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Corporate governance of Chinese privatized firms: Evidence from a survey of non-listed enterprises ☆

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ABSTRACT

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By using a dataset containing over 1200 Chinese non-listed firms, this study examines the corporate governance of privatized firms. Based on the summary statistics for 22 governance structures, I find that privatized domestic private firms have set up stronger governance than domestic private firms that have not experienced privatization. I propose seven hypotheses to explain the leading performance of privatized firms on corporate governance. I find that while some differences are explained by the diversity of firm-level characteristics, privatized firms' better performance on setting up a board of directors and providing the CEO with company shares is highly robust. Finally, I find strong correlations between local governments' fiscal conditions in the privatization year and privatized firms' governance, which suggests a significant role played by local governments in shaping corporate governance during the privatization process. *Journal of Comparative Economics* **43** (4) (2015) 1101–1121. School of Economics and Management, Tongji University, 1239 Siping Road, Shanghai 200092, PR China .

1. Introduction

Privatization has been a crucial step in China's great transition from a planned economy toward a market economy in the past decade. Through privatization, thousands of companies have been restructured from state to private ownership.[1] It is generally found that privatization has quickly led to improvements in firm efficiency and profitability (e.g. Megginson et al., 1994; Boubakri and Cosset, 1998; Aivazian et al., 2005). Nevertheless, by acknowledging the short-run gains, many studies also highlight the importance of corporate governance development to achieve the long-run successes of privatization (e.g. Qian, 1995; Black et al., 1999; Boubakri et al., 2005).

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[1] As a result, the shares of the state sector and the private sector in the economy have reversed. For example, in 1988, the state sector's share of total urban employment was 70%; but in 2008, the private sector's share became 77% (MLSS, 2009). The private sector now also contributes two-thirds of China's industrial value-added.

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Have privatized firms established sound corporate governance structures? To answer this question, this study examines a firm-level dataset from a 2006 survey of 1268 enterprises in 12 Chinese cities. Except for 56 firms, all sample organizations are non-listed enterprises. In the sample, there are 251 domestic private enterprises that have experienced privatization (privatized DPEs hereafter). I compare these firms with state-owned enterprises (SOEs) and domestic private firms that have been privately owned ever since their founding (non-privatized DPEs) on the set-up of 22 corporate governance structures. These structures cover five governance aspects, namely information disclosure and financial transparency, CEO contracts, ownership structures, boards and its functioning, and firm charters and its contents. Unlike listed companies that have to obey certain regulations by setting governance, non-listed companies such as the sample firms establish governance structures voluntarily. Hence, it is meaningful to make these comparisons.

The basic summary statistics show that on most of the 22 structures privatized DPEs perform better than SOEs. Moreover, they show better performance than non-privatized DPEs on half of the 22 structures (on the other half, the two groups are not significantly different). The leading performance of privatized DPEs over SOEs on corporate governance is easily understood. Compared with public (state) owners, private owners have stronger incentives to adopt governance structures to protect their interests. However, it is not straightforward to explain the leading performance of privatized DPEs over non-privatized DPEs because these two kinds of firms are similar in the sense that private owners hold the majority of company shares. Moreover, privatized DPEs still keep some features of SOEs that perform poorly in governance set-up. Therefore, one could expect that, on average, privatized DPEs would have worse performance than non-privatized DPEs on governance adoption.

Corporate governance is a costly investment that is made mainly to protect investors and discipline managers, and the payoffs from the adoption of governance mechanisms differ across firms (Aggarwal et al., 2010). This argument suggests that the differences between privatized DPEs and non-privatized DPEs can affect the payoffs and costs of their governance set-up. Accordingly, I propose seven hypotheses to explain the gaps in governance by firm-level characteristics.

To start with, corporate governance deals with agency problems, implying that the level of the separation of ownership and control in a firm primarily determines the benefits of its governance set-up. The first hypothesis is that agency problems are more serious in privatized DPEs, which generates demand for higher levels of governance and shareholder protection.

Next, some factors are able to partially replace internal governance structures and mitigate agency problems, including external finance providers and product market competition. The second hypothesis is formulated based on the fact that privatized and non-privatized DPEs rely on different major finance sources. Similar to Chinese SOEs, Chinese privatized firms have better access to bank finance; by contrast, non-privatized DPEs rely more on equity finance. These differences in corporate finance could have led to differences in governance mechanisms (e.g. Williamson, 1988). The third hypothesis concerns external product market competition, which can discipline managers who work contrary to the wishes of shareholders (Demsetz and Lehn, 1985). Since privatized DPEs enjoy greater market power than non-privatized DPEs, their external governance is weaker and thus they might set up stronger internal structures to compensate for governance power.

In addition, some internal and external factors affect the ease or costs of governance adoption. The fourth hypothesis is that privatized DPEs, like SOEs, attract better educated managers and employees who are more likely to understand better the benefits of modern corporate governance and to participate in setting governance mechanisms (OECD, 2006). The fifth hypothesis is based on labor power. Employees in privatized DPEs are more powerful than those in non-privatized DPEs due to the encouraged employee participation in China's privatization process; as a result, they may have played a larger role in shaping corporate governance. The sixth and seventh hypotheses are that due to their origins as SOEs, privatized DPEs have a stronger sense of corporate social responsibility (CSR) as well as stronger political connections, which may contribute to a higher level of governance.

To test each hypothesis, I construct related measures or proxies, the summary statistics of which demonstrate that the two groups are significantly different on these dimensions. Then, I add the measures set by set into the regressions, observing whether the estimated differences between privatized and non-privatized DPEs in governance are significantly reduced. The results support several of the hypotheses by suggesting that differences in the levels of agency problems, labor power, and CSR awareness could be part of the reasons for the differences in governance. Moreover, corporate finance and market competition measures are also strongly correlated with governance aspects, although the addition of these measures does not significantly affect the estimated gaps in governance (a more detailed summary is provided in Section 5). Following these tests, I also match the privatized DPEs and non-privatized DPEs samples by their industry and firm size and conduct regressions on the matched sample, finding that the leading performance of privatized DPEs remains on some governance aspects. In particular, in regressions with various specifications, privatized DPEs always perform significantly better in terms of the CEO holding company shares and the presence of a board of directors.

After examining the explanatory power of firm-level factors, I provide some evidence suggesting that the privatization process is related to privatized firms' governance. My conjecture is that the local governments who owned these firms have significantly affected their governance during privatization. Chinese local governments' economic decisions, including those on privatization, hinge largely on macroeconomic conditions. Therefore, in order to explore this idea, I merge the data on privatized firms with the privatization-year macroeconomic indicators of the province in which they are located. I find that local governments' fiscal conditions are positively related to firms' governance.

This study makes several potential contributions to the literature. First, to the best of my knowledge, it is among the few existing studies that carefully examine the corporate governance of non-listed firms. Compared with listed firms, external discipline in non-listed firms is much weaker because their key information is not public and they are not exposed to so many regulations. Therefore, the development of internal governance mechanisms is even more crucial for non-listed firms to prevent their managers from taking opportunistic actions at the cost of company successes. However, mainly due to data limitations, the