CHAPTER 3
CLASSIFICATION OF STATE-SHARE HOLDERS

As a socialist country trying to develop a market economy, China has attempted to improve the governance of Chinese companies since the launch of economic reform in 1978 (see Broadman (1995) for a history of China’s SOE reforms). During the reform process, Chinese government still holds a large portion of state-owned shares in listed companies. Sun and Tong (2003) argue that the ideology of public (or state) ownership leads Chinese government to retain a substantial portion of the ownership of listed companies. Simon (1996) provides four additional reasons for Chinese government to reject the type of large-scale privatization implemented in Eastern Europe and retain a large portion of state ownership. First, mass privatization would likely produce an undesirable concentration of capital in private (especially foreign) hands. Second, state assets are vulnerable to expropriation by bureaucrats handling the sales because of the difficulties in valuation. Third, the capital markets are not efficient enough to facilitate large-scale privatization. Insiders and speculators would benefit at the expense of ordinary citizens who are less informed. Fourth, China lacks a developed system of tax collection and the social conventions that support it.

Given the large state ownership, how it affects governance and performance of listed companies becomes the focus of a growing stream of research. But so far the results are inclusive. Xu and Wang (1999) find that state-share holders are less efficient relative to legal persons (or institutions). Sun and Tong (2003) show weak negative relationship between state-owned shares and firm performance. On the other hand, Tian (2001) demonstrates that the government gives both a “grabbing
hand” and a “helping hand” and state ownership is not entirely inefficient. He finds that the relationship between firm performance and state ownership is U-shaped, i.e., firm performance decreases with an increase of state shareholding when the state is a small shareholder and increases with an increase of state shareholding when the state shareholding is sufficiently large.

3.1. The Chinese government share classification

A typical listed company in China has a mixed ownership structure, with three predominant groups of shareholders - the state, legal persons (institutions), and individuals - each holding approximately 30% of the stock (Xu and Wang (1999), Sun and Tong (2003)).

State-owned shares (guoyou gu)

State-owned shares are the shares obtained by an entity representing the central government. The state-owned shares cannot be traded on the stock exchanges but could be transferred to other institutions subject to approval by the “authorized organization” (mainly the Ministry of Finance) in accordance with laws and regulations. The entity can be the central government, a local government unit (such as Shanghai Bureau of Finance) or a SOE. State-owned shares can be transferred to non-governmental institutions to become legal person shares.

Depending on the origin of the state assets, state-owned shares (guoyou gu) can be classified into two types: state shares (guojia gu) and state-owned legal person shares.

7 On November 4, 2002, a notice regarding transfer to foreign investors of state-owned shares and legal person shares of listed companies was promulgated by the China Securities Regulatory Commission (CSRC), the Ministry of Finance (MOF) and the State Economic and Trade Commission (SETC), and approved by the State Council of the People’s Republic of China (see the online news from People’s Daily at http://english.peopledaily.com.cn/200211/04/eng20021104_106224.shtml). Before that, state-owned shares and legal person shares can only be transferred to domestic institutions.
shares (*guoyou faren gu*). The management of these two types of state-owned shares is subject to a regulation, *The Regulation for State-owned Shares in Stock Corporations*, promulgated by State Assets Management Bureau (SAMB) and State Reform Commission for Economic Restructuring on November 3, 1994. The Article 8 of this regulation is presented in Appendix B.

According to Article 8 of the regulation, state-owned shares should include: (1) the shares converted from the net assets of SOEs which have been transformed into joint stock companies; (2) shares initially issued by companies and purchased by the governmental departments investing on behalf of the state; (3) shares initially issued by companies and purchased by the investment companies, assets management companies, and economic entity companies authorized to make investment on behalf of the state.

*Legal person shares (faren gu)*

Another important type of shares in China’s listed companies is legal person shares held by legal persons. The legal person shares are shares owned by domestic institutions with a legal personal status. A legal person in China is defined as a non-individual legal entity. There are four types of owners of legal personal shares: state-owned or state-controlled legal persons (such as a SOE), collective enterprise legal persons (such as a town and village enterprise), private enterprise legal persons (such as a private company), and institutional legal persons (such as security firms, mutual funds, etc.). Legal person shares are not tradable at the stock exchanges, but can be transferred to other institutions upon approval.
3.2. The nature of state-share holders

