's first attempts to change its relationship with its enterprises. Jiang Qing would not have approved.

At first Shunde and Zhucheng turned their firms over to employees. In 1997, again before a broader shift in national policy, the two began selling companies directly to existing managements. Shunde, in particular, thrived. Two of the companies that emerged, a maker of bottle caps and a trader of duck feathers, are now among the world's largest appliance manufacturers, Midea and Galanz. Other factories have spread like wild flowers among what were once rice fields and fish farms.

Early signs of success led to modification of the rules on the ownership of companies. In 1995 the State Council endorsed a policy to "retain the large, release the small". In 1997 it approved a huge shift of ownership from the central government to municipalities with the explicit goal of expediting privatisations. These changes provided the foundation for the dramatic efforts in the late 1990s of Zhu Rongji, the then prime minister, that are reputed to have remade China's economy.

The short version is that Mr Zhu closed thousands of companies and broke the "iron rice bowl", a guarantee of living standards for the masses, in an effort to shake China out of economic lethargy. Between 1995 and 2001 the number of state-owned and state-controlled enterprises fell from 1.2m to 468,000 and the number of jobs in the urban state sector fell by 36m—or from 59% to 32% of total urban employment.

A longer version is that the process involved many more companies and has never ceased, and that the method has changed constantly. As some companies were transformed or closed, others were created, with various forms of state backing. The result has been non-stop experimentation with incentives and structures.

Privatisation remains a thorny issue in a country where private property became a constitutional right only in 2004 and where the right to own productive assets remains unclear. Many vibrant, purely private companies have sprung up despite this uncertainty, but take care to stay out of the limelight. Meanwhile, China's various experiments with privatisation have created several categories of companies which still have close ties to the state (see table).

## A taxonomy of privatisation

The first category comprises the vast banks and transport, energy and telecoms providers that were, and to some extent still are, government ministries. Gordon Orr, chairman of McKinsey's China business, calls this "version 1.0" of the modern state-controlled company. Although these entities have gained a lot of attention outside China, they account for perhaps 1% of privatised companies.

### The invisible hand

Private and partly privatised Chinese companies, selected

Category	Description	Examples
Large state-controlled enterprises	Usually monopolies or oligopolies. Minority shareholdings sold in public offerings	ICBC, China Construction Bank ( <i>banking</i> ) China Mobile, China Unicom ( <i>telecoms</i> ) China National Petroleum Corp ( <i>oil and gas</i> )
Joint ventures	Frequently involving foreign partner, providing technology in return for market access	Shanghai Volkswagen ( <i>cars</i> ) Xian-Janssen ( <i>biomedical</i> ) Denghai ( <i>agriculture</i> ) DHL-Sinotrans ( <i>logistics</i> ) Ameco ( <i>manufacturing</i> )
Private companies with some state influence	Often in new markets with no state-owned enterprises. Encouraged by friendly government policies and obstacles to foreign competition	BYD, Geely, Chery ( <i>cars</i> ) Goldwind ( <i>energy</i> ) Huawei ( <i>telecoms</i> )
Companies backed by publicly owned investment funds	Investors include foreign private-equity and venture-capital funds as well as city and provincial governments	Shanghai Environment Group, Nanhai Development ( <i>environmental protection</i> ) Digital China ( <i>IT services</i> ) China WLCSP ( <i>chip technology</i> )

Sources: McKinsey; Infinity Group; *The Economist*

The relationship between the state and most other businesses is less direct and more subtle. A second category contains joint ventures between private (often foreign) companies and firms backed by the state. A third consists of companies that are largely in private rather than state ownership, but in which the state remains influential nevertheless. Recently another class has started to emerge, in which the state plays the role of a venture capitalist: local governments invest in or create funds that back companies that they hope will bring both jobs and financial returns.

Start with the behemoths. Most of these huge companies have been turned into vaguely conventional-looking businesses. They have been restructured, recapitalised and rebranded. A minority of their equity has been sold to the public and is traded on the stockmarket. They have recognisable corporate structures with boards of directors, chief executives, chief financial officers and sundry other chiefs; and they publish financial reports with carefully presented accounts and dull letters from the bosses. They are steadily climbing up global rankings, symbols of China's growing industrial heft.

However, few contend that they are truly private companies. The proportion of shares issued is typically no more than 30%. They receive subsidised loans from state-controlled banks, they are given land cheaply and they usually enjoy a sheltered monopoly or oligopoly. Control by the government is never far away. The state appoints their senior managers—including a Communist Party committee headed by a party secretary.

Often, say insiders, these companies' doings reflect not so much the explicit orders of the government as managers' anticipation of what will earn its endorsement. An ambitious manager's career prospects depend on the party's Organisation Department, which oversees official appointments—and company bosses frequently move on to senior jobs in the ministries that oversee them. Direct control may have been severed, but rule by inferred command continues.

