

EMERGING
ECONOMIES
TRANSITION

China in the Global Economy

Reforming China's Enterprises

ECONOMICS

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REFORMING CHINA'S ENTERPRISES



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FOREWORD

The transformation of China's economy and its integration into world markets are having far-reaching repercussions for OECD Members that will only increase in the coming years. It was in recognition of these repercussions that a programme of dialogue and co-operation between the OECD and China was initiated in 1996. This programme, co-ordinated by the Centre for Co-operation with Non-Members, encompasses a wide range of policy dialogue initiatives whose ultimate aim is to share OECD experience and support economic reform in China and to improve understanding among OECD Members of the progress and challenges of economic development in China.

The study in this volume examines reforms to improve the performance and secure the long-term efficiency and competitiveness of China's enterprises, both those that are state-owned and the growing number of those that are outside the state sector. Reform of China's enterprises is a critical element of the broader process of completing the transformation to a "market-based socialist economy" that has been underway since 1978. Progress on enterprise reforms has also become essential to China's macroeconomic performance and the full realisation of its growth potential. Enterprise reforms have taken on greatly added importance with the prospect that China will become a member of the World Trade Organisation. The study examines the main problems facing China's enterprises, the reforms that are being undertaken to address those problems, the progress that has been made, and the challenges that remain. The basic message that emerges is that enterprise reforms are at a critical juncture. There have been important accomplishments but substantially more needs to be done to sustain the reform process and secure its ultimate success. The study emphasises that for several reasons, including the prospect of increased international competition, the progress made over the next several years is likely to be crucial.

The study was carried out by the OECD Economics Department. The study is based in part on extensive discussions held with officials and experts of government agencies, several enterprises, and other analysts in Beijing, Shanghai, and Wuhan in June 1999. It benefited further from comments received in seminars given in those cities in April 2000. The bilateral relations with Chinese government agencies that have been developed under this programme were essential to the preparation of the study. In particular, the work could not have been carried out without the extensive support provided by the Development Research Centre of the State Council of the People's Republic of China and the valuable information and insights provided by its experts. Very useful comments and other support were also received from officials at several Member country embassies in Beijing and consulates in Shanghai and Wuhan.

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I. INTRODUCTION

China's economic reform has led to two decades of impressive growth and development but is now at a critical juncture. Growing structural problems have become a drag on real growth and have prompted an acceleration and broadening in economic reforms. Progress on enterprise reforms is needed to sustain adequate growth in the medium term, to complete China's transformation to a market-based economy and to ensure the longer-term competitiveness of its industries.

A major component of enterprise reforms comprises economic restructuring and SOE reorganisation to alleviate the problems that are impairing enterprises' ability to compete. A second component is to improve enterprise behaviour by establishing effective corporate governance mechanisms and strengthening financial discipline. A third component is provision of supporting institutions and infrastructure needed for a market based enterprise economy. Key in this regard is the development of social benefit programmes to deal with the economy adjustments entailed by reforms, allow enterprises to focus on their commercial objectives, and provide for the longer term needs of the population.

The study indicates that substantial progress is being made on a broad front of the reforms. But much more needs to be done and success in the overall reform effort is not yet assured. Furthermore, the next several years are likely to prove crucial: rapid progress needs to be made in key areas to sustain the reform process and to preserve the gains that have been made so far.

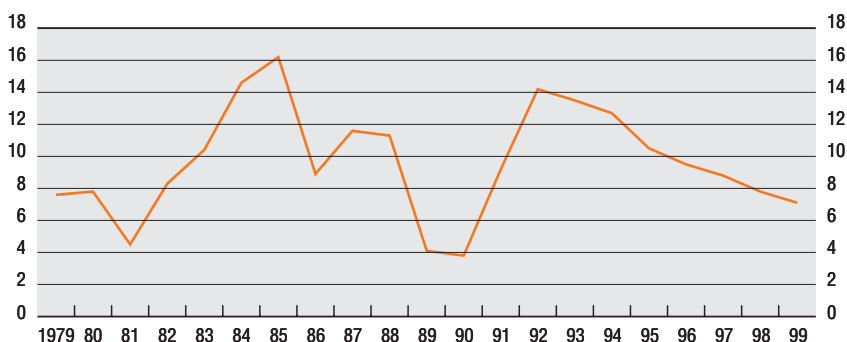
China's economic reform process that began in 1978 has produced impressive accomplishments. During the reform period, real GDP growth has averaged 9.8 per cent annually, a performance rivalled during the post war period only by those of Japan and Korea. The proportion of the population in absolute poverty has fallen from more than half the population in 1978 to 8 per cent (under national definitions) in 1997.¹ China began its reforms from a position of near autarky, to become by 1997 the world's fifth largest trader and second largest recipient of foreign direct investment. These achievements are all the more remarkable because China's reforms, in particular the retention of widespread state ownership, seem to contradict accumulated wisdom about the essential requirements of a successful transition from a socialist to market-oriented economy (Chow, 1997).

