

China's State-owned Enterprises Development under the Modern Enterprise System—the Case of Shougang Group

Jie Zhang, Graduate School of Economics, Kyoto University, Japan

ABSTRACT

This article examines the development of state-owned enterprises, in particular the Shougang Group, under the Modern Enterprise System. Shougang is one of the top four steel makers in China. It had been selected as one of the experimental enterprises for several SOEs reform stages, including the Modern Enterprise System, and so it is a typical case. Drawing upon both the research results by other scholars and many first-hand materials from Shougang Group, the author mainly analyzes from the corporate restructuring, administrative control, downsizing, divesting social burdens and eliminating loss-making business, etc. which are actually typical of all the large SOEs' transformation process. By undergoing these significant reforms, SOEs in China, in spite of some problems, are moving towards more "corporatized" and "marketized" form with great entrepreneurship and competitiveness, as the Modern Enterprise System aims to.

INTRODUCTION

It is known that in all transitional economies, China is different from most other countries on the point that while most countries realized the economic transition through privatization, China has always been trying to keep state ownership, especially the ownership of large state-owned enterprises (SOEs), although privatization has also happened in a controlled degree. Therefore, transformations of SOEs have always been the major focus of China's entire economic reform.

In 1993, Chinese government pronounced the "establishment of Modern Enterprise System" as the objective of enterprise reform, and China's SOE reform entered a different stage. About the Modern Enterprise System, while some scholars (Tenev, Zhang and Brefort, 2002; Tam, 1999) connect it mainly with the development of corporate governance in China, others (Forrester and Porter, 1999) regard it as a managerial revolution. Still many others (Hutzler, 2002; Pei, 2002) indicate that without the much-needed political reform, the present Modern Enterprise System reform in the SOEs is doomed.

Generally speaking, these research and studies are about the general conditions of SOEs under the structure of Modern Enterprise System in China and there is little work about specific and detailed changes happened in SOEs. In practice, what kind of changes happened to SOEs with the adoption of Modern Enterprise System? Do these changes make SOEs develop towards real modern enterprises by improving efficiency and performance?

By drawing upon both the research results by other scholars and many first-hand materials from the company, this paper tries to find answers to these questions by examining the Modern Enterprise System in relation to a single case, Shougang Group (Shougang in short). As a typical large SOE with a history of more than 80 years in steel industry, Shougang's development under the Modern Enterprise System tells specifically and clearly about SOEs' changes with the adoption of Modern Enterprise System. The Modern Enterprise System is reviewed in Section 2 briefly. Section 3 discusses SOEs changes in general and Section 4 analyses Shougang's transformation under the Modern Enterprise System, while Section 5 concludes this paper's findings.

THE MODERN ENTERPRISE SYSTEM

By the mid 1990s, China had experienced several reform stages for SOEs, such as Economic Responsibility System, the substitution of profit remittance by profit taxes, and the Contracting System. All these reforms gradually increased

enterprise autonomy, but also left some drawbacks. For example, enhanced enterprise autonomy had led to over-investment, asset stripping and collusion among bureaucrats, managers, and local governments. Many SOEs were in the red because of heavy welfare and tax burdens, poor management and reluctance to lay off redundant workers.

With the Contracting System abandoned by some enterprises, there was clearly a need for a new reform, one could solve the outstanding problems in enterprise structure and management that the Contracting System had either failed to resolve or not addressed at all. In such condition, the Modern Enterprise System was put forward, which pushes SOE reform into a new era.

The Modern Enterprise System was put forward in the Decisions on Issues Concerning the Establishment of a Socialist Market Structure issued on the Third Plenary Session of the 14th Party Congress in November 1993. The “Decision” made at the session writes: What we are going to establish is a Modern Enterprise System which suits the requirements of the market economy, and features clear-cut equity ownership, distinct responsibilities and rights, separation of government from enterprises and scientific management (Chen and Lin, 2002). The Modern Enterprise System is intended to promote the corporatization of SOEs, bringing in some features of typical Western company structure such as boards of directors and shareholders, reducing government interference in the running of enterprises, and making them more entrepreneurial and less reliant on the state. To realize these aims, enterprises need to practice *gaige*, *gaizao* and *gaizu*. *Gaige* (reform) means the adoption of new enterprise-management mechanism; *gaizao* (reconstruction) consists of technical transformation and improvement, while *gaizu* (restructuring) involves a reorganization of property rights and assets.

