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Why do Chinese local governments transfer their rights of control over SOEs to the central government?

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Abstract

This paper investigates local authorities' motives for transferring their rights of control over state-owned enterprises (SOEs) to the central government. Using a difference-in-difference approach, we find that both employment and investment improves significantly following such transfers, and these findings are more pronounced among firms located in regions where the political pressure on local officials is higher. However, we fail to find any significant improvement in profitability. Our findings suggest that local governments tend to alleviate the political pressure they face by giving up their control rights and even sacrifice long-term economic benefits to do so.

Keywords: State-owned enterprises; Control rights; China

JEL classification: H11; H7; J63

1 Introduction

Since 1980, many countries, and not only the ex-communist economies but also developed economies such as the UK, have substantially reformed their state-owned enterprises (hereafter SOEs) (D'Souza and Megginson, 1999; Megginson and Netter, 2001). As the largest transitional economy in the world, China launched its SOE reforms in 1979. Contrary to the big-bang approach to privatization adopted by the Eastern European and former Soviet Union countries, the Chinese government explicitly pursued a strategy of “grasping the big and letting go of the small”. That is, they retained state control of large enterprises and retreated from small and medium-sized enterprises (Sun and Tong, 2003). As a result, hundreds of thousands of local SOEs have been privatized during the last three decades, with local governments the major players behind the rise in privatization¹ (Cao et al., 1999; Garnaut et al., 2005; Liu et al., 2007).

The effect of China's privatization program has been controversial, and has come in for much criticism over the years. Despite some evidence supporting its positive role in improving the profitability of local SOEs (Jefferson and Su, 2006; Fisman and Wang, 2014), the privatization has been challenged for increasing the unemployment rate (Garnaut et al., 2005; Xu et al., 2005)², encouraging corruption, and causing a loss of state-owned assets (Fisman and Wang, 2014). After taking office in 2002, China's former president Hu Jintao stressed the importance of stability and social harmony, which were linked closely to an official's political achievements and hence promotion. In response to Hu's governing concept, local governments began to focus increasingly on social performance, through aspects such as employment opportunities (Huang et al., 2014). As a result, privatization was gradually slowed down, and replaced with a new form of SOE reform, in which local governments transferred their control rights over local SOEs to the central government at a low price or even for free. Following this, the local SOEs would eventually become centrally controlled. In return, the centralized SOEs made a commitment to improve

¹ The privatization reached its peak during the period of 1998-2002 (Fisman and Wang, 2014).

² Between 1995 and 2003, more than 43 million employees of SOEs were made redundant (Xu et al., 2005).

their level of investment and employ greater numbers in return for their greater access to financial resources and stronger fiscal position.

This paper attempts to examine the effects of local governments transferring their control rights over SOEs to the central government. Using a unique dataset and difference-in-difference (DID) approach, we find a significant improvement in both employment and investment after these transfers, and show the improvement to be more pronounced among firms located in regions where local officials face greater political pressure. In contrast, we find no evidence of improved profitability for the SOEs. Overall, our findings suggest that local governments are likely to chase political objectives at the expense of long-term economic benefits.

2 Sample and Model

The treated group includes 65 listed local SOEs whose control rights were transferred to the central government during 2004-2011. To reduce estimation bias due to confounding effects, each treated firm was matched to a non-transferred listed local SOE in the same industry and with the closest size, measured one year prior to the transfer.³ Additionally, using the transfer year of the treated firm as a benchmark, we ensured that every treated and matched firm had data available for four years, two years before and two years after the transfer. These criteria yielded a final sample of 1,015 firm-year observations.

