

CORPORATE GOVERNANCE AND FIRM PERFORMANCE: EVIDENCE FROM THE CHINESE STOCK MARKETS

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Abstract

In this paper, we investigate how ownership structure affects the market performance of the Chinese publicly listed companies. The sample consists of all firms listed in the Shanghai and Shenzhen Stock Exchanges from 1998 to 2001. We find that a firm's market performance is positively related to the proportion of legal person shares but negatively related to the proportion of shares owned by the state. Using cross-sectional regressions, we further find that corporate value decreases with a firm's increasing leverage and size, while surprisingly foreign ownership does not increase a firm's market performance. Moreover, ST (Special Treatment) firms are used to test the effectiveness of corporate governance in China, and our results show that the change of ownership structure cannot improve the firm performance of Chinese listed companies.

Keywords: corporate governance; ownership structure; firm performance; China

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1. Introduction

Since privatization improves incentives, many governments have been employing this policy as an important tool to improve the performance of state-owned enterprises (SOEs). The privatisation reform in China differs from that in many other countries, as this reform has been undertaken in a so-called "socialist market economy". Privatisation is only partial with the state being the largest shareholder in most listed SOEs after the Share Issue Privatizations (SIPs).

The unique ownership structure of the Chinese listed companies results in a conflict of interest between the government and other stakeholders. The main aim of this study is to investigate how this special ownership structure affects the performance of publicly listed companies within the framework of corporate governance. Specifically, it examines whether different ownerships such as the state-owned shares, the legal person shares and the foreign shares affect the firm performance differently in China's share issue privatization. Using a cross-sectional analysis, we find that the state-owned shares and legal person shares do have opposite impacts on a firm's performance and the foreign ownership, however, does not increase a firm's market performance.

In order to improve the quality and performance of the Chinese listed companies and to protect investors' interest, a new regulation was set up in 1998, which states that firms with poor performance would be labeled as Special Treatment (ST) firms and they will be delisted if the firm's profitability does not

improve substantially. ST firms provide an opportunity to study the effectiveness of corporate governance in China. In this paper, we also focus on the ST firms and explore whether there is any relationship between the performance change and the change of the ownership structure in ST firms. Our results, however, cannot find any significant relationships between the two, which means that corporate governance is not very developed in China and is not a useful tool to improve the performance of Chinese listed companies.

The remainder of this paper is divided into the following sections: section 2 introduces the ownership structure and corporate governance in China; section 3 studies how ownership structure affects firm performance and how effective corporate governance of listed firms is by using cross-sectional regression analysis; section 4 shows the empirical results; and section 5 concludes and discusses some challenges existing in China's current corporate governance reform.

2. Ownership structure and corporate governance in China

2.1 The Chinese stock markets

During the last two decades, China has been undertaking a series of economic reforms. The foundation of the China's stock markets is one of the key steps in this reform. The two stock exchanges, the Shanghai and Shenzhen Stock Exchanges (SHSE and SZSE) were established in December 1990 and July 1991 respectively. The Chinese Securities Regulatory

Committee (CSRC), which was set up in 1987, is the regulatory body that supervises new securities listing and daily trading activities. Since the establishment, the two exchanges have developed rapidly and there are more than 1000 firms listed in the two stock exchanges. The Shanghai Stock Exchange is now the second largest in Asia, just behind Tokyo.

2.2 The ownership structure in a Chinese listed company

The majority stock listings in China belong to the SIPs, which in most cases are in fact partial privatisations as the government still owns the majority of shares in a listed company after listing. A typical Chinese listed firm can have as many as five different classes of shares: state-owned shares, legal person shares, employee shares, A-shares and foreign shares. In addition, a company may issue shares on overseas stock exchanges, for example N-shares if listed in the New York Stock Exchange. The state-owned shares, legal person shares, and tradable A-shares are the three major types of shares in any listed firm in China. Although each type of shares is entitled to the same cash flow and voting rights, they are different in the way of trading. Only the A-shares, foreign shares (B-shares or H-shares) and employee shares can be publicly traded, while the legal person shares can only be transferred through irregularly scheduled auctions under the permission of the CSRC.

