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Hybrid Enterprises in a Hybrid Economy

By Victor Z. Chen

Asia Pacific Foundation of Canada

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Executive Summary: A large number of multinational enterprises have formed equity joint ventures with a Chinese government agent or a Chinese state-owned enterprise as their entry strategy into the dynamic Chinese market. These state-private equity joint ventures, which are usually called hybrid enterprises, are widely believed to be the best business model in countries like China, where the economy is hybrid, too, with an extensively liberalized market economy operating within an autocratic political and legal system. So far, these hybrid enterprises, which meld government support with private sector efficiency, have generally outperformed wholly state-owned or wholly private counterparts. However, the pressures on Beijing to maintain economic performance -- rather than any concerns for greater political freedom -- will likely lead to progressive liberalization of China's legal system and greater openness in decision making. As this occurs, the advantages of the hybrid business model will inevitably fade.

Introduction

Forming an equity joint venture with a Chinese government agency or a Chinese state-owned enterprise (SOE) is the popular entry mode for multinational enterprises (MNEs) wanting a foothold in the dynamic Chinese market. While wholly foreign-owned investments in some industries are still restricted in China, the most important reason for opting for a joint venture is because Chinese governments still maintain an influential role in commercial activities even after 30 years of economic reform. Some Canadian companies have taken that route into the market: Nortel formed Guangdong-Nortel Ltd. in 1995 with Guangdong Communications Services, a former provincial ministry, and China Netcom, a central SOE; Bombardier formed Bombardier Sifang Transportation Ltd. in 1998 with Sifang Locomotive & Rolling Stock Ltd., a subsidiary of state-owned China South Locomotive & Rolling Corporation; Manulife formed Manulife-Sinochem in 1996 with FORTIC, a subsidiary of state-owned Sinochem; Sunlife formed Sunlife-Everbright in 2002 with China Everbright, a state-owned bank; currently, Scotia Bank is entering a funding management joint venture with Bank of Beijing, a commercial bank partially owned by the Beijing local government. Consequently, it is important for Canadian investors who have entered or are going to enter this complex market, to understand such state-private equity joint ventures in the economic and institutional context of China, and to be aware of changes that could eventually undermine their strategy.

State-private equity joint ventures are usually called hybrid enterprises or mixed enterprises as they mix government and private ownership. Many believe that hybrid enterprises may be an optimal form of business organization in countries like China, where the economy, too, is hybrid -- markets are extensively liberalized while political and legal systems remain autocratic. The government in such an economy, which plays dual roles as an authority and a player in commercial activities, may exclusively provide numerous necessary resources, such as policy support, capital and access to networks. Consequently it is usually believed, and also widely found that such enterprises are superior to their wholly state-owned or wholly privately-owned counterparts as they combine government support and private efficiency together. Is that always true? The answer is yes and no. To understand this complex question, we should look at the origin and most likely path of development of China's hybrid economy and hybrid enterprises, and see how they perform over time.

Early Stage: Market Reform

Hybrid enterprises arose from the collapse of economic centralization in China in 1978, when then-paramount leader Deng Xiaoping started long-term economic reform away from Maoism and the Soviet-style planned economic system. Deng's reform was a hybrid process, balancing political pressure from the Communist Party of China and the economic goals of the 'Four Modernizations'.[1] A popular joke of the time described China's situation facing the changes of the 1980s, like facing an intersection in the road: *'US President Bush invited Deng and Russian President Yeltsin to visit Washington. When their cars moved to a crossing, Bush's driver turned right on the right light, so Yeltsin's driver also turned right on the light, and followed Bush. Deng's driver, who was used to Mao's 'turn on left light and turn left' policy, asked Deng if they should follow. Deng replied, 'turn on the left light, but turn right'.'* In fact, Deng introduced competition and privatization into the market while maintaining an autocratic political system, which was officially termed "the socialist market economy" by the Communist Party of China.