This model provides the government with continuing control of enterprises critical to the functioning of the economy. In particular, it facilitates the execution of big capital projects such as high-speed railways, steel plants, telecommunications networks and ports.

However, this comes at a cost. There are plenty of opportunities for graft. A close relationship between regulators and operating companies can mean that problems (with safety, as well as economic matters) are overlooked. The lack of commercial orientation frequently means that too many employees throughout the company are unproductive. At the top, there are often cushy, well-paid jobs for the children of the well connected. And the commercial and regulatory privileges of these companies crowd out private alternatives.

At home, it is hard to argue that any of the really big Chinese firms—the banks, the telecoms firms and petrol companies—draw customers because of any special appeal rather than their ubiquity and a lack of competitors. Abroad, despite their size, they are yet to become the global champions that the Chinese government would like them to be, even though the Chinese have sought for many years to learn from foreign corporations. This may be partly because the Chinese giants' ties to the state limit the extent to which they can imitate foreign multinationals, with senior managers from many countries.

In the late 1990s John Thompson, then head of IBM's international operations, and some colleagues attending a conference in Beijing were asked to visit Jiang Zemin, the president of China. Mr Jiang asked the IBMers how such a big company was managed centrally. He also asked how corporations and the American courts dealt with "corruption"—a worry, said Mr Jiang, when Chinese ministries were being privatised. Some months later, Mr Thompson recalls, Mr Jiang asked Lou Gerstner, IBM's chief executive, if the company would play host to a delegation of newly minted Chinese chief executives and some ministers. The group spent several days at IBM's executive-education centre in New York state. They then visited other organisations to learn more about how American capitalism was run and regulated.

Yet there was an unbridgeable gap between IBM and China's behemoths. In most successful global companies, a priority for executives from the home country is to prepare local managers who may one day accede to senior jobs at headquarters. The company becomes international inside as well as out. But because the Chinese giants are still in essence tied to the state, their leaders must remain Chinese.

Evidence of how these entities have performed is muddy because so much of their environment is distorted: for example, given cheap enough money and strong enough protection for their franchise, even corporate sluggards can show good profits and return on equity. However, in 2006 three Chinese academics began a vast study of the performance of privatised companies, summarised in a recent working paper<sup>\*</sup>. Jie Gan of Cheung Kong Graduate School of Business, Yan Guo of Peking University and Chenggang Xu of the University of Hong Kong conclude that the return on assets and profitability per employee for companies that have undergone partial share offerings is indistinguishable from those that were not privatised at all.

### **One driver better than two**

The second category of firms, joint ventures, is also small in number (2% of the academics' sample). Such ventures involve a bargain between the two sides. Often the private partner is a Western company hoping to gain access to a huge and growing economy. In return the Chinese gain Western know-how. For the Westerners, this involves obvious risks beyond the usual differences of opinion in a joint venture: that they will be pushed aside once the Chinese have acquired their knowledge.

In carmaking, where there have been several prominent joint ventures, a squeeze-out of the Western partner was part of the initial plan, says Michael Dunne, a car-industry consultant, and subtle moves along these lines emerge sporadically. Recently, for example, the government has pushed the Western companies to form "indigenous brand" joint ventures with intellectual-property and export rights. And at the end of 2009, Shanghai Automotive Industry Corporation bought an additional 1% of its venture with General Motors, gaining majority control.

Ms Gan, Mr Guo and Mr Xu find that, overall, joint ventures have yielded similarly lacklustre financial results to the partially privatised behemoths. However, carmaking appears to be an exception. Early ventures involving Peugeot-Citroën and General Motors flopped, but that is now ancient history. More than 20 ventures are currently in existence and although financial information is hard to come by, they seem to be doing well.

This may be because in cars joint ventures have been run more as private companies and less as state-owned entities, when compared with other industries. An explanation, says Mr Dunne, lies in the incentives of the two sides. The senior Chinese representative, inevitably appointed by the government, is rarely a car person. He brings valuable political contacts and is likely to move back to a political job eventually. Meanwhile he has little interest in disrupting a venture that produces profits and jobs. Foreign carmakers are interested chiefly in the success of the company. The two sides' interests turn out to be aligned, or at least not in conflict.

These same incentives, says Mr Dunne, also explain why the efforts of the Chinese joint-venture partners to develop their own brands have yet to produce much success, despite their access to Western technology, vast resources and political pull. The careers of the Chinese partners are tied to the state, not the car market.