SOES’ CHANGES UNDER THE MODERN ENTERPRISE SYSTEM

The Modern Enterprise System leads to great changes in SOEs. But it has different results on large ones and small and medium-sized ones, especially in 1997, at the fifteenth CCP congress when the policy of “Grasp the large and let go the small” (*zhuadafangxiao*) was set out.

For most small SOEs, the 1993 Decision led to a rash of *de facto* privatizations at the local level and a wave of incorporations, although “privatization” is not a term that the Chinese use. Table 1 shows that the ownership transformation has taken a variety of forms, with conversion to joint-stock company and restructuring the most commonly employed techniques, followed by mergers and leasing. The forms taken least are contracting out, sale and bankruptcy.

Table 1. Transformations of Small and Medium Enterprises in China by 2000

Nature of transformation	Coastal area *	Central area *	Western area *
Number of enterprises	17629	20713	21068
Percentage transformed	83%	83%	80%
Joint-stock company	22%	22%	19%
Restructuring	17%	14%	20%
Merger	13%	11%	12%
Leasing	11%	14%	9%
Contracting	9%	9%	8%
Sale	8%	9%	9%
Bankruptcy	8%	11%	11%
Others	12%	10%	12%

Source: Chiu and Lewis, 2006: 69.

Notes: Coastal area includes Liaoning, Hebei, Beijing, Tianjing, Shandong, Jiangsu, Shanghai, Zhejiang and Fujian. Central area includes Heilongjiang, Jilin, Shanxi, Henan, Hubei, Anhui, Jiangxi, Hunan and Hainan. Western area: Inner Mongolia, Shanxi, Ningxia, Gansu, Qinghai, Xinjiang, Tibet, Sichuan, Guizhou, Yunnan and Guangxi.

While on the other hand, for large SOEs, their transformations took a different form. The state has sought to retain ownership of the largest SOEs and take some measures to develop them to the critical production levels where economies-of-scale could be reached and make them internationally competitive in the world market. The main measures include:

- (1) Establishing enterprise groups by reorganizing the enterprises' resources, assets, and structure to create large companies to be more competitive.
- (2) Corporatization by setting up shareholding companies and limited liability companies within the group so that a parent holding company and a range of subsidiary companies would be formed.
- (3) Mass layoffs to enhance efficiency (*jianyuan zengxiao*). The government grants enterprises autonomy in employing and dismissing workers so that the SOEs could reduce redundant workers. It is estimated that layoffs from SOEs and collectives were 25.5 million during 1998-2001 (Chiu and Lewis, 2006: 71).
- (4) Debt-equity swap (*zhaizhuangu*). In 1999, 4 Asset Management Companies (AMC) were established to specialize in buying, managing and disposing of the non-performing loans of the four state-owned banks. This debt-equity swap policy was intended to eliminate heavy financial burdens, so that enterprises could start afresh. Huge interest payments would be alleviated immediately, allowing state commercial banks to pursue their own institutional reforms.
- (5) Shifting social burden from enterprises to local governments.
 - a. Building a new social security system which included the pension insurance, medical insurance, unemployment insurance and minimum guarantee system.
 - b. Housing commercialization and socializing the functions and organs of house construction, distribution, management and repair.
 - c. Separating the public organizations, such as hospitals, schools and other welfare and service facilities from SOEs.

These measures were directing against the serious problems that SOEs had. Then how were the measures practiced? By focusing on Shougang Group, one of the typical large SOEs, we can find some answers.

SHOUGANG'S TRANSFORMATION UNDER THE MODERN ENTERPRISE SYSTEM

Shougang was established in 1919, developing into a large-scale integrated iron and steel plant with Soviet assistance in the 1950s. By the mid-1970s it was China's eighth largest steel plant. Since 1981, Shougang experienced 15 years under the Contracting System during which time great changes took place. In the early and middle period of the Contracting System, Shougang achieved incredible performance. However, while approaching the end of the Contracting System since 1992, owing to the limitations of the Contracting System itself and Shougang's own problems, such as massive expansion efforts, low investment in technology, and management corruption etc. Shougang began to face some serious problems, especially financial troubles which almost led to its insolvency.