However, the state-owned/legal-person share distinction is more in form than in substance. Legal persons that hold shares can be state-owned and state-controlled, so many legal person shares are indistinguishable from state-owned shares. By the same token, some shares officially classified as state-owned shares are in fact held by some corporate groups that are controlled by a government agency (see Appendix A). They are legal persons technically but are defined by regulation as state-share holders because they are directly controlled by government. In summary, the official shareholder classification fails to distinguish the nature of shareholder. State-owned shares may be held by either government agencies that have no market interests or legal persons who are more market-oriented. The incentives of government agencies and legal persons are vastly different. Thus, any study based on such official shareholder classification should be interpreted with caution. Unfortunately, none of the previous studies have mentioned this shareholder classification issue. For example, Xu and Wang (1999), Qi, Wu, and Zhang (2000), Chen (2001), Tian (2001), Sun, Tong, and Tong (2002), and Sun and Tong (2003) all depend on the official classification. Therefore, their inconsistent empirical findings on the relationship between state shareholding and firm performance may be caused by the ambiguous official shareholder classification. In this thesis, I re-classify the state-owned shares for China’ listed companies based on the degree of governmental intervention.

8 The principles governing the classification of shares as legal person shares or state-owned shares are neither clear nor uniform because of the ambiguous property rights in China. Here are two anecdotal examples. Shanghai Securities News (SSN (2001a)) reports that a listed company, Yong Chenggong (Ninbo Success Information Industry Co., Ltd.), proposes to release portion of its state-owned shares which actually has been classified as legal person shares in its 2000 annual report. Management of Yong Chenggong argues that this portion of shares originally belong to the state in responding to the question “where do the state-owned shares come from”. Another example is that the state-owned legal person shares are counted as state-owned shares by the SAMB but as legal person shares by the CSRC (Lin (2001)).
3.3. Further classification of state-share holders

The difficulties in classifying China’s state shares discussed above are due to the complicated types of state-share holders. This is the result of the China’s insistence on reforming its economy into a market-based one with “Chinese characteristics”. There are numerous studies that summarize the history of China’s SOE reforms and discuss the state’s role as SOE shareholder (see, e.g., Broadman (1995), World Bank (1996), World Bank (1997), and Broadman (2001)). As argued in Broadman (2001), a centerpiece of these reforms has been decentralization of governmental authority over SOEs, with all but about 3,000 SOEs placed under the supervision of local governments rather than under the central authorities in Beijing. At the same time, large-scale national enterprise groups or holding companies (such as the national industrial companies) are established to manage state assets directly. Experiments have also been undertaken to establish a multi-tiered organizational network of state assets management bureaus, state assets operating companies and state assets supervisory committees.

Appendix A depicts the overall structure of China’s state assets management system. From the figure in Appendix A, state-share holders can be divided into two groups: one is comprised of GA shareholders who are government agencies (or institutions transformed from former government agencies) including central government ministries and commissions, national industry groups, local government bureaus, local state assets management bureaus, and local state assets management companies; the other group is comprised of corporate state-share holders who are non-government agencies such as SOEs or other types of market-oriented economic entities.
These GAs directly act as state-share holders in China’s listed companies through two means. One is that GAs act as state-share holders of a listed company which has been wholly restructured from a SOE. The other is that GAs invest state-owned assets in listed companies directly. Thus, there emerged two main types of state-share holders for China’s listed companies: GA shareholders and corporate state-share holders. Recently, there emerges a trend that GAs want to transfer their shareholdings to corporate entities and exit from listed companies (Shanghai Securities News (2001b), SSN hereafter). The main reason reported is that GAs desire to reduce governmental direct or indirect interference and increase listed companies’ competition power after China’s entry into WTO. In fact, these two types of shareholders differ in the degree of governmental interference, which has been blamed as one source of the inefficiency of state shareholdings. GA shareholders have a higher degree of political interference because they are purely government agencies. Corporate state-share holders should have a lower degree of government intervention because they have much more autonomy (Groves et al. (1994)). Thus, corporate state-share holders act more like private owners than GA shareholders and may play better governance roles.

9 Different governmental interference brings different incentives between GA and corporate state-share holders. I will elaborate the detailed difference in incentives between them in the hypothesis development section.