2.2.1 State-owned shares

State-owned shares are held by the central and/or local governments, which are represented by local financial bureaus or state asset management companies. State-owned shares are not tradable. In China, in order to preserve the economy's socialist feature, the percentage of the state-owned shares after SIP is as high as 30-50% in a company.

2.2.2 Legal person shares

Legal persons are other domestic companies and usually the second largest shareholders in listed companies. Although legal person shares cannot be publicly tradable either, they are transferable to other domestic institutions or enterprises upon approval from the CSRC.

2.2.3 Employee shares

Companies that went public before November 1998 could issue 10 percent of the shares out of the total public offerings to their managers and employees. Due to the severe underpricing of Initial Public Offerings (IPOs) in China, these shares are designed to provide benefit to employees. Employee shares are registered under the title of the labor union of the company. After a holding period of 6 months, the company may file with the CSRC for its employee

shares to be traded publicly.

2.2.4 A-shares

A-shares are available to Chinese citizens and domestic institutions, which are publicly traded in local currency on the two Chinese stock exchanges. The goals of issuing A-shares are to raise capital for SOEs as well as to increase external monitoring and improve corporate governance for SOEs.

2.2.5 Foreign shares

In order to attract foreign investors, some companies also issue foreign shares (B or H shares). B shares are traded in the two mainland Chinese stock exchanges, while H shares are listed in the Hong Kong Stock Exchange. Since the Chinese currency is not convertible under the capital account, the B-share market is separated from the A-share market with SHSE B-shares denominated in US dollars and SZSE B-shares in Hong Kong dollars. Since February 2001, in order to develop the B-share market, the CSRC has allowed domestic Chinese investors to invest in B shares in corresponding foreign currencies.

The complicated ownership structure in Chinese listed companies raises a question on corporate governance, which is, whether the partial privatization of the state-owned companies is effective in terms of improving monitoring and firm performance.

2.3 The history of corporate governance in China

An understanding of the history of Chinese corporate governance is essential for this study. Schipani and Liu (2001) address that the Chinese corporate governance has experienced three stages in its development. The three models are as follows.

2.3.1 The traditional model

The traditional model of corporate governance was dominant from 1950s to 1984. The traditional model emphasizes that state ownership is paramount, since state ownership is considered the highest form of public ownership and the goal of socialism. The traditional model not only depresses the development of private sectors in China but also deprives SOEs of economic and legal independence.

2.3.2 The transitional model

The transitional model of corporate governance was dominant from 1984 to 1993 and ended when the Chinese Corporate Law was enforced in 1993. The SOEs Law (1988) recognizes that "SOEs should become legal persons that enjoy full management authority and full responsibility for their own profit and loss. The enterprise may, in accordance with the decision of competent government agencies, adopt contracts, leasing or other forms of systems of

managerial responsibility”.

2.3.3 The modern corporate model

The Company Law, promulgated in November 1993, provides the legal concept of a modern enterprise system. The modern corporate model recognizes more shareholder rights than the traditional and transitional models do. While increasing the autonomy of SOE management, the government is also seeking to strengthen the supervision of state property. Accounting reforms are enforced to ensure that owners, boards of directors and managers are provided with reliable information for monitoring company performance.

2.4 Current legal framework for corporate governance in China

The current legal framework for corporate governance is based primarily on the following laws: the Certified Accountant Law (1993), the Auditing Law (1994), the Company Law (1994) and the Securities Law (1998).

Under the current legal framework, a three-level governance structure is in place over a company's operations: the shareholders' general meeting, the board of directors and supervisors and management. The highest level is the shareholders' general meeting which has the final say over the key issues of a company, such as the approval of the management strategy and the key investment plans, and the nomination of the board of directors. The second level consists of the board of directors who make key decisions for a company and the board of supervisors who oversee the decision-making process. The third level is the management team who is responsible for day-to-day operations and for implementing the decisions of the board of directors. This framework is meant to maximize shareholders' interest. The organizational structure of a typical Chinese listed company is shown in Figure 1.

3. Data and Methodology

3.1 Data

Our sample consists of all 406 newly listed companies on the SHSE and SZSE over the period from 1998-2001. The study begins with 1998 because this is when the government carried out a significant restructuring, aiming to reduce provincial and local government intervention in the management of SOEs and to improve the soundness of the financial system by strengthening the financial supervision. All data used in the study are collected from listed companies' annual reports and other information released from the Shanghai and Shenzhen Stock Exchanges, as well as from the Datastream Database and the Qianlong Stock Trading Database.

