Selling Down the State Share: Contested Policy, New Rules

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Since the middle of 2001, the issue of reducing the government ownership stake in corporations listed on the Shanghai and Shenzhen Stock Exchanges has been high profile and highly contentious. This issue touches on many fundamental problems relating to the future of China's economic reforms, including the public ownership system, the development of capital markets, and the long-term social security of China's aging population. The twists and turns in Beijing's approach to this issue in recent months illuminates evolving decision-making processes and sheds light on the continuing role of Premier Zhu Rongji.

Policy on the issue of reducing the government ownership stake in enterprises listed on the stock exchanges has been in an obvious state of flux for more than a year. After six months of rumors, a modest program to reduce state share ownership was decreed by the State Council on June 12, 2001. The program was abruptly suspended on October 22nd. A new set of principles was promulgated on January 26, 2002, but it has not put an end to vigorous discussion and debate. As of March 2002, the program of state share reduction had not been reinstated, and the issues were far from settled.

This process of policy contestation and uncertain implementation was punctuated by a remarkable episode on November 13, 2001, when the stock market regulator--the China Securities Regulatory Commission (CSRC)--posted a notice on its official website, soliciting public suggestions.[1] Send us your proposals, said the posting, for the best means to implement the reduction of government ownership. The posting included an email address (jc@csrc.gov.cn) to facilitate public comment. And in fact, by early December, the CSRC had received over 4,100 suggestions and proposals. Working with four government research institutes, the CSRC then grouped these proposals into seven broad categories, and produced discussion drafts for scholarly and policy meetings in January and February 2002. These meetings then hammered out a provisional set of principles for further reform. These novel procedures provide some insight into the policy-making process in China.

Because of the importance of the issues involved, this analysis begins with a brief overview of the main economic issues. It then narrates the basic decision process, insofar as that is known to outsiders. It concludes with some inferences about what the decision process reveals about policy formulation and decision-making in China today. In a subsequent piece, we will return to examine some of the related political issues, and in particular what the example reveals about interest group politics in contemporary China.

Economic Issues: The Role of the Stock Markets

The handling of government-owned shares listed on the Chinese stock exchanges touches on many critical economic and political concerns, but the economic issues can be grouped into two basic questions. First, what role will China's stock markets play in the overall process of ownership reform? Second, how will China provide social security protection for its current retirees and for those workers who will retire in the future. Each of these fundamental questions has been in play throughout the recent policy discussions and decision process.

With respect to the first question, China has used the stock markets in Shanghai and Shenzhen to advance the process of ownership reform. At the end of 2001, there were 1,160 firms listed on the two exchanges, virtually all of them former state-owned enterprises (SOEs). Most of the largest state enterprises have already been listed on the exchanges. In order to list, firms had to convert to joint stock corporations, reform and upgrade their accounting systems, and increase the information available to outsiders. In addition, of course, the government had to share ownership rights with the new shareholders created by stock issuance. This has been a significant achievement, but there is also much less to it than might initially appear. In order to facilitate rapid listing, in almost all cases, the original government agency that listed an enterprise retained a majority of the equity in the firm. Moreover, these retained shares were not allowed to circulate. At the end of 2001, only 35 percent of shares were actually allowed to circulate on the market. Instead the original issuers hold the majority of shares (60 percent). These are held either as state-owned shares (46 percent of the total), or as so-called "legal person" shares, generally referring to a state-owned entity that maintains a stake (13 percent of the total).[2] Moreover, while the number of firms listed on the exchanges has grown rapidly, the proportion of shares that circulate has crept up very slowly.