Before 1980, the 'household big three' (s*an da jian*), a slang term to describe the most desired, but hard to get, household appliances for an average Chinese household, were watches, bicycles and sewing machines. Interestingly, the problem was not that there were any technical difficulties in producing those appliances, which were in short supply, but that a planned economic system 'wasted' too much investment on heavy industries, and was not able to produce what consumers most demanded. Fortunately, the planned economy was soon replaced by Deng's economic 'reform and opening up,' which was officially announced in December 1978 at the Third Plenum of the 11th Central Committee. A newly freed market attracted an enormous number of surplus workers into household or other forms of private businesses. The market expanded massively from 1979 to 1992: the number of planned commodities was reduced from 256 categories to 19 categories; industrial production subject to planning declined from 95% to less than 10%; market pricing replaced administered pricing for 90% of retail products, 80% of agriculture products, and 70% of resource products. The effect of the market was soon noticeable – the 'household big three' were soon replaced by televisions, washing machines and refrigerators.

Deng Xiaoping, regarded as chief architect of China's economic reform and opening-up. *(Picture Source: Xinhua Net.)*

[1] The goal of modernizations of agriculture, industry, technology and defence was introduced by Zhou Enlai in 1975 at the Fourth National People's Congress in one of his last public acts. After his death and Mao's soon thereafter, Deng Xiaoping assumed control of the party in late 1978. In December 1978 at the Third Plenum of the 11th Central Committee, Deng Xiaoping announced the official launch of the Four Modernizations, formally marking the beginning of the reform era.

Notwithstanding a quick introduction of competition and privatization, Deng adopted gradualist reform instead of the shock therapy widely applied with controversial outcomes in Eastern Europe and the former Soviet Union. For instance, the Chinese government did not apply privatization at once to government-owned enterprises, which then accounted for over 85% of the total employment.[2] Rather, until the late 1980s, private businesses were only allowed in areas of surplus labour, i.e., those who were not employed, with the State remaining an autocratic authority in economic control and decision making. The State's strategy for SOEs from 1978 to 1992 was to clarify the relationship between property rights and control by separating ownership from management. The government, as the property right owner of the enterprises, shared in the profits while giving independence to the managers. In this way the leadership aimed to reduce the government's direct interference, and made SOEs more independent from politics, to make their own decisions according to the market. However, the financial outcome was not quite as the government had hoped. First, with its property rights and full ownership, the government was able to impose socio-political objectives on SOEs in such areas as employment, production levels, sales or policy loans. Second, without property rights and a share of the profits, SOE managers, who served as the government's agents, had no incentives to maximize profits; instead, those managers, who were politicians, tended to transfer resources out of the enterprises for the benefit of themselves and their supporters. Third, lacking an efficient financial market, SOEs relied almost fully on capital injection from the government and state-owned banks, which caused a huge build-up of non-performing loans (NPLs) in the banking system.

Expansion Stage: Enterprise Reform

Since 1993, the *separation* strategy was replaced by a strategy of *privatization of SOEs*, which was officially announced and termed *corporatization reform of SOEs*, to avoid the politically sensitive phrase 'privatization,' in November 1993 at the Third Plenum of the 14th Central Committee. The new strategy involved enterprise reform by building a modern financial market and massive privatization of SOEs.

Modernization of corporate governance began with the corporatization of enterprises. Establishment of Shanghai Stock Exchange on December 19, 1990, and Shenzhen Stock Exchange on July 3, 1991 marked the beginning of practical corporatization in China. Further in 1992, foreign strategic investors were allowed to invest in those markets, with some restrictions. Modernization strategy also included the restructuring of the banking system. In 1994, all policy-based, not-for-profit businesses were transferred from the big-four commercial banks, which were all fully state-owned, to three newly-established state-owned policy banks.[3] Meanwhile, tens of local commercial banks were established collectively by the State, local governments and local private companies. As of 1996, the modernized banking system covered all medium-sized and large cities across China. The process was accelerated in 1999, when the Ministry of Finance established four special asset management corporations[4] to further strip off almost all NPLs from the big-four commercial banks. In this way the former state-owned banks were no longer specially protected under the State's fiscal umbrella. Establishment of a modernized financial market enabled the following massive privatization of SOEs under the slogan 'seize the

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[2] See Jeffrey Sachs (2005) *The end of poverty: Economic possibilities for our time (pp.160)*. The Penguin Press: New York.