To analyze the effects of the transfer of control rights we employ a DID approach as follows:

$$Performance = \alpha_0 + \alpha_1 Treat + \alpha_2 Post + \alpha_3 Treat * Post + Controls + \varepsilon \quad (1)$$

where *Performance* represents an array of dependent variables, including *Employment* defined as the percentage of workers who would be laid off if the firm were operating at the industry-average level of sales per capita (Bai et al., 2005), *Investment* measured as investment expenditure divided by total assets, *ROA* measured as net income divided by total assets, *ROE* measured as net income scaled by shareholders'

3 The unreported results show that, after the matching, the main variables were indifferent between the treated and non-treated groups. We did not use the propensity scoring matching (PSM) approach due to the small sample size of the treated firms.

equity, and *Turnover* defined as sales scaled by total assets. *Treat* is a dummy variable that equals one if the firm is in the treatment group and zero otherwise. *Post* is also a dummy variable that equals one for the post-transfer period, and zero otherwise. In addition, we control for other factors that may affect the performance variables, including *Size* (logarithm of total assets), *Lev* (total liabilities/total assets), and *Growth* (growth rate of total assets).

In a further piece of analysis we examine the impact of political pressure on the effect of the transfer of control rights. Since the early 1980s, China has gradually shifted its focus for personnel evaluation criteria away from political loyalty towards economic and social performance (Chen et al., 2005). Given the centralized control of personnel, local government officials come under pressure regarding both social stability and economic growth. In other words, local officials may suffer from greater pressure if the employment rate and economic growth in their jurisdiction fall behind those of their counterparts. Thus, we use two measures to proxy for political pressure. One is the regional unemployment rate. Local officials face greater pressure if this is above the national median. The other proxy is relative GDP growth. Local officials face greater pressure if this statistic is lower than that of neighbouring regions (Cai et al., 2014).

The variables used in our study, other than those concerning political pressure, come from the China Securities Market & Accounting Research (CSMAR) database. The data used to proxy for political pressure, including the regional employment rate and GDP growth, were manually collected from the China Statistical Yearbook. To reduce the effect of possibly spurious outliers, all continuous variables were winsorized at the 1% and 99% levels. Table 1 presents summary statistics of the variables.

3 Regression Results

Table 2 presents regression results on the effect of the transfer of control rights on employment and investment. As seen from Columns 1 and 4, the treated firms experienced a significantly higher increase in employment rate and investment

expenditure than their non-treated peers. This supports the view that a transfer of control rights to the central government does facilitate job creation and investment expansion, which are the top priorities of local government officials. Further analysis suggests that the effects of transferring control rights are not uniform across firms but are conditional on the level of political pressure in their region. For instance, as indicated by Columns 2 and 3, the coefficient on the interaction term *Treat*Post* is significant only when the regional unemployment rate is high. The difference in the coefficient between the two subsamples is significant at the 5% level. When it comes to growth-related pressure, we obtain similar findings, as reported in Columns 5 and 6. The coefficient on *Treat*Post* is significantly positive when the regional growth pressure is high, and insignificant otherwise. In addition, the difference in the coefficient is significant at the 1% level. These findings support the notion that local officials tend to relieve their political pressure at the cost of the control rights of local SOEs. This is especially the case when the pressure facing the local officials is higher.⁴

The results reported in Table 2 suggest that the measures directly related to political achievements, namely employment and investment, improved significantly following the transfer of control rights. An equally important question then arises, as to how the transfer of control rights affects the firms' profitability. As seen from Table 3, where profitability is measured as ROA, ROE and Turnover, transferring the control rights of local SOEs to the central government fails to bring any economic benefits. For instance, the coefficients on *Treat*Post* are consistently insignificant across the three columns. Taken together, the overall findings suggest that, through the transfer of local SOEs' control rights, local governments achieve their political objectives to some extent, but sacrifice long-term economic benefits in the meantime.

⁴ As suggested by the anonymous referee, the motivation for transfer of ownership might be greater among export-led SOEs than others due to higher needs for protecting employment. In an attempt to address the point, we carry out a subsample analysis for comparing export-led and non-export-led SOEs. Export-led industries are identified according to the China Customs Statistics. The untabulated results suggest that our main findings, i.e. the increase in employment and investment, are primarily driven by the export-led SOEs operating in regions with higher political pressure. The results are available upon request.