Table 1 shows the proportions of different ownership in Chinese companies that went public between 1998 and 2001. A typical listed company in China has a mixed ownership structure with three predominant groups of shareholders -- the state, legal persons and individual shareholders. Employee shares are ignored since the fraction of these shares is very small. Table 1 shows that the state owns the majority of shares, and decreases its shareholding gradually from 1998 to 2001. The average proportion of tradable A-share is around 30%.

3.2 The relationship between ownership structure and firm performance

3.2.1 Hypotheses

We employ Tobin's Q as the proxy to measure listed firm's market performance. Today, Tobin's Q has been widely used as a measure of firm performance in the accounting and finance literature. Jerry and Stevens (1990) indicate that Tobin's Q ratio, a firm's financial market value divided by replacement cost of its assets is a better measure of firm performance than accounting rates of return. Henery (1998) also finds that Q estimates have smaller average errors than accounting rates of return. In addition, the Q ratio is found to have a much higher average correlation with its true measure.

Since the state-owned and legal person shares are not tradable and their value is difficult to determine, the market value in our study is calculated by multiplying the share price at the end of IPO year with only the number of tradable shares outstanding at the year-end. Therefore, the Tobin's Q ratios in our study are generally quite low.

Since privatization improves incentives, a rapid transfer of ownership should be desirable. The arguments for supporting privatization policies are based on such beliefs as government should not provide services or products when these services or products are available in the private market; private firms are more efficient than government agencies and private managers are better than public administrators.

Although privatization shifts residual income and control to private investors, restricting redistribution and improving incentives, it can also be argued that state ownership can play a positive role so that partial privatisation is better than complete privatization. Perotti (1995) shows that being the largest stakeholder of the partially privatized SOEs, the government sends a credible signal that it is willing to bear residual risk, a signal that it does not intend to redistribute value through a future shift in policy. Therefore, partial privatization may serve to enhance policy commitment.

However, Liou (2001) points out that in developing and transition economies such as China, the potential problem associated with partial

privatization policy is the increasing dangers of the twilight zone, where individuals fall into a situation that they will receive less than optimal treatment compared to the government. Boycko and Shleifer (1996) also argue that governments may pursue strategies, such as excess employee, that satisfy the political objectives rather than the economic objectives.

The current situation in China is that the state is the major shareholder of most listed companies. However, despite its majority ownership, the state does not exercise effective control over the companies. The significant proportion of shareholding owned by the state undermines the effectiveness of corporate governance. Hu and Goergen (2001) argue that there are three kinds of agency problems existed in Chinese listed companies. They are the conflict of interests between large shareholders and creditors, between large shareholders and small shareholders as well as between shareholders and managers. From individual investors' viewpoints, state shareholdings are detrimental to firm management and profitability. Hence, a negative relationship between state shareholdings and firm market performance is expected in Chinese listed companies.

Hypothesis 1.1:

H₀: There is no relationship between Tobin's Q and the proportion of the state-owned shares in a Chinese listed company.

H₁: There is a negative relationship between Tobin's Q and the proportion of the state-owned shares in a Chinese listed company.

The legal persons are typically other domestic companies or institutions. Most legal persons have significantly more shares than any individual investors. In China, large legal-person shareholders usually have seats on the board of directors and/or on the supervisory committee. Being on the board with a substantial portion of shares, legal-persons are able to make a difference to the management of a company, by changing the incumbent management team, influencing the companies' business decisions, etc. In addition, in comparison with the state, legal persons are companies themselves and have more economic incentives to increase the value and performance of a listed company. Therefore, it is expected that legal-person ownership has a positive impact on firm market performance.

Hypothesis 1.2:

H₀: There is no relationship between Tobin's Q and the proportion of the legal person shares in a Chinese listed company.

H₁: There is a positive relationship between Tobin's Q and the proportion of the legal person shares in a Chinese listed company.