With the ending of the Contracting System in Shougang in 1995, when actually the Modern Enterprise System had already been in practice, Shougang also entered an age of adjustment and transformation, accompanied by new development. Actually it was soon added to the group as a Modern Enterprise System pilot (Hassard, Sheehan, and Morris, 1999). Therefore, it is of special meaning to select Shougang as the object of our case study.

Corporate Restructuring

Group reform program and corporatization

By the time the Contracting System ended in February 1995, Shougang was still in the traditional structure of organization. All the 168 factories were under the centralization management of Shougang Corporation which was the only legal person who would bear the accompanying responsibilities for all the factories (Internal material 1: pp2). Furthermore, factories, especially non-steel industries were mainly to produce and offer service for inside Corporation (Internal material 1: pp2).

From November 1995, as part of the Modern Enterprise system, group reform program in Shougang began to put into practice. The State Council assigned the shareholder's responsibility to the Beijing municipal government. Shougang Corporation (the core company) was renamed as Beijing Shougang (Group) Corporation Limited (BSGCL), and was re-registered. The Beijing government designated BSGCL as the core company with the authority to enforce its shareholder's rights upon second tier companies within Shougang Group (Internal material 1: pp4).

The core company is the parent company which consists of administrative departments and most component parts involved in their core line of production (i.e., iron and steel). In this way, other component parts including special steel-making plants and those that engaged in non-core and unrelated lines of business became second-tier

sub-companies which were turned into “legal persons”. They have managerial and financial autonomy, and they are responsible for their own profits and losses. Economic transactions between the core and second-tier companies (or among second-tier companies) must be based at market prices.

By 1998, the first stage of the group company system had finished and by then, there were altogether 83 member units in 18 provinces (Internal material 2). A year later in 1999, Shougang selected 7 profitable core-line production units which involves coking, sintering, iron-making, steel-making and casting to form Beijing Shougang Company Limited and listed as an A-share company in the Chinese stock market (Internal material 3: pp4). Of all the 2310 million shares, the state share (the core corporation of Shougang) was 84.85%, and tradable share was 15.15%. With the reform of segmented share structure (guquan fenzhi gaige) and converting bonds into shares (zhuanzhai zhuangu), by January, 2007, the state share has decreased to 73.18% (Shougang Company Limited homepage; Shougang Company Limited share structure homepage; Shenzhen Stock Exchange homepage).

Then in August 2000, based on the debt-equity swap policy, Beijing Shougang Xingang Company Limited was formed with 7 other units including the nonlisted part in the core-production line and a part of the former Special Steel Company (Internal material 4). China was strict in selecting those that would convert their debt into equity, learning from the East European Experience. The selected company to practice debt-equity swap should have the potential to turn a profit, or at least break even, after restructuring (Ma, Mok and Cheung, 2001).

With the corporate restructuring, a hierarchical managerial system with the board of directors, managers and a monitoring committee in the core and second-tier companies has been established (figure 1). The board of directors in the core company is assigned by the Beijing government, with a three-year term of office. A worker representative is entitled to sit on the board. The general Managers and members of the Monitoring Committee also are assigned by the government. No members could sit on the board of Directors and the General Managers simultaneously (Nolan and Godfrey, 2001).

Figure 1. Shougang Group Corporate Structure After Restructuring

Sources: Nolan, P. and Godfrey Yeung. 2001: 169; Internal material 5.

The establishment of this hierarchical managerial system with the board of directors, managers and a monitoring committee is to separate government and management functions, and in a certain degree, the management level does enjoy greater autonomy. However, since Shougang is a typical SOE, the Party still has its role although its power is decreasing little by little. Actually since the Modern Enterprise System was practiced in Shougang, the government has always assigned the same person as both the chairman and the Party secretary. And likewise, the general manager also holds the position of the deputy Party secretary. In this way, the Party secretaries have become part of the management, which actually reduces the administrative cost, and decreases power struggles and responsibilities diffusion between the

management and the Party.

Change on administrative control

For a long time, the overall development of the Chinese steel industry was under the close control of the Ministry of Metallurgical Industries (MMI, Ye Jin Bu). However, since the reform, a large and fast-growing share of output was produced in local plants, sometimes outside the system of local state ownership. Since the 1980s, especially with the practice of Modern Enterprise System, even for the large state key plants, the role of market forces has increased strongly. The changed planning environment was reflected in the system reforms of 1998 when MMI was abolished and replaced by the Bureau of Metallurgical Industries (SBMI). In reality, many of the functions of the old MMI were not transferred to the new Bureau, but were transferred down either to the province level or to the enterprises.

