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# Ownership structure and firm performance: Evidence from the Chinese corporate reform

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ABSTRACT

We employ a new classification of ownership identity to analyze the impact of ownership structure on enterprise performance in China. Using both fixed effects model and Generalized Methods of Moments (GMM), this study finds that marketized state-owned enterprises outperform firms controlled by the government, indicating that partial privatization of state-owned Chinese firms improves corporate governance. Non-controlling large shareholders of marketized state-owned enterprises and private enterprises are found to play active roles in corporate governance. Lastly, there is evidence that ownership concentration of a controlling shareholder decreases the incentives to expropriate minority shareholders.



## 1. Introduction

The strategy of China in implementing transition toward a market economy was in stark contrast to that adopted by countries in Eastern Europe and former Soviet republics. "Dual-track" approach, under which economic transition occurred while addressing political and institutional constraints, succeeded in improving economic performance (Lau, Qian, & Roland, 2000). Some of the reforms during the transformation included gradual price liberalization, and experimentation with responsibility systems and special economic zones.

Transformation into a market economy would be incomplete without privatization of enterprises (Barberis, Boycko, Shleifer, & Tsukanova, 1996; Boycko, Shleifer, & Vishny, 1996; Megginson, Nash, & van Randenborgh, 1994). However, a market economy would not work without relevant institutions and human capital. That is, capital market development, the provision of institutional and legal infrastructure, and the growth of human capital are required to make an effective market economy (Stiglitz, 1996, 1999). One can argue that rapid privatization in spite of the lack of proper market supporting institutions and regulatory framework can lead to a large output drop, asset-stripping of insiders, rent-seeking, and blocks of future reforms by existing interest groups, as exemplified in Russia. In this regard, a gradual approach to privatizing enterprises can be justified because it offers time for institutional and legal frameworks to be built and evolve.

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Instead of rapid and complete privatization, Chinese authorities introduced partial privatization as a principal strategy to reform state-owned enterprises (SOEs) (Qian, 1999). Although the significant portion of the shares of SOEs in China are transferred to domestic institutions and the public after corporatization, the ultimate ownership of the majority of listed firms still remains with the state. This strategy can be viewed as a gradual but a second-best solution in a society facing a weak institutional development.

Is this type of Chinese privatization conducive for growth of firms? One group of scholars argues that partial privatization through corporatization of SOEs merely is another manner of implementing state ownership and thus fails to improve efficiency of firms (Sun, Tong, & Tong, 2002; Xu & Wang, 1999). Another group regards this strategy as a successful attempt to transform the behavior of firms by installing different ownership structures in SOEs. Reflecting the importance of this issue, the relationship between ownership structure and firm performance in China has been the focus of a great deal of research (Delios & Wu, 2005; Sun & Tong, 2003; Sun et al., 2002; Tian & Estrin, 2005; Xu & Wang, 1999).

This study extends the existing literature on ownership structure and firm performance in the following three ways. First, this study uses an alternative classification scheme for the ownership of SOEs that focuses on the ultimate owner of the firm instead of the legal owner. Previous studies on the effects of ownership on corporate performance relied on the official classification scheme of ownership dictated by law. However, that manner is likely to obscure the controlling shareholder of a firm. For example, the legal person ownership, which is extensively used by previous studies to contrast with state ownership, includes both state agencies and profit-oriented institutional investors, often leading to inconsistent empirical results. Second, this study conducts a regression of proxies for firm performance not only on the variables relevant to the status of ownership but also on change in ownership from government-controlled SOEs to profit-oriented SOEs, i.e., marketized SOEs (MSOEs). In other words, this study looks at the effect on firm performance of change in ownership structure from one that has complete government control to one that is marketized. Arguably, this yields more reliable estimates because other variables potentially affecting firm performance can be more accurately controlled. Third, this study estimates the equations of firm performance affected by changes in ownership using not only the fixed effects panel method but also the Generalized Methods of Moments (GMM). Although fixed-effect estimations are robust to the positive correlation between time-invariant variables and the error terms, GMM is known to further reduce problems arising from reverse causality and omitted variables.

This study examines how corporate governance works under the circumstance where the state remains an important owner for most listed firms. More specifically, it addresses the following questions. First, was launching a new type of firm under the ultimate control of the state, namely, MSOEs, a successful strategy? Second, do non-controlling large shareholders improve corporate governance? Third, is the ownership concentration of the largest shareholder associated with better performance?

The rest of the paper is organized as follows. The following section provides a brief review of related literature. Section 3 examines the institutional background of the ownership structure in China. Section 4 introduces the research design of the study, and describes the data and methodology, respectively. Section 5 discusses the empirical results. Section 6 presents the conclusion.

## 2. Chinese ownership structure and performance of firms

The impact of state ownership on firm performance has been a major area of research not only because state shares account for the largest portion of shares of listed firms in some countries, but also because they serve as instruments for intervention by the government. One group of economists argues that state ownership may undermine the performance of firms (Shleifer & Vishny, 1996). One suggested reason is that political pressure for excessive employment is likely greater on SOEs. Another is the difficulty in monitoring managers and the lack of interest in restructuring. In contrast, some economists claim that state ownership may positively affect firm performance particularly in developing and transition economies. According to them, state ownership can facilitate the resolution of matters regarding unclear property rights (Jefferson, 1998; Stiglitz, 1996, 1997; Sun et al. 2002). Following this line, Lin, Fang, and Zhou (1998) claim that decreases in state ownership may undermine firm performance by causing severe principal-agent problem.

The effect of ownership reform in China attracted much attention from researchers. Legal person shareholding, which is an essential feature of Chinese ownership reform, is considered to give firms freedom in deciding on investment projects, disposal of major assets, and profit allocation. Furthermore, legal person shareholders are expected to be efficient in monitoring management because they are typically large block holders. In this regard, one may expect that Chinese ownership reform results in better firm performance. In contrast, there is an argument that Chinese ownership reform is merely “a change of logo” that disguises true ownership of the state and keeps state involvement in operation of firms (Xu & Wang, 1999). Legal person shareholding also can possibly be a source of conflict of interests; it promotes collusion between legal person shareholders and managers but hurts the interests of other shareholders, including minority ones. Hence, Chinese ownership reform possibly fails to improve firm performance or even undermine it. This implies that an improvement in firm performance requires full privatization, which was observed in East European economies (Lee & Hahn, 2004; Qian, 1996).

Empirical findings from the existing studies on ownership reform and firm performance are not clear-cut. Using the data on listed Chinese companies for the period of 1993–1995, Xu and Wang (1999) find a negative relationship between state ownership and firm profitability, but little association between state ownership and market-to-book value. Sun and Tong (2003) contrast legal person ownership with state ownership using data on listed firms from 1994 to 2000. They claim that state ownership and legal person ownership have a negative and a positive impact on firm performance, respectively, when firm performance is measured by the market-to-book value. However, they find that state ownership does not influence return on sales or gross earnings. Sun et al. (2002) obtain results on state ownership that were different from the abovementioned findings. They use