China’s Mixed-ownership Enterprise Model: Can the State Let Go?

Sep 26, 2014 Business Radio Asia-Pacific
China
Management

China’s leaders want the country’s industrial economy to gain increased value and competitiveness with a “mixed ownership” model, where private investors and the state jointly own companies. However, those goals can be achieved only if the state also cedes substantial control of mixed ownership enterprises to private investors, according to new research co-authored by Marshall W. Meyer, Wharton emeritus professor of management.

Meyer and his co-author, Changqi Wu, a professor at the Guanghua School of Management, presented the findings of their research in a paper published last week titled, “Making Ownership Matter: Prospects for China’s Mixed Ownership Economy.” The paper was published by the Paulson Institute at the University of Chicago, a research center focused on furthering Sino-U.S. collaboration. Meyer discussed the key takeaways from that research on the Knowledge@Wharton show on Wharton Business Radio on SiriusXM channel 111. (Listen to the podcast at the top of this page.)
Meyer said that although China has been trying to expand the mixed ownership model for several years, the “latest impetus” comes from the third plenum of the central committee of China’s Communist Party in November 2013. At that meeting, party leaders called for rapid development of mixed ownership, defined as “… cross holding by, and mutual fusion between, state-owned capital, collective capital and non-public capital,” the paper’s authors noted.

Accordingly, the Chinese government wants more private investments in its 113 centrally owned state enterprises. Another 15 provinces and municipalities have also said that companies they own at the local level will be targets for mixed ownership programs. They are encouraged also by the success of privately owned Chinese companies such as Huawei and Lenovo, the paper noted.

Trials in a Halfway House

China’s mixed ownership model is not new, and is a hybrid outgrowth of the earlier model of the 1970s and 1980s where “almost everything of significance was state-owned,” said Meyer. In the economic reforms of later years, the Chinese government initially separated the state-owned enterprises (SOEs) from the government. In subsequent stages, it created a “halfway house” or a hybrid structure called a “legal person entity” that allowed the state to reduce its ownership but retain control of companies.

“When companies are state controlled, “they might as well be state owned.”

“To most observers, these will appear to be private companies, but they are state controlled entities — and when they are [state controlled] they might as well be state owned,” said Meyer. “It’s a waffle. It’s a compromise between outright privatization to which the conservatives in the party object very strongly and maintaining the present system, which isn’t working very well.”

Mixed ownership is seen as a solution for the financial problems facing many of China’s state-owned enterprises. Meyer traced those problems to China’s massive stimulus program launched in 2008 to escape the global economic downturn. In that stimulus program, its state-owned enterprises made huge investments in fixed assets like infrastructure and real estate. The returns on those investments have been disenchanting, and many state-owned enterprises are in deep debt, Meyer noted.

“All of this was done by state enterprises that had access to credit,” Meyer said. “Non-state-owned enterprises didn’t make such investments because they have to tap into the shadow banking system paying three, four or five times the interest rate that state-owned enterprises pay.”

Enthusiastic or Reluctant ‘Yes’?

Now, as the Chinese government seeks out private investors, the response it is getting is not exactly encouraging. Private investors worry that returns on their investments will not be attractive as the state will continue to control those companies, even if it does not own them fully in the mixed ownership model, said Meyer.

In their paper, the authors cite a survey that found that 90% of private business leaders felt they would have no influence as board members of mixed-ownership companies, and more than half said they had no plans to seek mixed-ownership partners. One survey respondent, the general manager of a Nanjing-based private electrical equipment manufacturer, noted: “Even if we participate, we have no controlling stakes. Who can safeguard our interests against powerful SOEs?”

“No matter how many shares are privately owned, the decision lies with the state.”
In fact, in a major highlight of the paper, its authors established the mismatch between the levels of ownership and control in China’s mixed ownership enterprises. “We had believed – following the work of many economists – that information on control is available only in the aggregate form, not on a firm by firm level,” said Meyer. “We then went through annual industrial surveys and went through the directions in Chinese – hundreds of pages – and low and behold, we came across a very simple item which says who’s the controlling shareholder [in each company].” These mixed ownership companies make up about 40% of China’s industrial economy, Meyer said.

Meyer takes the example of Alibaba, the Chinese company that stormed through the capital markets last week by raising a record $22 billion in its initial public offering. One of the questions Alibaba’s investors face is about control, because it has different classes of shares, and the company is controlled by a group of minority shareholders. “People buying [Alibaba] shares listed in the U.S. may not have control rights. The same thing happens in China with state-owned enterprises and state-controlled organizations,” says Meyer. “No matter how many shares are privately owned, the decision lies with the state Twitter.”

Private capital will help China’s mixed ownership enterprises reduce their debt, allow for transfer of technology and managerial expertise, and improve productivity, according to Meyer. However, bottom-line performance measured by returns on investment is not likely to improve much, he said. “That is because it is much harder to transfer the ethos of capitalism – the idea that you operate for your shareholders, rather than for the whole people. In some senses, the state gets what it wants – a little bit out of debt, more output, more GDP. The problem is the investors don’t get what they want.”

Put as bluntly as possible: the prospects for a mixed ownership economy will ultimately depend on the state’s willingness to cede control — not just ownership — of some of the nation’s largest enterprises to private interests,” the authors note in the paper.

Will China’s plans for the mixed ownership model take off, or are they doomed from the word go? Meyer said it helps that China’s president Xi Jinping is “a very powerful leader and any program that has his personal endorsement – and this does – is going to go forward.” All the same, he is not sure if the response from private investors will be an “enthusiastic yes” or a reluctant one.

Private capital will help China’s mixed ownership enterprises reduce their debt, allow for transfer of technology and managerial expertise, and improve productivity.

Delicate Balance Needed

Meyer noted that one big worry in revamping China’s public sector enterprises is the prospect of job losses. “A really delicate balance has to be struck between encouraging private investment where it is needed – and not simply opportunistic private investment that goes for the best assets but cherry picking – and putting that investment where it will do some good.” He suggested that the Chinese government could find opportunities to marry good business sense with social good and ease control “to allow private investors a little more elbow room in shaping the direction of an enterprise.”

Meyer added that an emphasis should be placed on improving the workforce. “What I would have done is take some of the money – otherwise put into plant and equipment – and put it in upgrading the labor force – into human capital rather than physical capital,” he said.

All said, there is no time to lose, Meyer warned. “If you look at the rates of growth, everything is … trending downhill inexorably, especially the profitably of the large state-owned enterprises,” he said. “Something has got to be done; otherwise, it is a further drag on the economy. The question is [whether to] swallow the pill now or swallow a bigger pill later.”