Economic reform has led to impressive gains

Economic developments over the past several years suggest, however, that China's reform process has reached a critical juncture. Economic growth has declined steadily since 1992 (Figure I.1).² The slowdown has highlighted worsening structural problems, including growing losses by state-owned enterprises (SOE) and extensive non-performing loans in the commercial banking system, that are comparable in some respects to those experienced by several Asian countries that underwent crises in 1997. Township and village enterprises (TVE), which have been a key growth engine for much of the reform period and the dominant source of new jobs in rural areas, also are now experiencing serious financial difficulties. Economic strains arising from the structural problems – declining enterprise cash flow, rising job and income insecurity in urban areas, slowing growth in rural incomes, and deflation – have

The reform process is now at a critical juncture

Figure I.1. Real GDP growth
Percentage changes



Sources: China Statistical Yearbook; The People's Bank of China Quarterly Statistical Bulletin.

been an important factor in the recent aggregate growth slowdown. Government revenues are already being stretched by the fiscal stimulus needed to sustain adequate real growth; and will be strained much further by the outlays that will be required to re-capitalise the banking system and establish a social safety net.

Reform is accelerating and broadening

These developments have prompted a substantial acceleration and broadening of reforms affecting China's enterprises, along with some important changes in orientation. Reform experiments in particular regions and industrial sectors are being expanded into a more comprehensive national effort. The role of the private sector has been progressively upgraded in the official reform architecture. Financial reforms necessary to improving enterprise performances are now advancing rapidly and on a broad front. These efforts reflect a realisation that structural reforms have become critical, not only to secure China's longer-term growth potential, but also to overcome the deflationary forces engendered by enterprise problems that have been slowing growth in recent years.

WTO entry increases the urgency of reforms

China's prospective entry into the World Trade Organisation has substantially raised the stakes on the success of the reform process. The economic returns from substantial and comprehensive progress on reforms over the next several years should be reinforced by the opportunities afforded by WTO entry. However, if reform falters, the strains on the economy are likely to be all the greater.

Purpose of the study

Reforms affecting enterprises are examined...

This study examines progress on reforms shaping the development of China's enterprise sectors. The analysis covers not only state-owned enterprises, which have been the main focus of the explicit reform measures, but also non-state enterprises, which have been the most dynamic elements of the economy. The basic purpose is to describe the main reforms that are shaping

the evolution of the enterprise sectors; the problems they are intended to remedy; the progress being made; and the issues that remain to be addressed. These reforms involve nearly all the main dimensions of the broader economic reform process in China, including policies that, while directed at other areas, have an important bearing on enterprise performances.

The analysis here takes as given the basic goals of the reform process in China and the distinctive features of the Chinese economy and society that condition that process. China's reform process is different from that of other countries in certain respects. At the same time, experiences of OECD and other emerging market economies (EME) provide insights about the fundamental economic processes involved in systemic changes that are potentially relevant to China's reform efforts.