Limiting the proportion of shares that circulate has a number of serious consequences. First, the stock market does not serve as a market for corporate control. With only a few exceptions, government ownership of listed companies is so large that private shareholders have no possibility of gaining control over a company by buying a majority (or controlling) block of shares. Thus, the market cannot really serve to discipline the management of existing firms, and the role the stock market plays in improving corporate governance is minimal. Stock market listings have not led to privatization, except for a tiny handful of firms. Second, the market is "thin"--meaning that the supply of desirable shares is quite limited--and their prices can be relatively easily manipulated. On average, Chinese shares are costly—the ratio of the share price to the current year's earnings per share (the P/E ratio) averaged 40 at the end of 2001, compared to about 25 for the US Standard and Poor 500 companies at the end of 2000. Thus, the stock markets have a long way to go to live up to the potential role they could play in increasing the market orientation and improving the efficiency of the Chinese economy.

Nearly everyone seriously concerned with advancing China's transition to a market economy believes that the proportion of shares that circulate should be increased. Indeed, China's leaders seem to share a general consensus that this is desirable, although they differ substantially about the speed with which it should occur. One of the main reasons for caution is that an increase in the number of shares available to circulate on the stock markets will almost certainly cause the price of currently circulating stocks to decline. In part, this is simple supply and demand—increased supply leads to lower price. But in addition, a decline might be anticipated because many market participants hold stocks today because they believe that the government—as majority stockholder—will implement policies that will keep the value of shares high. This applies to the market in general, but also to individual stocks that are perceived—rightly or wrongly—to have powerful patrons in the government apparatus. Thus, selling down the state ownership stake may signal a reduced willingness by the government to prop up the market. Investors appear to anticipate these effects: every time the government has even discussed reducing state shareholding, the value of stocks has declined. This has caused significant political repercussions.

Economic Issues: Strengthening the Social Security System

China has begun to create a social security system, but it is still far from adequate. Here a key issue is the difference between a "pay as you go" system (PAYG), and a funded pension system. In a PAYG system—like the U.S. Social Security system—today's workers pay taxes that go directly to pay the pensions of today's retirees. In a funded pension system, today's workers make contributions that are invested in various financial instruments and receive the value of their contributions when they retire. When China designed its social security system in 1993, it envisaged a mixed system, under which a PAYG system would be maintained but limited to a relatively small level of pensions, while at the same time current workers would begin to contribute to their own funded pension accounts. This system was roughly in line with international "best practice," as advocated by the World Bank and other agencies. In the late 1990s, implementing legislation was passed for this system, and implementation began at the provincial level.

In implementing this type of system, the most difficult problem is how to handle current workers who are near retirement age, who have already put in many years of work, but who have not had the opportunity to contribute to funded pension plans. In China in the mid-1990s, the decision was essentially deferred. All workers started contributing to individual funded accounts. In addition, a PAYG system was set up to generate substantial surpluses which could then be used to top off the pensions of older workers as they retired. In the meantime, the government hoped to be able gradually to direct catch-up funding into the accounts of older workers from pension fund surpluses and from other sources, to be designated later. In other words, part of the new pension system was designed to look like a funded pension system, but in reality it still functioned as a PAYG system.

This arrangement has been breaking down. In 1998, pension fund outlays surpassed pension fund revenues for the first time.[3] This means that not only were there no pension surpluses available to fill up the empty individual funded accounts of older workers, but in provinces with high proportions of retirees, the contributions that should have gone into funded accounts for younger workers were in fact being used to pay current pensions. The value of "empty" accounts that was supposed to be declining over time has instead been increasing.[4] How is the Chinese government to increase the funding available for pensions? An attractive option is to transfer the huge stock of assets still in government hands into the pension funds, either directly or indirectly. Transferring shares to pension fund managers—who would be concerned primarily with maximizing share value—might be able to reap many of the advantages of privatization without necessarily affronting socialist sensibilities. After all, did not the elderly workers play a key role in creating this wealth? Is it not compatible with socialist equity for this kind of transfer of ownership to support the sunset years of the vanguard of the working class? With this background in mind, we now turn to the discussion of the actual decision process with respect to state share reduction.