### **Private management, party influence**

The third group, largely in private hands, contains the most successful privatised companies: the half that ended up in the hands of their managers. According to the three academics, management buy-outs have done much better than behemoths, joint ventures or firms privatised through other methods (such as leases or sales to outsiders or employees). This probably has much to do with another finding: that the degree of government control declined most in this group of companies. In only 1% of these firms did the state have a shareholding of more than 20%, against a sample average of 19%. And in only 16% of them did the state have "strong control" of corporate decision-making, against 31% overall. The state has thus forgone ownership in an effort to achieve better results. It does, however, continue to exert influence, notably through party representatives.

Consider the state's involvement with the three Chinese car companies that have done most to build their brands: BYD, Chery and Geely. They are still under the state's wing, being thought to receive ample financial help from the provinces where they operate (though much the same could be said of many carmakers in the West). Their leaders surely would not last if the state disapproved of them. Yet they are not state-controlled, unlike the behemoths or the Chinese partners in joint ventures. The bosses are not political appointees but charismatic businessmen in pursuit of commercial goals.

There are similar ventures in other industries: ZTE and Huawei, two telecoms-equipment giants; Lenovo, a maker of PCs, in which the Chinese Academy of Sciences has a large minority stake; and TCL, an electronics firm. The number of companies in this group continues to swell, even if they are less well known than these. As a rule, they are in industries designated as "strategic"—notably anything to do with energy, be it wind, solar or stored—and can also be found in medical equipment, drugs and technology. Such companies benefit from protection against foreign encroachment, research-and-development subsidies, and subsidised purchases from state customers. Someone involved with a foreign health-care company says that buyers connected with the Chinese state demand such generous terms—with payment delayed for up to a year—that only domestic providers, backed by accommodating credit from state banks, can bid for orders.



The fostering of successful private companies becomes particularly attractive in markets in which state entities have plainly been found wanting. The clearest example is the internet, in which China's state-controlled news providers and broadcasters have the resources and content to succeed but have failed to create much of a buzz. From private internet companies, which were never state-owned, the buzz is deafening. Their managers have often trained abroad. Competition is rampant—although foreign companies face impediments—and quick wits are essential for success. Employees often receive a significant amount of compensation in that most Western of forms: shares or share options. Many of these companies, because of their listings in overseas markets, or backing from foreign investors, could technically be considered foreign, a cause of some scathing criticism in China.



Yet even these companies depend on the good graces of the state. The Western firms that some of them imitated find obstacles in their way in China. Baidu, China's leading internet-search company, profited hugely in the past from being a conduit for pirated Western entertainment. Alibaba, a facilitator of e-commerce, has used Chinese ownership laws to take a large slice of Yahoo!'s valuable stake in its electronic-payment company, Alipay. Relations with officialdom are not always smooth. Beijing's Communist Party chief recently warned Sina, a social-media firm, that it was too slow to delete remarks that displeased the party. And recent programmes on CCTV, the state broadcaster, have criticised Baidu's business methods.

### Back to the cities

The success of this third group of companies has encouraged the development of the fourth. Officials in cities and provinces have created hundreds of municipally backed funds to invest in promising ventures. According to Z-Ben Advisors, a research and consulting firm, the biggest of these, CDB Capital, a private-equity fund established only in 2009, has raised 40 billion yuan (\$6.3 billion) and has a target of 60 billion yuan.

Some of these official investors have brought in foreign partners, including big private-equity firms such as Blackstone, Carlyle and TPG. Infinity Group, an Israeli venture-capital firm, has 12 funds, ten of which have direct ties to different Chinese cities. Its earliest effort, founded in 2004 with money from the Israeli and Chinese governments and private sources, has had much success creating companies combining Chinese manufacturing and Israeli technology.

In theory, making the state into a purely financial investor rather than an operating partner, as in Shunde and Zhucheng 19 years ago, should be beneficial: entrepreneurs, not bureaucrats, run the business. Practice is rarely so neat. Cities back companies that provide local jobs. That affects acquisitions and disposals, where factories are built and where research takes place. Worse, China's private-equity industry has become another lucrative billet for the children of powerful officials.

It is also troubling that little is disclosed about the operations and returns of these public funds. Many may be managed cleverly and provide money for municipalities and jobs for their citizens; others, though, may turn out to be financial black holes. Equally troubling, they receive favourable attention from local governments, to the disadvantage of China's most dynamic sector, its truly private companies.

Taken collectively, these iterations of state engagement reflect how China's government has not only held on to economic control but found subtle ways to extend it. At the very least, they constitute an important series of large-scale economic experiments with implications for China's economy and, because of China's size, the world's too. Some may see in this a path to follow. China has come far since the trials in Shunde and Zhucheng, but the state has always controlled the itinerary.

\* "What Makes Privatisation Work? Evidence from a Large-Scale Nationwide Survey of Chinese Firms".

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