The study necessarily draws heavily on official data which are subject to serious limitations that have been extensively discussed by analysts and whose existence is recognised by Chinese officials. As noted at several points in the following chapters, it is widely believed that official statistics distort profit figures and other key indicators of enterprise financial conditions and performance. Other data are difficult to interpret because of uncertainties about their definition or the quality of their reporting. In some cases, there is a consensus on the direction if not the magnitude of the resulting bias: for example, figures on aggregate real growth are widely acknowledged to be overstated. However, it would be mistaken to presume that all data tend to be overly optimistic: in many cases, figures are subject to both positive and negative biases whose net effect is difficult to determine and which probably changes with circumstances. Data deficiencies are not of course unique to China and stem in large part from limitations in reporting systems and in the procedures for refining and analysing the raw figures that are present in many other developing, and even some advanced, economies. However, the problems in China are aggravated by the country's large size and diversity and, and by lingering incentives to report favourable if exaggerated outcomes derived from the past central planning regime. Because of the problems in the data, any assessments of progress on China's reforms are subject to more than the ordinary level of uncertainty surrounding such exercises. At the same time, the official data provide information that is both informative and essential to this analysis. This is particularly the case given that alternative sources of information, such as partial or anecdotal evidence from non-official sources, are subject to equally great, or even greater, limitations.

Following a brief overview of the main elements and characteristics of enterprise reforms in China given below, Chapter II describes the current economic conditions of enterprises, the deterioration in their economic performances, and the factors behind that deterioration. With this "diagnosis" of the enterprise sectors as backdrop, the following chapters examine reforms to bolster enterprise performances and to reorganise the SOE sector (Chapters III and IV); to establish effective corporate governance mechanisms (Chapter V); to improve the financial environment shaping enterprise behaviour (Chapter VI); and to reduce SOE burdens for social benefits so that they can function effectively as commercial entities (Chapter VII). The last chapter concludes with some final observations and suggestions concerning the direction for future policies.

Taking as given the basic goals and constraints

Official data are necessary for the analysis but need to be regarded with caution

Focus: the problems and major reforms

Objectives, constraints, and conditioning factors

A market-based economy is the ultimate goal

The overall objective of China's reform process is to create a "market economy with socialist characteristics". In principle this means an economy in which substantial public ownership of industry is retained; but where enterprises, regardless of their ownership, seek to maximise profits in response to market forces in essentially the same manner as enterprises in other economies. This objective is not itself unique and indeed is compatible with the mixed economy (or "middle way") approach embraced by several western European countries during the first half of the post-war era, and by several central European countries during the 1970s and 1980s. As in other transition economies, creation of a market economy is seen as less of an end in itself than a necessary means toward realising the country's full potential for growth and development in a manner consistent with its social objectives. These two closely related objectives, the creation of a market based economy and realisation of growth potential, are the benchmarks against which progress on enterprise reforms must ultimately be measured.

Market forces are already well established

The move toward a market-based economy is already far along. Most product prices, and to a lesser extent wages, are free to vary with market conditions.³ Competition is strong in many although not all industries. The economic behaviour of enterprises has become increasingly responsive to market forces as a result of competition, the growth of non-state enterprises, and management reforms to SOE carried out in the 1980s (Naughton, 1994). The main tasks remaining are to convert state enterprises into modern commercial entities, restructure and reorganise the enterprise sectors, develop financial, legal, and other institutions necessary to the functioning of a market economy, and to complete the opening of the domestic economy to international markets.

Conditioning factors: continued public ownership...

Economic reform in China is shaped by several distinctive characteristics, reflecting policy-imposed constraints and other special characteristics of the economy, that need to be taken into account in drawing conclusions about the process. The first characteristic reflects the fundamental policy choice that significant public ownership and control of industry will be retained. This choice partly explains why enterprise reforms have been so heavily focused on SOE. Although often viewed as necessary for economic development in its earlier stages, public ownership in China is also seen as necessary to preserve social equity and other values; in that sense it is an objective (or constraint) and not simply a means of reform. These values are also reflected in some remaining ambivalence about the appropriateness of wide-scale private ownership of industry and a preference for collective ownership forms in the non-state sector. However, the scope of public ownership has been substantially narrowed in recent years while the scope for private ownership has been widened.⁴

... gradual and evolutionary change...

A second factor conditioning the reform process is gradualism: economic reform has been underway for nearly two decades and under current plans will continue for at least the next decade.⁵ The choice of gradualism reflects official belief that very rapid reforms in an economy as vast as China are prone to go off track and produce socially unacceptable disruptions.⁶ The need to avoid socially unacceptable disruptions also conditions reforms in other ways, although it is recognised that reform inevitably entails painful

adjustments for some segments of the economy and that reform's benefits will be unevenly distributed for some time.⁷ Gradualism in reform has also been an evolutionary process rather than derived from a single comprehensive “master” plan. The goals of reform and the modalities for achieving them have broadened progressively over time. Finally, gradualism has not been a smooth process in which all reforms proceed at the same pace. Rather it has been marked by periodic “leaps”, such as the freeing of agricultural prices at the beginning of reforms and the creation of special economic zones in the late 1980s, that have fundamentally altered the forces shaping the economy's development. Presently, the severe problems of much of the enterprise sector, the growing strains on fiscal resources, and the prospect of WTO entry mean that fairly rapid progress on a wide range of reforms is necessary if the overall reform process is to be sustained.