The Rise and Fall of the State Share Reduction Policy

The Chinese government has been paying increased attention to social security reform lately. According to some accounts, the higher priority for pension reform dates from labor unrest in Liaoning province in February 2000. Concerned about non-payment of wages and especially of pensions, some 20,000 workers and retirees took to the streets. Subsequently, at the leadership's summer 2000 meetings at the seaside resort Beidaihe, Liu Zhongli, the former finance minister, and head of the System Reform Office, was appointed to preside over a Social Security Commission together with Premier Zhu Rongji. Zhu tasked this new commission with designing a program for funding pension plans by reducing government stakes in listed companies. At the same time, Zhu, in accord with his own habitual practice, solicited alternative proposals from a number of other sources, including some foreign economists. By early 2001, Zhu was getting back the results of these requests. We do not know exactly what these proposals called for, but we do know that some of them, at least, envisaged very significant reforms. One of the proposals called for the transfer of two trillion *yuan* worth of state shares into the pension fund, which would be sufficient to fully fund a system of individual accounts.[5] This would have envisaged a one-time transfer of assets equal to 21 percent of GDP, restoring the pension fund to health and drawing down government claims on public enterprises at one step. At around the same time, a new national Social Security Fund (*Quanguo Shehui Baozhang Jijin*), with an unspecified mandate, was set up in Beijing. The fund was also headed by Liu Zhongli, who had headed the main study group and is widely regarded as one of China's most competent bureaucrats.

These bold plans were opposed by the Ministry of Labor and Social Security (MOLSS). MOLSS proposed a much more modest plan in which the state would use asset sales of some kind to plug the holes in the existing PAYG pension system. MOLSS estimated that this would require only 10-20 billion *yuan* per year. It was much less risky, they argued, to set up modest annual transfers than to try to reassign ownership of assets worth more than a hundred times as much. They might also have pointed out that the new Social Security Fund had just been established, and did not yet have the expertise to manage vast assets pools effectively.

We are not privy to the specific arguments made by MOLSS Minister Zhang Zhuoji and his lieutenants, but MOLSS has consistently opposed rapid movement toward funded pension schemes. Their arguments have both a public policy and a self-interest component. On the public policy side, MOLSS is, understandably, concerned about the workability of such a large-scale reform. After all, MOLSS bears primary responsibility for making sure that retirees get their pensions right now, and they face enormous difficulties managing shortfalls. If the new program fails because it is too complex or simply takes a long time to get up and running and de-bugged, MOLSS will be stuck with keeping things going in the meantime. It should be pointed out, however, that the arguments that MOLSS was making were also self-serving. Under the current PAYG system, MOLSS bears primary responsibility for transferring and managing funds among payers and recipients. If a national Social Security Fund were empowered with the ownership of trillions of *yuan* worth of assets, MOLSS would lose day-to-day control of very large financial flows, surely a prospect MOLSS is unlikely to welcome.

In early 2001, Zhu Rongji made the decision among competing plans, and he endorsed the approach of MOLSS. Having allowed MOLSS to set the framework and objectives of the pension rescue program, Zhu then solicited proposals from various parties to provide the funding by drawing down government shares in listed companies. The plan ultimately adopted was tabled by the Ministry of Finance, which proposed that all initial public offerings (IPOs) and new share issuances should set aside a block of state shares equal to 10% of the value of the offering. These shares would then be sold onto the market, with the proceeds going to the Social Security Fund. By design, the total value of the additional shares sold onto the market would equal 10-20 billion *yuan* annually. Note that in the version of state share reduction implemented by Zhu, some state shares are sold, but none are transferred to the Social Security Fund.