10 There is a debate over the impact of Chinese SOE reform (introducing business autonomy) on total factor productivity (TFP): Groves et al. (1994), Groves et al. (1995), and Jefferson, Rawski, and Zheng (1996) report a positive TFP growth; Woo et al. (1994) and Huang and Meng (1997) report a non-positive TFP growth. From a corporate governance perspective, Zhang (2000) argues that Chinese state enterprise reform has been relatively successful in solving the short-term managerial incentive problem but has failed to solve the long-term managerial incentive problem and the management selection problem.
3.4. Identity of GA shareholders and corporate state-share holders

The identity of state-share holders was identified from Genius, a commercial database covering China’s listed companies. The database provides detailed information on the top ten shareholders in China’s listed companies, including the name, number and percentage of shares held by each top shareholder. Each of the top shareholders is identified to see whether it is a GA shareholder or not. As demonstrated in Appendix A, five types of state-share holders are classified as GA shareholders. They are explained in detail below:

1. *Central government ministries and commissions.* This type of state-share holder is rare because most central government ministries or commissions have been restructured into national industrial companies. But some still exist. For example, the Ministry of Water Resources is the second largest shareholder in Chongqing Three Gorges Water Conservancy and Electric Power Corporation. Some other line ministries or commissions are also found for some listed companies, such as the Ministry of Agriculture and the Administrative Bureau of Sports.

2. *National industrial companies.* These companies were set up by the central government to develop some industries or were restructured from former government industry management institutions. There are eight national industrial companies: nonferrous metal industry, electronic industry, north industrial group (enginery production), automobile industry, petrochemical industry, coal industry, petroleum industry, and shipping industry. In virtually all cases, they retain governmental as well as business ownership functions (Broadman (2001)). In fact, there is only a name change and many

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11 I would like to thank Shenyin & Wanguo Securities Research Institute Co., Ltd. at Shanghai for allowing the use of this database when I visited this company in the summer 2001.
of the underlying SOEs see little difference between the old industrial bureaus and the new structures. Thus they are still treated as GA shareholders in my classification.

3. *Local government bureaus.* Provincial bureaus of finance are very typical state-share holders of many of China’s listed companies. For example, the Shanghai Bureau of Finance holds two listed companies: Shanghai Pudong Development Bank and Shanghai Jinqiao Export Processing Zone Development Corporation. This category also covers some local governments such as Yunnan provincial government and Wuhan municipal government.

4. *Local state assets management bureaus.* To protect state assets from expropriation during economic transition, China’s government set up the National State Assets Management Bureau (under the Ministry of Finance) in 1988 to administrate all the state-owned assets, including state-owned shares in listed companies. Under the national organization, there are local chapters of state assets management bureaus acting as state-share holders in many listed companies.

5. *Local state assets operating companies.* In order to separate the government from the operation of state assets, many local governments set up special investment companies to manage state-owned assets. To some extent, state assets operating companies act more like entrepreneurs than government agencies but are still under the full control of local government and thus are considered as GA shareholders.

The above five types of state-share holders are defined as GA shareholders. The state-owned shares held by corporate holders is the difference between total
state-owned shares from the Taiwan Economic Journal database (TEJ) and the state-owned shares held by GAs identified above. Appendix C presents the data sources used in this thesis. Table 1 contains statistics on the state-owned shares from 1993 through 2000. It is seen that the government still directly holds over 30% of shares in listed companies. However, the percentage of state-owned shares held by GAs is decreasing and that of corporate state-share holders is increasing, which is consistent with China’s economic reform process; the government has been transferring state-owned shares to some operating entities gradually but maintaining control rights.12

[Insert Table 1 Here]

Highly concentrated ownership is more likely to occur in less developed countries (Shleifer and Vishny (1997), La Porta, Lopez-De-Silance, and Shleifer (1999)). Table 2 confirms their prediction and shows that the ownership of China’s listed companies from 1993 through 2000 is highly concentrated in the largest shareholder. It is shown that the largest shareholder holds more than 40% of total shares issued. It is also shown that there is a big gap between the shareholding of the largest shareholder and the second and third largest shareholder, e.g., in the recent year 2000, the average size of stakes of the second and third largest shareholder are only 8.24% and 3.17% respectively, compared with 44.13% for the largest shareholder. Table 2 also presents the summary statistics of shareholdings by top-3 shareholders for firms with GA shareholders and firms with corporate state-share holders. It is shown that the ownership is also highly concentrated in the largest shareholder. In this thesis, some multiple GA or corporate state-share holders of one

12 SSN (2001b) reports that there is a trend that government agencies transfer their state shares to corporate entities but the nature of shares is still state-owned.
listed company are regarded as a single entity. The highly concentrated ownership structure for China’s listed companies presented in Table 2 suggests that the bias from this treatment be trivial. In the following analysis, an ownership concentration ration is also used to control for the degree of ownership concentration.

[Insert Table 2 Here]