Apart from these constraints, the economic reform process is strongly conditioned by several features of the economic policy process itself. Particularly important is the relatively low level of government revenues,⁸ which is partly a result of past reforms and partly a reflection of structural problems current reforms are trying to address (see Box I.1). As will be seen repeatedly in the subsequent chapters, limits on government revenues constrain both the pace of reforms, the specific options available to implement them, and the immediate benefits enterprises derive from the reforms. Limited government revenues magnify existing distortions in taxation, as a number of key reforms impose implicit taxes on successful SOE to support financially weaker enterprises.

Also important is the substantial decentralisation in the implementation of reforms, and many other economic decisions, to provincial and other local authorities. Most state-owned enterprises are controlled by provincial and urban authorities, while local governments have (at least) a major role in township and village enterprises (Naughton, 1994; Che and Qian, 1998). Provincial and local authorities, while subject to central government decisions about the overall parameters of individual reforms, typically have significant latitude in determining how they will be carried out. This decentralisation complicates the task of assessing the progress of economic reforms in China, since much of what is happening at provincial and local levels is not systematically compiled or reported.⁹ This regionalism in policy implementation has had both adverse and beneficial effects on China's overall reform process. Responding to soft budget constraints and regional barriers to competition, regional authorities were instrumental in the early 1990s investment boom that has been the source of many of the present problems of China's enterprises. At the same time, regional authorities have strong incentives to promote development of their regions since their advancement depends to an important degree on its success. The result has been a growing regional dynamic in the overall reform process that is likely to become increasingly important in coming years.¹⁰

... scarce government revenues...

... and regional decentralisation

Reform schematic

The process of reforming China's enterprises involves many individual measures in a wide range of areas. The basic strategy is to improve enterprise financial performances in the near term in order to generate resources to upgrade productive facilities and other key capabilities; with the ultimate

Success depends on virtuous circle of reforms

Box I.1. Fiscal constraints on economic reforms

Three weaknesses in China's fiscal systems contribute to enterprise performance problems and impede progress on reforms. The first is the relatively low level of total revenues in relation to GNP. Explicit tax revenues of central and local government are now about 12 per cent of GDP, less than half the ratio for countries at a comparable stage of development, such as India and Brazil. Extra-budgetary revenues, derived from various fees and charges and typically earmarked for specific purposes, raise the revenue total to about 18 per cent of GDP – but this is still quite low by international standards. The current low level of revenues represents the culmination of a secular decline in the ratio of revenues to GDP since the early 1980s and is due mainly to the shrinking economic share of SOE, whose activities have been the primary tax base for the government. Scarcity of government revenues is a major limit on the ability to socialise burdens, such as excess labour, that have been imposed on individual public enterprises. The use of bank lending to subsidise enterprise losses and for other quasi-fiscal purposes, which is a major source of the current high debt burdens of enterprises as well as the non-performing loans of the banking sector, is also traceable largely to the scarcity of explicit government revenues.

Revenue scarcity is further compounded by antiquated and inadequate mechanisms for allocating revenues to the areas where they are most needed. Due in part to the reliance on SOE, the central government share of total revenues is relatively low while that of provincial and local governments is comparatively high. However, central government mandates imposed on local governments more than make up for their apparently high share of revenues. In particular, local governments typically bear the cost of enterprise reform programs imposed by the central government. This, together with the low central government share and the limited mechanisms for transferring funds among regions, has severely impaired the ability of weaker regions to implement economic reforms.