[3] Big four commercial banks: Bank of China, China Construction Bank, Agricultural Bank of China and Industrial and Commercial Bank of China. Three policy banks: Agricultural Development Bank, China Development Bank and Export-Import Bank of China.

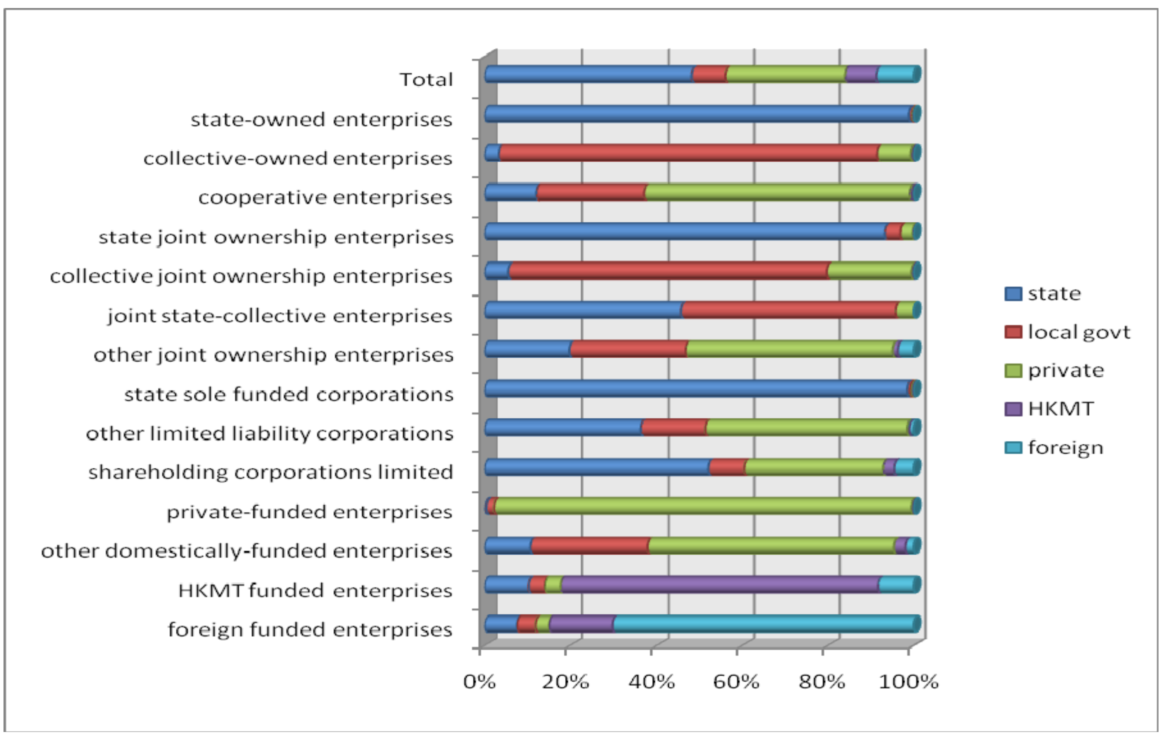
[4] They are Cinda, Orient, Great Wall and Huarong, each of which bought almost all NPLs respectively from China Construction Bank, Bank of China, Agricultural Bank of China and Industrial and Commercial Bank of China.

large, release the small.' In short, the process was to introduce diversified private ownership into SOEs, and to build up board governance to monitor managers' behaviour. Though not all SOEs were privatized through initial public offerings (IPOs) on stock exchanges, almost all SOEs sold their assets more or less to private investors. Since China's accession to the World Trade Organization (WTO), more pressure for opening up and international competition forced SOEs to accelerate their corporatization reform. From 1992 to 2006, over half of the central SOEs and over 90% of the medium- and small-sized SOEs completed corporatization.[5] With the average annual speed of 9,865 newly privatized SOEs, there were only 119,254 SOEs remaining in 2006, compared to 158,712 in 2002, according to the State Council's 2008 *Report of Reform and Development of State-owned Enterprises*.