4 Conclusions

This paper examines local governments' motives for transferring their control rights over local SOEs to the central government. Our findings suggest that employment and investment improve significantly following such transfers. However, they do not yield any significant economic benefits in the long term. Our results extend the literature on the political side of economics and finance by showing how the incentives of politicians can affect firms' economic activities and performance. Also, our findings contribute to the current debate over which path the SOE reforms should take: privatization or centralization.

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Table 1 Summary Statistics

	Mean	Median	Min	Max	Std
<i>Investment</i>	0.076	0.056	-0.083	0.445	0.081
<i>Employment</i>	-0.004	0.176	-1.978	0.744	0.690
<i>ROA</i>	0.019	0.023	-0.237	0.181	0.063
<i>ROE</i>	0.020	0.200	-1.080	0.050	0.340
<i>Turnover</i>	0.730	0.490	0.080	0.600	2.580
<i>Size</i>	21.619	21.612	18.756	24.486	0.941
<i>Lev</i>	0.535	0.544	0.113	1.291	0.204
<i>Growth</i>	0.134	0.081	-0.346	1.485	0.266

Table 2 The Effect of Control Rights Transfer on Employment and Investment

	Dependent=Employment			Dependent=Investment		
	Full sample (1)	High unemployment (2)	Low unemployment (3)	Full sample (4)	Low growth (5)	High growth (6)
<i>Treat*Post</i>	0.134** (2.020)	0.315*** (2.928)	-0.041 (-0.325)	0.015* (1.722)	0.020** (2.374)	0.013 (1.093)
P-value for the equality test			[0.029]**			[0.001]***
<i>Post</i>	0.051 (1.157)	-0.059 (-0.677)	0.141* (1.704)	-0.025** (-2.418)	-0.022** (-2.272)	-0.029** (-2.126)
<i>Treat</i>	-0.010 (-0.100)	-0.084 (-0.743)	0.072 (0.509)	-0.018** (-2.152)	-0.005 (-0.481)	-0.029** (-2.528)
<i>Size</i>	-0.239*** (-3.731)	-0.168* (-1.805)	-0.313*** (-5.806)	0.014*** (3.524)	0.017*** (3.067)	0.013** (2.521)
<i>Lev</i>	-0.032 (-0.128)	-0.309 (-1.028)	0.362 (1.261)	-0.041** (-2.264)	-0.031* (-1.733)	-0.046** (-2.201)
<i>Growth</i>	-0.317** (-2.216)	-0.382** (-2.024)	-0.264 (-1.592)	0.068*** (3.176)	0.052 (1.593)	0.076*** (4.802)
<i>ROA</i>	-0.879 (-1.636)	-1.702** (-2.161)	0.197 (0.349)	0.046 (1.144)	0.112* (1.881)	0.021 (0.403)
<i>Intercept</i>	5.179** (4.013)	3.838** (2.046)	6.519*** (5.814)	-0.197** (-2.244)	-0.274** (-2.349)	-0.168 (-1.497)
<i>Obs.</i>	1011	501	510	1015	458	557
<i>Adj.R²</i>	0.160	0.140	0.210	0.124	0.114	0.139

Table 3 The Effect of Control Rights Transfer on Profitability

	ROA	ROE	Turnover
	(1)	(2)	(3)
<i>Treat*Post</i>	0.006 (1.042)	-0.012 (-0.652)	0.037 (0.894)
<i>Post</i>	-0.003 (-0.417)	-0.007 (-0.498)	0.084*** (2.594)
<i>Treat</i>	-0.012** (-2.240)	-0.008 (-0.450)	0.013 (0.179)
<i>Size</i>	0.009*** (3.504)	0.031*** (3.321)	-0.003 (-0.082)
<i>Lev</i>	-0.131*** (-8.808)	-0.370*** (-5.868)	0.028 (0.136)
<i>Growth</i>	0.068*** (5.387)	0.209*** (4.674)	-0.135 (-1.526)
<i>Intercept</i>	-0.106** (-2.010)	-0.465** (-2.554)	0.740 (0.822)
<i>Obs.</i>	1015	995	1013
<i>Adj.R²</i>	0.296	0.198	0.012