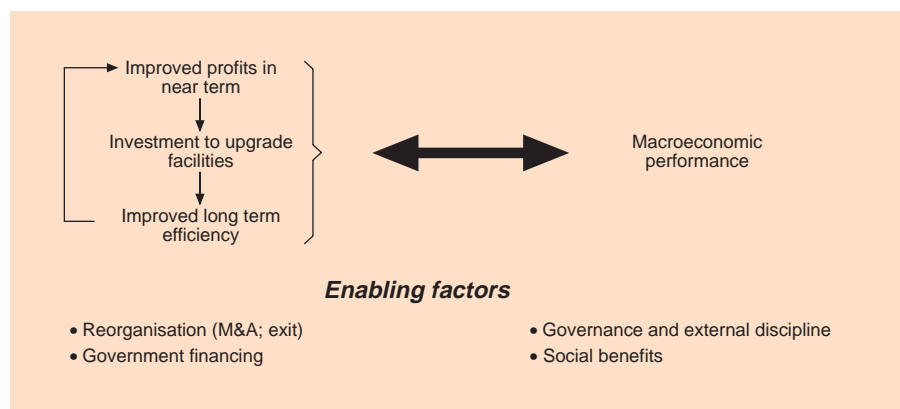
A third weakness is the relatively narrow effective tax base together with the unevenness of tax burdens across various types of enterprises. The bulk of tax revenues come from direct product taxes (value-added and sales) and from corporate income taxes. Personal income taxes are still quite limited, in part because of weak reporting and enforcement, while payroll taxes to finance social benefits are low and coverage is limited. Although all enterprises are equally subject to the business taxes in principle, in practice, exemptions granted to non-state enterprises (particularly foreign-funded enterprises), and inefficiencies in collection and tax evasion leave most of the burden with SOE. Effective tax rates on SOE are more than twice as great as those on collectives and an even higher multiple of those borne by foreign-funded enterprises. Tax forgiveness or non-payment by loss-making SOE, together with the tendency of local governments to shift some of their own burden for financing of reforms, impose a disproportionate share of the overall SOE tax burden on profit-making SOE. The overall result has been to distort after-tax returns to investment, reduce the competitiveness of SOE relative to non-state enterprises, and to spread the weaknesses of loss-makers to financially stronger but not necessarily completely healthy enterprises.

Particularly given the high savings rate and rapid growth, the low level of government revenue in China is not so much a reflection of a scarcity of financial resources in society as a whole as of antiquated mechanisms and distortions in the fiscal system derived from the past central planning era. Many of the problems were addressed by the major tax reform of 1994, which defined responsibilities for collecting the main taxes and their allocation among various levels of government. In principal, the reforms were intended to raise overall revenues as well as the central government's share, impose uniform tax rates on enterprises regardless of their type, and broaden the scope of the individual income tax. In practice, there has been little increase in total and central government revenues in relation to GDP and tax disparities among various types of enterprises remain still quite substantial, due in large part to weaknesses in tax collection and compliance and extensive exemptions and other loopholes. Improvements in these areas are expected to lead to a gradual increase in revenues over time and to a more even tax treatment of enterprises. However, further changes to broaden the tax base are likely to be necessary as reforms to social benefit programs progress.

Fiscal limitations also pose a potential future risk to the reform process. By official measures, the budget deficit and public debt to GDP ratios, although increasing, are still low by international standards. However, more realistic measures incorporating outlays that are now made through bank lending and future obligations are substantially higher. The relatively low level of revenues makes it more difficult to sustain public debt levels at moderate levels. Thus while not presently a problem, fiscal sustainability could become a more serious constraint if current enterprise reform efforts falter and structural problems worsen further.

goal of achieving sustained improvement in efficiency and competitive viability in the long term (Figure I.2). These measures are highly interdependent and success depends ultimately on sustaining a positive dynamic, or “virtuous circle”, of mutually reinforcing progress on a wide range of reforms. As indicated

Figure I.2. Dynamic of sustainable reform



below, this dynamic involves key “enabling” factors, such as improvements in corporate governance to ensure that enterprises make effective use of increased profits. Success also requires a positive dynamic between the reform process and the growth of the economy as a whole. Adequate real growth is needed to ensure the success of measures to boost enterprise profitability, as well as to allow the economy to absorb workers displaced in the course of reforms. At the same time, progress on the reforms is necessary to contain and ultimately reduce the deflationary forces generated by the structural problems of enterprises.