However, this privatization process has been only partial. The State and local governments remain influential, important and active investors. According to the most recent China Economic Census, by the end of 2004, 56% of received equity for enterprises was from governments, of which 48.1% came from the State, and 7.9% from local governments, whereas only 28% was from private owners, only 7.3% from investors in Hong Kong, Macau and Taiwan, and only 8.7% from foreign investors (see Figure 1). By the end of 2006, it was estimated that government-controlled enterprises contributed 46% to total GDP, 48.75% to total assets, 46.66% to total revenue, 55.12% to total profits, and 42.97% to total employment (see Table 1). Those statistics suggest that notwithstanding China's 30 years of privatization, governments remain dominant in the market, and that most businesses in China have become hybrid enterprises.

FIGURE 1

Equity Share Structure of Chinese Enterprises by Registration Category, 2004



Note: HKMT covers Hong Kong, Macau and Taiwan.
Source: 2005 China Economic Census, Statistics Bureau of China.

[5] Media Press on 'China SOEs Reform' featuring Chairman Rongrong Li of SASAC. http://www.china.com.cn/news/2008-08/10/content_16183271.htm

TABLE 1

Contribution of Enterprises by Category of Registration, 2006

Unit: 100 million yuan

Item	# of enterprises	GDP	Total Assets	Revenue	Total Profits	# of employees (10,000)
State-owned enterprises	14555	30728	48942	31437	2012	707
Collective-owned enterprises	14203	9175	5504	8919	529	267
Cooperative enterprises	6313	3079	2107	2963	147	91
Joint ownership enterprises	1075	1306	1461	1281	78	24
State sole funded corporations	1343	15601	26883	16552	1337	397
Other limited liability companies	45738	55213	56139	54847	4043	1311
Shareholding corporations limited	7210	33597	32173	33291	2751	456
Private enterprises	149736	67240	40515	64818	3191	1971
Other domestically-funded enterprises	916	574	382	549	32	16
HKTM-funded enterprises	29181	33760	27291	32956	1796	1031
Foreign funded enterprises	31691	66317	49818	65980	3588	1087
Total	301961	316589	291215	313592	19504	7358
Contribution by government ownership c	23.63%	37.78%	48.57%	38.39%	43.22%	36.25%

Notes: These statistics included all state-owned industrial enterprises, and non-state-owned industrial enterprises with annual revenue from principal business over 5 million Yuan; HKTM covers Hong Kong, Macau, and Taiwan; It is estimated by using equity share of the governments as weights.

Source: 2007 Annual Statistics Report, Statistics Bureau of China

This gradualist process in the 1990s was seen as optimal, or at least the only real option that China had. First, during the early stages of reform, given the low level of per capita income, there was little private surplus capital, and few private investors; therefore, the only way to privatize SOEs was to sell assets to insiders, which would create considerable moral hazard if the sale process went too fast and became a voucher privatization. The voucher privatization was a major reason for the failure of privatization in Russian: over-rapid privatization via a voucher program, with assets sold to insiders at unrealistically low prices. Instead of introducing incentives to management, privatization became a huge source of corruption. Second, external private investors were not willing to purchase a sizeable share of SOEs because an effective financial market had yet been developed, and thus information asymmetry between insiders and external investors was very high. Third, ownership of Chinese enterprises has only been gradually opened to foreign investors since China's accession to WTO in 2001, and still with still many restrictions.

Nevertheless, the partially privatized economy became much more dynamic, and those partially privatized enterprises have been extensively tested and shown to be superior to their former SOEs or still wholly state-owned counterparts. By building up a financial market, and introducing private ownership into enterprises since 1992, the desire for maximization of profits or value to shareholders has been set free. With a share of the profits and property rights over the assets, private owners have a strong incentive to monitor the operations of their enterprises, reducing the costs, improving the quality of their products, and ultimately increasing overall efficiency. Meanwhile, with governments remaining as strong interventionists in commercial activities in terms of their provision of capital, local networks, and sometimes policy support such as tax reduction and reduced waiting time for a licence, a moderate level of government ownership in enterprises worked well to internalize the governments' resource provisions, which were normally non-tradable or extremely costly in external markets. This ultimately helped the hybrid enterprises to perform better than wholly private rivals, which have not internalized those resource provisions. For instance, Dr. Qian Sun, a finance professor at Xiamen University, and his colleagues studied all listings on the Shenzhen and Shanghai Stock Exchanges over the period 1994-1997, and found that a moderate level of government ownership improved a listed corporation's financial performance in terms of market-to-book ratio of equity. Similarly, Dr. Xiaoyuang Dong, an economics professor at the University of Winnipeg, and her colleagues examined enterprises in urban areas in Jiangsu province, and found that enterprises with some government ownership tended to perform better in terms of total factor productivity and profitability.