The State Council issued the implementing regulation on June 14, 2001.[6] As soon as rumors of the proposal began to circulate, the stock market reacted. Through mid-2001, the Chinese stock market had been one of the best performing in the world, bucking the world bear market that started in 2000. B-shares (reserved for foreigners) soared on expectations that A and B-share markets would be consolidated. A-shares rose more moderately, but still strongly, with the Shanghai index surpassing 2200 in June, comfortably surpassing historic highs. With the new regulations, the market went into reverse. Even though very few state shares were actually sold, market psychology changed dramatically. The market continued to slide through October. Ironically, the few private firms on the market felt the impact as much as did the state firms directly affected.[7] By October the Shanghai index had drifted down toward 1600, a decline of over a quarter, representing a loss of 400 billion *yuan* of market value (counting circulating shares only).[8] Tensions mounted.

What happened next is described in a brief account in the *Hong Kong Economic Daily*.[9] On October 10 and 11th, the market went into a renewed slump, and Premier Zhu Rongji expressed concern. On the morning of Friday, October 12, he ordered the CSRC, the Ministry of Finance, the State Planning Commission, and the People's Bank to send him market stabilization proposals by that evening. The next day Zhu met with advisers to go over the reports, but was unable to settle on a plan. Meanwhile, according to this account, representatives of more than twenty securities companies had gathered secretly, and—presumably because they knew that Zhu was wavering on the state share sales plan—decided to dump shares in a concerted effort to force the market down. The securities firms were wagering that by manipulating the market, even though they would face steep short-term losses on their portfolios, they would be able to force the central government to abandon the program of selling down state shares. In fact, the market plunged. Prices dropped daily throughout the next week, and by the following Monday, October 22, signs were emerging of panic selling by shareholders and possible payments difficulties by securities firms. Shareholders used web postings and suicide threats to pressure the government. At 5 p.m., the CSRC convened an emergency meeting—presumably called by Zhu Rongji—and forwarded a report to the premier's office. At this point, Zhu pulled the plug. At 9 p.m., a notice went up on the CSRC website, suspending the program.

The CSRC notice, dated October 23, defended the principle of state share reduction, but it also acknowledged problems of implementation and stressed the fact that the program had been experimental.[10] The market promptly stabilized. Market analysts gave CSRC high marks for quickly correcting a problem, but criticism of the policy itself was quite pointed.[11] In the wake of this decision, the CSRC posted the request for public input on new policies described at the beginning of this piece. The posting had a number of effects. First, it signaled that the regulators maintained their commitment to the basic idea of state share reduction, while abandoning their attachment to the particular approach adopted between June and October.[12] Second, it attempted to maintain a generally transparent decision-making environment, minimizing the market shock from sudden, unanticipated policy shifts. In that sense, the regulator was beginning to behave more like the U.S. Federal Reserve Board, where the chairman has to be extremely careful in his statements to avoid moving the market too much. Third, by soliciting input, CSRC could get input from market participants, perhaps get some workable ideas, and move toward a more open form of policy discussion and formulation.

Suggestions poured in. The more detailed and fully formulated proposals came primarily from economists with investment banks and equity funds. The proposals were collected into seven general categories, and a discussion meeting was convened by the State Council Development Research Center on January 11, 2002. At that meeting, economists from eight investment and securities research companies presented proposals, along with economists and officials from all the relevant government agencies. Ten days later, a follow-up meeting was convened to hammer out a discussion draft, based on the policy type that had generated the most support. This particular approach advocated giving existing holders of circulating shares the right to buy a given number of previously non-circulating state shares of the same company. In this system, the price for the government shares newly released to circulate would be available at below the existing market price, indemnifying existing shareholders against the losses from the decline in the price of their existing holdings due to the increased supply. This provisional draft was posted on the CSRC website on January 26, 2002.[13]

Along with the provisional proposals, a set of general principles was posted as well. Chen Qingtai, deputy director of the Development Research Center, wrote that State share reduction could and should be a win-win proposition. In particular, the interest of existing shareholders, based on the current share price created by the existing (distorted) system, should be protected. State share reduction should be beneficial to the orderly development of China's equity markets. In addition, Chen argued that future IPOs should no longer include any non-circulating shares. Thus, the stock of non-circulating shares would no longer increase, and, as the overall size of the market increased, it would tend to grow out of the historical liability of non-circulating shares. Policies to sell down existing non-circulating shares could then be adopted gradually and in a flexible fashion, allowing the interests of all concerned to be protected. This paper was posted as an expression of consensus opinion at the meeting.[14]