Ownership concentration is defined as the sum of the second to tenth largest shareholding over the first largest shareholding. Shleifer and Vishny (1986)

indicate that large shareholders play an important role in ensuring the quality of corporate governance, even when they cannot monitor the management themselves. Large shareholders can facilitate third party takeovers by splitting the large gains on their own shares with the bidder. Therefore, larger shareholders may have an opportunity to improve the firm's operating strategy to maximize the value of the firm. However, compared to that in most developed countries, the ownership concentration of China's listed companies is not so high. In most cases, the state is the ultimate controlling shareholder and the top ten shareholders can be a mixture of the state and legal persons. Therefore, the role of ownership concentration on firm performance in China can be limited.

Hypothesis 1.3:

H₀: There is no relationship between Tobin's Q and the ownership concentration in a Chinese listed company.

H₁: There is a positive or negative relationship between Tobin's Q and the ownership concentration in a Chinese listed company.

The foreign ownership dummy takes the value of 1 if a listed firm issues B-shares and/or H-shares and zero otherwise. Empirical studies show that within given country and industry contexts, firms with foreign ownership will on average perform better than their domestic counterparts due to better monitoring and corporate governance. Chhibber and Majumdar (1999) study the foreign-owned firms in India and find that the asset turnover ratio of foreign-controlled firms is higher than that of the domestic-controlled firms and foreign-owned firms can generate more internal funds for reinvestment purposes due to a superior management style. Therefore, we expect that the foreign ownership will have a positive impact on the firm performance.

Hypothesis 1.4:

H₀: There is no relationship between Tobin's Q and the foreign dummy which represents whether a Chinese listed company has foreign shares.

H₁: There is a positive relationship between Tobin's Q and the foreign dummy which represents whether a Chinese listed company has foreign shares.

Firm size is defined as the natural logarithm of annual sales revenue, since larger SOEs tend to have larger sales revenue.

Firm size can have an ambiguous effect on the firm performance. Kumar (2004) documents that firm size measures a firm's market power or the level of concentration of the industries in which the firm operates. Bigger size makes the operation more effective, allowing firms to generate greater net profit margin as well as higher Return on Equity and Return on Assets (ROE and ROA), and leading to a higher firm performance. Chhibber and Majumdar (1999) argue that the size of a firm can affect a firm's performance in many ways. Large-sized firms have the ability to exploit economies of scale and better access

to bank credits which could improve corporate profitability. On the other hand, larger firms could be less efficient due to the loss of control by top managers over strategic and operational activities within the firm.

Size has its own meaning in the Chinese context. In China, larger SOEs usually have longer history and stronger connections with the government. The bureaucracy existing in the large firm could lead to poor management and low profitability. Therefore, we expect that size will have a negative impact on the firm performance.

Hypothesis 1.5:

H₀: There is no relationship between Tobin's Q and the firm size in a Chinese listed company.

H₁: There is a negative relationship between Tobin's Q and the firm size in a Chinese listed company.

Leverage is defined as the ratio of total liability to total assets. Under the socialist system, the budget constraints on state-owned enterprises are not rigid, since the state functions as a universal insurance company that compensates the losses of enterprises. The debt problem of SOEs is a major concern in China and has afflicted the SOE reform. Sun et al. (2002) report that from 1980 to 1994, the average debt ratio of SOEs increased significantly from 18.7 to 79%. Martin et al. (2003) document that Chinese investors have concerns regarding the debt level of a listed company. Although the high debt level indicates the government support for the firm, Chinese investors still view the firms that borrow too much unfavorably, since high debt level seems associated with strong government relation and poor profitability. Therefore, it is expected that leverage in a Chinese listed company will have a negative impact on firm performance.

Hypothesis 1.6:

H₀: There is no relationship between Tobin's Q and the leverage in a Chinese listed company.

H₁: There is a negative relationship between Tobin's Q and the leverage in a Chinese listed company.

The industry dummy takes the value of 1 for firms involved in heavy industries and zero for those involved in common industries. Examples of companies in heavy industries include chemical, power, equipment, steel companies and etc. Since companies in heavy industries usually have old and traditional business and heavy employee burden, it is expected that the relationship between industry dummy and firm performance is negative.

Hypothesis 1.7:

H₀: There is no relationship between Tobin's Q and the industry dummy which represents whether a Chinese listed company belongs to the heavy industry.

H₁: There is a negative relationship between Tobin's Q and the industry dummy which represents whether a Chinese listed company belongs to the

heavy industry.