In the case of Shougang, before 1998, Shougang was under two-tiered administrative control of both MMI and the Beijing Municipal Government. While MMI was mainly in charge of the administration of Shougang's production and investment, the Beijing Municipal Government would control its employment, wages and finance. Accordingly, MMI had the right to appoint and dismiss the general manager of Shougang, and Beijing city government correspondingly took the power of appointing and dismissing the Party secretary. The two-tiered administrative control made things very complicated and even conflicting between the two administrative parties.

Therefore, the abolishment of MMI for Shougang was great, because ever since then, Shougang would only reports directly to the Beijing city government (Figure 1). The new SBMI would not take administrative control over Shougang as the old MMI did in the past. Thus it was in accordance with the State Council's assigning Shougang's shareholder's responsibility to the Beijing municipal government as mentioned above.

Divesting itself of social burdens

For a long time, the functions of SOEs in China were seriously distorted, namely enterprises had to shoulder a lot of social affairs, such as surplus labor, welfare of pension, medical care and housing etc. Enormous social welfare burden had long been regarded as one of the main reasons for SOEs inefficiency and uncompetitiveness. Shougang, as a typical large SOE, was no exception at all, but was dramatically heavy with these burdens. Therefore, Shougang was active in relieving itself from social burdens in the following aspects.

Reducing the burden of surplus labor—downsizing and retrenching

Iron and steel making industry in China was seriously overmanned, so under the Modern Enterprise System, several of the steel corporations have planned reductions in employees of between 16 to 50 percent in their core iron and steel business.

Since the Contracting System, Shougang began to reduce redundant workers from core business lines and re-assign them to tertiary sector. After the practice of Modern Enterprise System, substantial reduction began. In 1998, Shougang estimated that roughly one-third of its total employees were redundant, but the actual reduction is larger than that, about half of the total employees had been reduced, from 1996's 239 thousand to 2004's 120 thousand, meaning 13 thousand of reduction every year (Internal material 6—13).

It is really a drastic work-force reduction, which is related on one hand to the actual redundant employees in Shougang, and on the other to the program of Shougang's moving out Beijing area. Shougang management is acutely aware of the political sensibility of unemployment in Beijing context, so Shougang employed a number of methods in their efforts to help them to be re-employed.

Through much effort, the reemployment ratio of 1999 was 75.05% in the Group, and that of 2003 was 89.5% in Beijing and Qianan area, a high figure compared to most of the SOEs (Internal material 14 and 15).

Reducing the burden of welfare responsibilities—passing to the government

Traditionally, social welfare provision has been the responsibility of SOEs, and it had been said that SOEs were responsible for the provision of cradle-to-the grave welfare, including housing, schooling, health care, and pensions (Solinger 1997).

Several stages of China SOE reform before the Modern Enterprise System did nothing in this field. Within this context, Chinese government began to establish a new social security system in 1995 which was independent of the enterprise system with a purpose to alleviate burdens on enterprises (Wu jinglian, 2005).

It is from January 1, 1998 that Shougang began the reform in pension insurance, medical insurance and unemployment insurance and by 2002 basically the reform was completed. The 178,000 employees, including the retired from 92 unit members, in Beijing and Qianan area of Shougang participated in the social security system in Beijing city government and enterprises in other areas also participated that under the local government (Internal material 16 and 17).

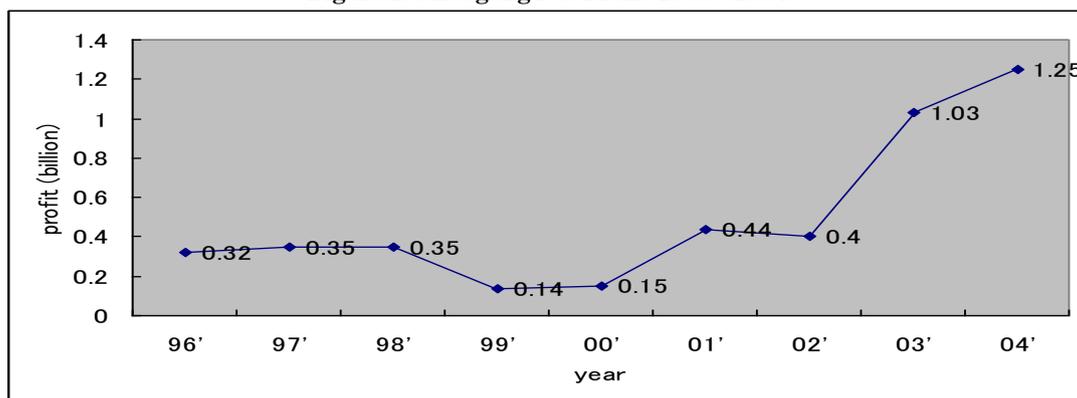
The establishment of social security system made many SOEs, especially SOEs with a long history and a large number of retired employees like Shougang freed from social burden. As for Shougang, it would save 150 million yuan only in the pension payment every year (Internal material 17).