Despite the caution—and the obvious effort to reconcile state share reduction with the interests of existing shareholders—the market chose to interpret the announcements as a sign that the government was soon going to resume the sell-off of state shares. The market went into a renewed nosedive, forcing the CSRC to issue a clarification. Unlike many "clarifications" in China, this really was a clarification and not a modification of policy: it reiterated the principles of respecting the interests of existing shareholders, and it emphasized that the provisional draft was posted to gather further comment and suggestions and that no final decision had been made. CSRC Chairman Zhou Xiaochuan made a speech the next day stressing that future state share sales would occur "only when market stability and the rights of investors are protected."[15] The market seemed to accept this reassurance, interpreting it as a sign that further state sales had been indefinitely postponed. Of course, it is never possible to say for sure exactly what drives market movements, but, for whatever reason, the market stabilized after this clarification. Having declined to 1339 at its lowest, the Shanghai index recovered to around 1500 and has remained at that level through February 2002.

Lessons for the Chinese Policy-Making Process

What do these remarkable events tell us about policy-making in China today? A number of initial observations emerge:

- First, all of the key decisions are still being made personally by Zhu Rongji. It was Zhu who structured the process of soliciting policy advice; Zhu made the decisions about which share reduction program to adopt; and it was Zhu who pulled the plug on the program in October 2001.

- Second, the process of discussion and policy debate seems to have reached a new stage of openness. It has already been observed that, under Zhu Rongji, policy advice had been routinely sought from several competing research institutes. However, these have traditionally been government institutes, and the process of advice and consultation has taken place primarily behind closed doors.[16] In the case of state share reduction, the process of discussion became strikingly more open. Proposals were solicited from the public, although the subsequent discussion was hosted by a government research institute and attended by invitation only.

- Third, interest groups--relatively independent from the government policy-making apparatus--were considered to be legitimate participants in the decision-making process. The securities firms that participated in the January meetings have direct stakes in the outcome of that process. The securities firms are not private firms—they were all set up with government money and remain government owned. But at least in some cases, they reflect the interests of powerful groups of shareholders. Ironically, the one private firm present--Tianxiang Investment Consulting--does not have trading rights and so was less likely to represent the interests of a specific group. The securities firms tabled detailed proposals. Indeed, one of them actually wrote the provisional draft posted on the CSRC website on January 26, 2002.

- Fourth, the discussion process is more open, but the actual determination of policy remains highly centralized and indeed authoritarian. Since we do not know which factors Zhu Rongji ultimately considers the most important, we cannot really say that the decision-making process is more open or transparent.

- Finally, the popular wisdom has been that major reforms are unlikely before the autumn 2002 transfer of power to a new generation of Communist Party leaders. The story of state share reduction provides only partial support for that view. On the one hand, the truly radical reform proposals were discarded, and even the more modest proposals are now on hold. But bold reforms have been proposed in the context of a broad, if vague, consensus that the state ought to reduce its role as direct owner of company equity. The process of discussion and consultation is very much alive. Whether the leadership can muddle through to a new proposal remains to be seen.

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[1] "Zhongguo zhengjianhui guihua fazhan weiyuanhui gongkai zhengji guoyougu jianchi fang'an [The Planning and Development Commission of the CSRC Publicly Solicits Proposals on Reducing State Share Holding]", November 13, 2001, at www.csrc.gov.cn. All of the key documents for these policies are accessible on the CSRC website. The documents, along with many descriptive and analytical articles, are also available at the China Securities Network, an extraordinarily rich and well-designed website run by *Shanghai Zhengquanbao*. See www.cnstock.com/tebebaodao/gyg/default/htm,

[2] Legal person shares can sometimes be transferred by private placement or auction. Legal person shares transferred from the original sponsors account for almost 5 percent of total shares. Workers in the listed firms also hold 0.5 percent of total shares, and these do not circulate either.