3.2.2 Methodology

The cross-sectional regression analysis is used in our study. The Ordinary Least Square (OLS) regression model can be described as follows:

$$\text{Tobin's } Q_i = \alpha_i + \beta_1 ST_i + \beta_2 LP_i + \beta_3 \text{CONCEN}_i + \beta_4 \text{FORDUM}_i + \beta_5 \text{REV}_i + \beta_6 \text{LEVE}_i + \beta_7 \text{INDUM}_i + \xi_i \quad (1)$$

The state ownership (ST) and the legal-person's ownership (LP) are the fractions of shares owned by the government and by the legal persons respectively. Other independent variables include ownership concentration (CONCEN), foreign dummy (FORDUM), size (REV), leverage (LEVE) and industry dummy (INDUM). Prior to running the regressions, the correlation analysis of the independent variables are conducted. The correlation matrix in Table 2 shows that the correlation between the state ownership and the legal person ownership is very high (-0.914). Therefore, we examine these two variables (ST and LP) in separate regressions to avoid multicollinearity.

3.3 Special treatment firms and corporate governance

Since 1998, the CSRC has started implementing the delisting system on the two stock exchanges. As most individual investors in China are not very knowledgeable or experienced in investment, to protect individual investors' interest, a listed firm will be labeled as special treatment (ST) firm before delisting if one of the following four conditions is met:

- ❑ A listed company has negative net profits for two consecutive fiscal years;
- ❑ The shareholders' equity is lower than the registered capital (the par value of the share);
- ❑ A firm's operations have been stopped due to natural disasters or serious accidents and have no hope of restoring in three months; or
- ❑ Auditors express a negative opinion or show that they are unable to express any opinion on a firm's financial situation.

ST companies will be delisted if they have negative net profits for three consecutive years according to the Company Law. In China, the listing status is a very valuable resource to a firm given the restricted entry of listing. Once a listed firm is labeled as ST, the company would take all means to retrieve losses and improve its management, and ownership restructuring could be a quick and efficient way to turn things around if corporate governance matters. Therefore, we believe that ST firms provide a unique opportunity to study the corporate governance in China. By using the information provided by the two stock exchanges, we identified 52 ST events during 2000-2001. We follow up these firms for two years

after they become ST firms and study the relationship between the change of the profitability and the change of the ownership.

As net income is the only measure to determine the listing status of ST firms, net income return (NIR) between the ST year and the two years after is used as the dependent variable in the cross-sectional regression to measure the firm performance change. We use three variables to measure the change of the ownership. The owner-dummy (owner-dum) takes the value of 1 if the largest shareholder has been changed in these two years and 0 otherwise. In our study, 19 ST firms have changed their largest shareholder. The variable -- Share change (share-change) is defined as the shareholding change of the largest shareholder between the ST year and two years afterwards. The change of ownership concentration (concentration-change) is defined as the difference of concentration between the ST year and the two years after. If ownership restructuring does improve the performance of a ST company and the corporate governance works well among Chinese listed companies, we would expect a positive relationship between net income return and the change of the largest shareholder, the decrease of the largest shareholding and increase of ownership concentration. The hypotheses we test in this study are as follows:

Hypothesis 2.1:

H₀: There is no relationship between net income return and the owner dummy which represents whether a ST firm changes its largest shareholder.

H₁: There is a positive relationship between net income return and the owner dummy which represents whether a ST firm changes its largest shareholder.

Hypothesis 2.2:

H₀: There is no relationship between net income return and the decrease of the largest shareholding of a ST firm.

H₁: There is a positive relationship between net income return and the decrease of the largest shareholding of a ST firm.

Hypothesis 2.3:

H₀: There is no relationship between net income return and the increase of the ownership concentration of a ST firm.

H₁: There is a positive relationship between net income return and the increase of the ownership concentration of a ST firm.

The OLS regression model can be described as follows:

$$\text{NIR}_i = \alpha_i + \beta_1 \text{Owner-dum}_i + \beta_2 \text{Share-change}_i + \beta_3 \text{Concentration-change}_i + \hat{\epsilon}_i \quad (2)$$

4. Empirical results

Table 3 reports the statistic summary of regression variables for our sample of 406 firms listed on the SHSE and SZSE between 1998 and 2001. The average

state shareholding is 48.9%, which is much higher than that of legal persons. This indicates that the state is still the major shareholder after China's share issue partial privatization.