Fading Stage: Institution Reform

However, what has been the best corporate model in the past, may not be the best for the future. The leadership of the Communist Party of China still considers ownership and control in selected industries and enterprises as a core tool of political control,[6] but they may have to re-think, or maybe already are re-thinking that position in the face of increasing pressures. The expanding share of private enterprises, particularly those in industrial sectors, has been forcing SOEs to further reform themselves toward a more efficient corporate and governance structure amid increasingly intense competition.

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[6] Chairman of SASAC of the State Council, Dr. Rongrong Li, explicitly expressed this idea in his *Report on Reform and Development of State-owned Enterprises*, published April 21, 2008 in *Study Times*, a CPC-run newspaper.

According to the State Council's *2008 Report on Reform and Development of SOEs*, by year-end 2006, 91.73% medium and large-scaled industrial enterprises in China were privately owned; with only 51.4% control of the national assets, they generated 64.2% of the national industrial value-added, and 56.5% of the national received profits. The current corporate structure of hybrid enterprises -- the heavy policy burden due to government ownership, and an ineffective and costly principal-agency structure due to the appointment of representatives from the political ranks – is already a significant drawback, and thus needs to be modified. Some recent policies of the State signal its response to the increasing competition: for instance, rather than appointing managers from the political ranks, SASAC organized 16 central SOEs to seek senior management team members in the international labour market in January, 2009.

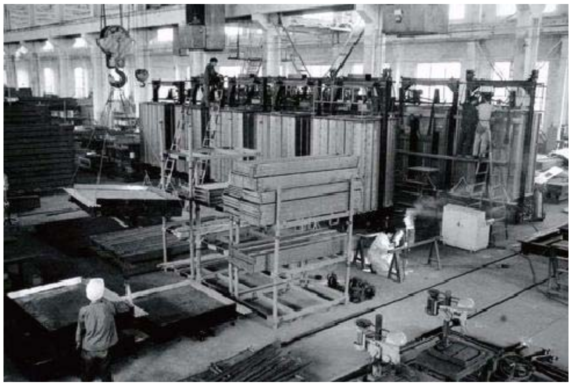
However, to sustain the Chinese economic miracle is far more complex than simply reforming the market and SOEs. Although economic reform has already been underway for over 30 years, China's political and legal systems remain autocratic, if no longer centralized. Government decisions still follow a tightly controlled top-down, one-party model, with no transparency that a wide range of citizens can monitor. However, such a model is becoming a contradiction to the decentralized market system. For instance, the Communist Party has already noticed the potential danger that insufficiently secured property rights creates a bottleneck to further economic progress, which is considered the key to its political legitimacy. Without secured property rights, private owners tend to hide their incomes, and are not willing to re-invest in their enterprises to scale up production. Besides, private owners tend to be short-sighted, and have weak incentives to invest in activities like R&D for quality improvement and long-term return. In some cases, private enterprises divest from their institutionally-weak home country, and to transfer their capital into a new registered company in an institutionally-strong market such as Hong Kong.

Amendments to the Constitution, which highlighted the protection of private property, during the Second Session of the 10th National People's Congress in 2004, can be seen as a signal for a start to extending economic reform from the market and enterprises upward to institutions. It is easier to understand such an amendment as the Communist Party's compromise to the rising pressures from the private economy than as political liberalization by an autocratic ruling party. Nonetheless, such a small step suggests that without reforming the institutions, the government cannot sustain the country's economic miracle, and thus not sustain societal and political stability.