[3] Song Xiaowu, "Woguo shehui baozhan zhidu mianlin de yanjun xingshi [The serious situation faced by our social protection system]," *Jingji yu guanli yanjiu* [Economic and Management Studies], 2001 no.3: 4.

[4] There are a number of reasons that the pension system is in deficit. Many laid-off workers have taken "early retirement," shifting a huge burden onto the retirement system. In some cases, funds have disappeared due to official corruption and speculative investments.

[5] Wu Jinglian, "An alternate proposal to reduce state-owned shares," *Caijing* [Finance], January 21, 2002. English version from China Online.

[6] Guowuyuan fabu, "Jianchi guoyugu chouji shehui baozhang zijin guanli zhanxing banfa," 2001-06-14 at www.cnstock.com/tbebaodao/gyg/xwzl/200106140507.htm

[7] Mark O'Neill, "'Black' Week Sell-off Zaps China's Richest," *South China Morning Post*, August 6, 2001 [Internet edition.]

[8] Data on index levels and market capitalization from www.csrc.gov.cn/CSRCSite/tongjiku

[9] "Zhuzong jiwan paiban, jiushi wenshehui" [Premier Zhu makes a decision late at night, Bailing Out the Market and Stabilizing Society] *Xianggang Jingji Ribao* [Hong Kong Economic Daily], October 24, 2001, p. A3. This paper is considered to be a reasonably reliable, middle-of-the-road paper. The specific details of this account cannot be independently verified, but the general account has been supported.

[10] CSRC, "Zhongguo zhengjianhui guanyu guoyougu jianchi xinwengao" [News Release by CSRC on State Share Reduction Program], October 23, 2001, at www.csrc.gov.cn; Mark O'Neill, "China Ban Lifts Markets: Beijing Pulls Plug on Sales of State Holdings in Listed Firms, Easing Fears of Heavy Dilution," *South China Morning Post*, October 24, 2001 [Internet edition]

[11] "Sida jijin jingli kandai zhanting guoyougu jianchi" [Managers of Four Big Funds React to the Suspension of State Share Reduction], *Beijing Chenbao*, October 29, 2001, and "Jiaoting guogyougu jianchi: 1.7 wanyiyuan shizhi huanlai jiucuo jizhi" [Suspending State Share Reduction: Exchanging 1.7 Trillion Market Value to Correct a Mechanism], *Zhongguo Qingnianbao* [China Youth Daily], October 24, 2001, both at www.cnstock.com/tebebaodao/gyg/xwdt

[12] Of course, the June to October proposal had not been designed by CSRC in the first place, so it did not have any ownership of the specific proposal.

[13] Details are included in the document and appendices "Guoyougu jianchi fang'an jieduanxing chengguo [An Intermediate Result on Policies for Reducing State Shares]" January 26, 2002, at www.csrc.gov.cn.

[14] *Ibid*.

[15] "China Shares Crumple as State Share Sales Weigh," *South China Morning Post*, January 28, 2002 [Internet edition]; "Zhongguo zhengjianhui guihuawei guanyu guoyougu jianzhi fang'an de shuoming" [CSRC Planning Committee Clarification on Plan for Reduction of State Shares], January 29, 20002, at www.cnstock.com/tebebaodao/gyg/xwdt/200201290744.htm; Xinhua, "Domestic Stocks Show Signs of Recovery after Month-long Slide," February 1, 2002, at moftec.gov.cn.

[16] Barry Naughton, "Economic Think Tanks in China: Their Role in the 1990s," forthcoming in *The China Quarterly*, No. 171 (September 2002).