Tables 4a and 4b report the cross-sectional regression results on the impact of ownership structure on the firm performance.

As expected, the state-ownership has a negative impact on the firm value and its coefficient is statistically significant at the 10% level. This suggests that investors view government shareholding negatively, and the higher the proportion of shares held by the government, the lower the value a listed company has in the market. The legal person's ownership, on the other hand, has a positive and significant impact on the firm value. The LP coefficient is 0.266 with a *t*-test of 2.06, which is significant at the 5% level. This is due to the fact that comparing to the state, legal persons have more incentives to monitor listed companies, while in comparison with individual investors, legal persons have better means for corporate control. Our results, consistent with Qi et al. (2000) and Sun and Tong (2003), suggest that the state and legal person ownerships have opposite impacts on firm value, and firm performance decreases with the proportion of state-owned shares and increases with the proportion of legal person shares. Therefore, the hypotheses 1.1 and 1.2 can be rejected.

The results in both regressions suggest that there is no significant relationship between ownership concentration and firm performance. A possible explanation is that the top ten shareholders in a Chinese listed company can be a mixture of both the state agents and the legal persons. Since the state ownership and the legal person ownership have the opposite impacts on a firm value, this unique corporate structure can make the effect of ownership concentration quite confusing. Hence, the null of hypothesis 1.3 cannot be rejected.

Unlike many studies on other countries, we find that the foreign ownership has a negative and significant impact on the firm performance. However, this result is not difficult to understand in the Chinese context. Among 16 companies in our sample that issue foreign shares, foreign shares only account for less than 5% of the total shares. In China, in comparison with the state and the legal persons' shareholding, the foreign ownership is the minority and much more dispersed. Like other individual shareholders, foreign shareholders cannot actually monitor a company or influence its management in a meaningful way. Therefore, foreign ownership in a Chinese listed company plays little role in terms of improving corporate governance and firm performance. Second, due to the limited role of foreign ownership, foreign shares are not very popular among foreign investors. The market price of B-shares has been much lower

than that of A-shares. Therefore, the market performance of firms with foreign shareholding is lower than the average.

The results on the three control variables are all the same as we expected. The coefficients for the independent variable -- revenue, used as a measure of size, are negative and significant at the 1 percent level for both regressions. In China, large SOEs often have old business and a stronger government impact compared to small enterprises. The bureaucracy and hierarchies from the government and heavy social duty would reduce the efficiency of management of large firms, while small firms can be much more flexible when adapting to the changing economic environment. Second, we find that the high debt ratio is associated with a low firm market value, due to the bad image resulting from the triangular debt and policy lending problems among the government, state banks and state-owned enterprises. Third, the industry dummies are negatively and significantly related to firm performance in both regressions, showing that investors do not favor listed companies in heavy industry due to the severe government impact, heavy employee burden and the out-of-date business in this industry. Therefore, the nulls of hypotheses 1.5 – 1.7 can be rejected.

Table 5 reports the results of the cross-sectional regression on net income return of 52 ST firms listed on the SHSE and SZSE between 2000 and 2001. The ST system provides an opportunity to develop the corporate control in China, since ST firms face the possibility of delisting and are under great pressure to improve their management and profitability, and efficient ownership restructuring can be a quick and useful way. However, the most striking finding from the regression results is that none of the variables that measure the change of ownership structure has significant explanatory power on net income return of ST firms, which means that ownership restructuring could not improve the profitability of ST firms, and the monitoring from large shareholders and corporate governance as a whole are very poor in China.

5. Conclusions and discussions

China's SOE reform has been undertaken for over 20 years. During this economic reform, the Chinese government founded two stock exchanges and gradually partially privatized over 1000 large SOEs through SIPs. The relationship between firm performance and ownership structure of Chinese listed firms has attracted lots of debates. The cross-sectional regressions on 406 newly listed companies from 1998 to 2001 on the China's two stock exchanges are used here in an attempt to explore this relationship. We find that different ownerships do have different impact on market performance across firms. The state ownership has a negative impact on the firm performance, while

the legal persons' ownership has a positive one. The ownership concentration does not matter much to the firm performance, and surprisingly the foreign ownership has a negative impact on the firm's market performance. In addition, we study the relationship between the change of profitability and the change of the ownership structure of ST firms, and find no significant relationship between the two and that the corporate control and governance are relatively under-developed in China.