At the same time, Shougang successfully passed some of schools and kindergartens to the education departments of local governments.

Housing commercialization has been basically realized since houses which belonged to Shougang in the past have been sold off to employees at discounted market rates.

With these transformational measures, Shougang's performance is improved. This could be seen from the profit rising tendency in spite of some fluctuations in 1999 and 2000 (Figure 2) which was due to the price rising of the upstream product. Surely, the profit rising is not only the result of these measures mentioned above, eliminating loss-making industries from the group also contributes a lot to it, which would be discussed in the following part.

Figure 2. Shougang Net Profit 1996 - 2004



Sources: Internal materials 6-13.

Eliminating loss-making non-steel business

Owing to the historical reasons, some administrative merging happened in Shougang before the Modern Enterprise System was adopted. For example, in 1988, Shougang was asked to merge 13 former military equipment industries to salvage loss-making enterprises. Of the 13 industries, 12 of them were in loss. In spite of the long-time efforts, by the end of 1996, there were still 7 of them in loss, of which 6 were in serious loss, and some of the production almost stopped (Internal material 18, pp 4). In order to help these factories to maintain production, develop new products, adjust production structure, and upgrade technology, Shougang invested a large sum of money. Materials show that by the end of 2002, totally RMB2.036 billion yuan had been invested (Internal material 19, pp.1).

With the adoption of the Modern Enterprise System and the autonomy that the management granted, from 1996, Shougang tried to transfer these former military equipment industries to local governments where they are located (Internal material 20). Besides the transferring, Shougang also applied for these loss-making industries to go bankruptcy.

It is not an easy work to practice transferring and bankruptcy of these loss-making enterprises, because it relates to 47 thousand of employees' living. In order to make the work go smoothly, Beijing city government, together with Shougang core company, negotiated many times with General Office of the State Council, State Economic and Trade

Commission, State Assets Management Commission, Ministry of Finance, and the concerned local governments (Internal material 21).

By the end of 2005, for the 13 military equipment industries, 6 were successfully transferred to the local governments, 2 were just under the operation of transferring, 2 had finished the preliminary work of going bankruptcy and 1 had transferred the bankruptcy wok to the local government (Beijing city government People's Representative Congress homepage).

CONCLUSION

As a case study, this paper examines Shougang Group—one of the top 4 steel works in China by introducing Shougang's development under the Modern Enterprise System which was adopted to promote the corporatization of SOEs, to bring in some features of typical Western company structure, and to reduce government interference so that the enterprises would be made more entrepreneurial and less reliant on the state.

While the Modern Enterprise System led to a rash of privatizations among small and medium-sized enterprises, large SOEs took a different form of transformation by keeping the state ownership as the Shougang case has shown here.

By corporate restructuring of establishing Shougang Group and a hierarchical managerial system, Shougang is experiencing the separation between government and enterprises, through which the government is trying to reduce the administrative control. By reducing surplus labor in large numbers and passing the responsibilities of social welfares to the local government, Shougang is divesting itself of social burden to increase its efficiency and profitability. By eliminating loss-making non-steel business, Shougang management is making full use of the autonomy they granted to get rid of the non-profitable factors, making Shougang competitive to meet the challenge of the changing environment and fierce competition.

All these suggest that under the Modern Enterprise System, SOEs have undergone significant reforms, developing towards real modern enterprises and improving entrepreneurship and performance. It is true that there are still some problems. For example, the separation of government from enterprises has not been fully realized; the social burden has not been completely removed yet and more seriously, the property right of SOEs nowadays has brought about great debate, especially on the issue of infringing state assets caused by MBO. Therefore, further policies concerning SOEs reform are still necessary. We are expecting about that

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