If institutional reform goes further, the hybrid business model will inevitably no longer be as effective for both the economy and enterprises. During the past 30 years of economic reform, governments contributed to the economy as providers of some necessary resources, such as capital and information, which were scarce in the underdeveloped external market. With deeper institutionalization of the financial and information system, governments' role as resource providers will be unnecessary; resources will supposedly be traded through markets at fair prices. If the government remains as an influential provider of capital and information, and competes with private businesses in the market, its dual role of authority (game ruler) and business player (game player) will cause huge potential opportunity cost – too much policy burden imposed onto the market, reducing overall efficiency. Therefore, the need for internalization of capital and information resources into the enterprise may be largely reduced.

However, many private owners, particularly foreign investors, built a hybrid ownership model not only to access financial and information resources, but also, and maybe most importantly, to reduce high transaction costs due to policy uncertainty. With an influential government agent as an equity partner, and assistance from its appointed directors, who usually are current or former influential officials in the political hierarchy, transaction costs due to policy uncertainty can be significantly reduced, e.g., less waiting time for a licence, more tariff reductions, and even the waiver of quality investigation by the Customs. However, such a *guanxi*-based model creates high opportunity costs both for the economy and for the hybrid enterprises themselves. First, as government representatives, directors appointed to the board will always try to impose socio-political goals on the hybrid enterprise, which causes high costs of resolving goal conflicts, and thus reduces the enterprises' overall performance. For instance, private owners may have to bribe those directors for agreement with a plan to lay off some workers to cut costs. Second, government representatives, who have neither direct property rights in the state-owned assets, nor share in the profits, may have weak incentive to help improve enterprises' financial performance. Rather, they tend to sacrifice the enterprises' resources for their own benefits, such as a large office, luxury business residence, and appointing unqualified senior management members through from their personal networks. Third, even if the government may track financial performance (usually, it is annual industrial production) as a measure of grading the political achievement of its appointed representatives, those representatives may still be not be interested in operating the enterprises efficiently and profitably. Rather they tend to impose objectives such as building a large business group, or over-ambitious sales and production, which are normally more measurable than efficiency as in total factor productivity or unit value-added.

In fact, irreconcilable goal conflicts and huge agency costs have aborted many Chinese hybrid enterprises, particularly those owned by foreign multinational enterprises -- the foreign private owners have purchased the equity shares of their government partners, and fully privatized the enterprises. For example, Schindler, a Swiss elevator company, fully privatized its Chinese joint venture in 2001, 21 years after its establishment of the first Chinese international industrial joint venture in partnership with state-owned China CMIIC Engineering & Construction Corp; P&G acquired all the equity shares from its Guangzhou and Beijing state-owned partners in 2002; the same happened to Chinese hybrid enterprises built by Gillette, Siemens, Johnson & Johnson, Unilever and FedEx.



The first Chinese-foreign industrial equity joint venture, Schindler Elevator Corp., which was established by Swiss Schindler Corp. and Chinese state-owned CMIIC Engineering & Construction Corp. in 1980, became wholly Swiss-owned in 2001.
(Picture Source: MOFCOM.)

With the markets' continuing decentralization and private economy further expanding, more pressure from private owners will inevitably force the government to carry out deeper institutional reform. This is likely to include further securitizing property rights, strengthening the legal system, and building a transparent political decision-making system. Notwithstanding the securing of property rights in the Constitution, an insufficient and non-transparent legal enforcement system may not be capable of fully easing the private owners' fear. Further, without a transparent political decision making, and an effective monitoring mechanism by citizens, it is impossible to convince people that the legal rights are sufficiently enforceable.

In short, with institutionalization of market-oriented bodies, the Chinese government's previous role as a resource provider will gradually fade, to be replaced by a fair and less costly market system. More importantly, the model of hybrid ownership adopted to reduce the transaction costs of policy uncertainty will make no sense if there is not so much policy uncertainty – institutionalizing transparent political and legal systems could reduce the need for enterprises to introduce government ownership, lower the transaction costs, further free the economy, and thus consolidate China's economic miracle.