In conclusion, even though one of the main goals for the Chinese government to found its stock markets and implement SIPs is to improve the corporate governance of large SOEs, this goal has not been fulfilled so far. There are several obstacles for the development of corporate governance among Chinese listed companies.

First, the state is the largest shareholder in most listed companies, but there is no clear responsibility as to who shall represent the state. The unclear responsibility makes the corporate control from the state ownership very inefficient. Chi and Young (2007) document that the most important step to improve the corporate governance and efficiency of Chinese listed companies is to reduce the government control and political costs in these companies. Chung et al. (2005) also suggest that the state ownership of the Chinese listed companies should be reduced and the system that splits shares into tradable and non-tradable should be abolished. Since 2000, the government has been carrying out a reform, trying to reduce the state shareholding. However, as indicated by Qiang (2003), instead of readjusting the ownership structure, improving corporate governance and resuming market discipline, during the reform, the government is mainly interested in how to finance the huge social deficit by selling the state-owned shares at high prices. The conflict of interest and the disagreement on the selling prices between the government and the investors have slowed down this reform process.

Second, even though the organizational structure of a typical Chinese listed company looks no difference from that of listed companies in developed stock markets, due to the strong government influence, the organizational structure does not actually work very well. For example, the board of supervisors generally has very little power to stop or correct any decisions made by directors or managers, and many independent directors are only university professors in business who have the knowledge, but no ability to improve the corporate governance of listed companies. As concluded by Clarke (2006), "proponents of the institution of independent directors misconceive the nature of the corporate governance problem in China, and have not taken into account specific features of the Chinese institutional environment -- particularly the legal environment -- that affect the viability of any proposed solution."

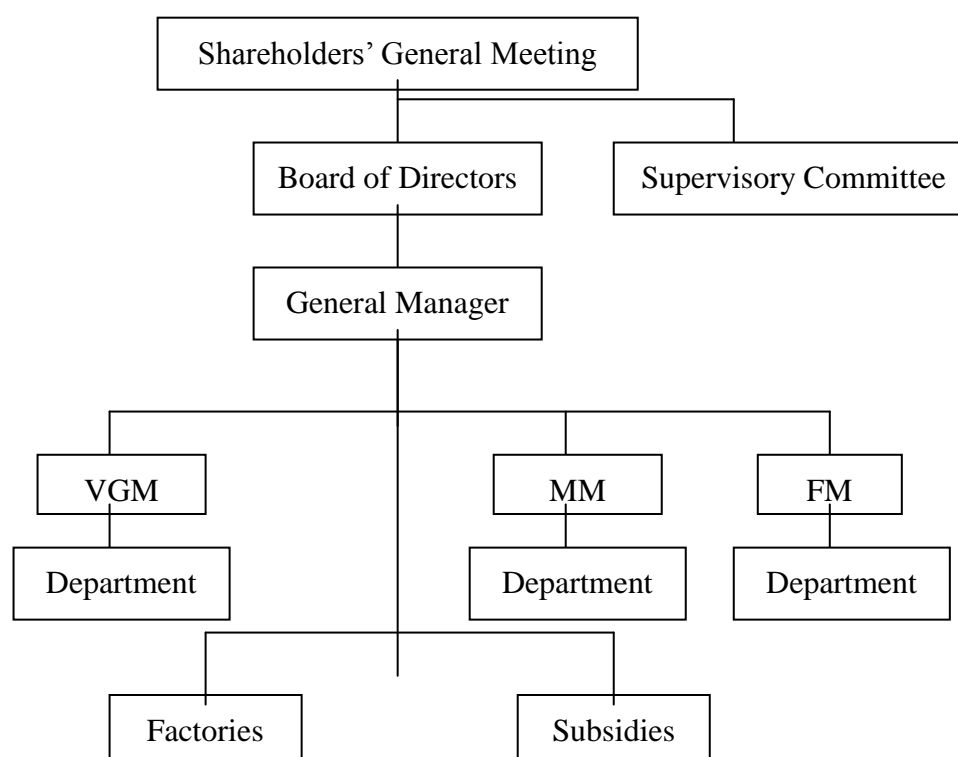
Third, the structure of the tradable shares also has a detrimental impact on the corporate governance. The 30% of the tradable shares are mainly owned by individual shareholders. The dispersed ownership makes the external monitoring very difficult to implement. Xu and Wang (1999) state that if financial institutions (such as banks, pension funds and insurance companies) are encouraged to own a significant proportion of shares in Chinese listed companies, they would have incentives and better means to monitor the management closely, which will lead to more efficient corporate governance. Since 1998, the CSRC has started to develop institutional investors, such as mutual funds and pension funds. However, there is still a long way to go for institutional investors and the external monitoring system in China to become mature.

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Appendices

Figure 1. The Organizational Structure of a Typical Chinese Listed Company



Note: VGM stands for the vice general manager; MM stands for marketing manager; and FM stands for financial manager.

Table 1. The Ownership Structure and the Number of Newly Listed Firms from 1998 to 2001

Ownership Structure of Newly Listed Firms (Percentage)

	1998	1999	2000	2001
State-owned shares	53.09	48.02	47.46	46.84
Legal person shares	13.59	17.22	18.94	16.17
A shares	24.94	27.09	32.29	30.42
Foreign shares (B and/or H shares)	0.72	0.79	0.35	3.28

Number of Newly Listed Firms

	1998	1999	2000	2001
Total for the SHSE and SZSE	104	93	132	77

Table 2. Correlation Matrix of Independent Variables in the Cross-sectional Regression Studying the Impact of Ownership Structure on the Firm Performance

	State_share	Legal_share	Concentration	Revenue	Leverage
State_share	1.000				
Legal_share	-0.914	1.000			
Concentration	-0.424	0.356	1.000		
Revenue	0.308	-0.214	-0.179	1.000	
Leverage	0.137	-0.099	-0.022	0.304	1.000

Table 3. Statistic Summary of the Variables in the Cross-sectional Regression Studying the Impact of Ownership Structure on the Firm Performance

	Tobin's Q	State_share	Legal_share	Concentration	Revenue	Leverage
Mean	0.912	0.489	0.166	0.481	19.934	0.338
Median	0.804	0.598	0.050	0.167	19.797	0.341
Std. Dev	0.614	0.254	0.221	0.663	1.088	0.131
Minimum	0.015	0.000	0.000	0.010	17.508	0.046
Maximum	7.899	0.834	0.802	3.930	26.441	0.733

Table 4. Cross-sectional Regression Analysis on the Impact of Ownership Structure on the Firm Performance

Table 4a: Cross-sectional Regression Analysis on the Impact of State Ownership on the Firm Performance

Dependent Variable: Tobin's Q

Independent Variables	Coefficients	t-Stat
Constant	4.5785	8.5259
State_share	-0.2135	-1.7568*
Concentration	0.0161	0.3610
Foreign_dum	-0.2489	-2.4561**
Revenue	-0.1590	-5.6053***
Leverage	-1.0053	-4.6917***
Industry_dum	-0.2529	-3.2993***
F-Statistic	23.986	
Observations	406	
Adjusted R-Squared	0.254	

Table 4b: Cross-sectional Regression Analysis on the Impact of Legal Persons' Ownership on the Firm Performance

Dependent Variable: Tobin's Q

Independent Variables	Coefficients	t-Stat
Constant	4.4887	8.2943
Legal_share	0.2661	2.0571**
Concentration	0.0157	0.3610
Foreign_dum	-0.2252	-2.2355**
Revenue	-0.1619	-5.7953***
Leverage	-1.0015	-4.6806***
Industry_dum	-0.2844	-3.7676***
F-Statistic	24.244	
Observations	406	
Adjusted R-Squared	0.256	

*, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively.

Table 5. Cross-sectional Regression Analysis on the Relationship between the Net Income Return and Shareholding Changes of ST Firms

Dependent Variable : Net Income Return

Independent Variables	Coefficients	t-Stat
Constant	-1.0994	-0.7330
Owner-Dum	-0.2395	-0.0963
Share-change	-3.3102	-0.8616
Concentration-change	-8.0378	-0.4883
F-Statistic	0.2491	
Observations	52	
Adjusted R-Squared	0.0262	