For the discussion that follows, it is helpful to consider the individual reforms in terms of three basic objectives, as summarised in Figure I.3. The first is to *improve performances* of enterprises so that they are technically capable of competing in a market environment. Policies to improve performances are largely focused on problems that have accumulated over time because of remaining distortions in the economy. There are two related components to these efforts. The first is economic restructuring to bolster financial conditions in the medium term and to improve efficiency over the longer term. The second is reorganisation of the SOE sector so that it is viable on its own and can serve as the “core” of China’s efforts to secure the international competitiveness of its key industries. The effort to improve enterprise performances has become perhaps the most pressing element of reform in the near term, in part because it is most necessary to reviving growth, facilitating China’s adjustment to WTO entry, and freeing up government resources so that they can support other areas of reform. However reforms that are fundamental in the longer term, such as better corporate governance, are unlikely to succeed until enterprises are technically capable of competing in a market environment.

Reforms encompass measures to raise near-term performances...

The second key objective of enterprise reforms is to improve *enterprise behaviour* to ensure that enterprises respond appropriately to market forces. These reforms are necessary to ensure that near term improvements in enterprise financial performances lead to greater efficiency in the long term, and to prevent problems that have impaired financial performances (many of which stem from past distortions in enterprise behaviour) from recurring. Two sets of measures are most critical in this respect. The first are policies to establish

... improve enterprise behaviour

Figure I.3. Schematic of the enterprise reform process

Major objectives	Primary focus	Key tasks
Improving performances (Ensuring enterprises are capable of competing in the market)		
Economic restructuring	SOE	Improve profitability by reducing excess capacity; shedding surplus labour; lowering debt loads; and upgrading productive capacity. Facilitate business reorganisations to reduce industry excess capacity and improve economies of scale and scope; release resources by promoting exit of unviable firms.
Reorganisation of the SOE sector	SOE	Establish the "strategic core" where SOE will be concentrated while facilitating the withdrawal of state ownership and control from other "competitive" industries where state intervention is not needed.
Improving behaviour (Ensuring enterprises respond appropriately to market forces)		
Establish effective corporate governance mechanisms	SOE	Establish modern ownership forms ("corporatisation"); clarify ownership and control rights; separate government from enterprise management; establish effective oversight mechanisms for enterprise owners.
Financial system reform	Financial system	Provide adequate financing outlets for non-state as well as state enterprise sectors; establish credit allocation on commercial standards and exert financial discipline; provide mechanisms to transfer ownership and provide a market for corporate control.
Supporting institutions and infrastructure (Ensuring compatibility between commercial objectives and social needs)		
Social Security reform	Workers	Reduce SOE burdens for social security; establish "portable" pension and other benefit systems to improve the functioning of labour markets.
Legal and regulatory reforms	Enterprises	Clarify property rights; strengthen enforcement of contractual obligations.
Fiscal reforms	Enterprises and society	Reduce tax disparities among enterprises; increase and broaden revenue resources needed to facilitate adjustments caused by reforms and to socialise certain burdens now borne by enterprises.

mechanisms for effective *corporate governance* by transforming ownership structures, clarifying and strengthening property rights, separating enterprise management from government operations, and providing internal incentives and oversight mechanisms so that management acts in the interest of owners. The key priority in this area is to meet a challenge many OECD countries have faced and in some cases continue to face: namely to ensure effective governance of state-owned enterprises. However, there are also governance issues concerning the non-state sector. The second set of measures are *financial system reforms* to ensure that credit is allocated to enterprises on the basis of sound commercial principals, rather than on the basis of government mandates or other social considerations, as has been the case in the past. Reforms to develop and broaden the financial system are also necessary to accommodate the development of the non-state enterprise sectors as well as to facilitate the ongoing restructuring that is likely to be needed as the economy

evolves. As historical experience, including that of China, has amply demonstrated, good corporate governance mechanisms will not prevent enterprises from engaging in economically inefficient or disruptive behaviour if they are faced with distorted financial incentives.

The third set of reform objectives involve the *supporting institutions and infrastructure* needed to allow enterprises to pursue their commercial objectives in a manner consistent with the overall objectives of society. These include ongoing efforts to level the playing field among various types of enterprises and to provide for the enforcement of contractual obligations that are needed to support reforms to corporate governance and the external environment. A major present priority is *social security reforms* to socialise as well as broaden the quasi-governmental social welfare functions that have largely been provided by state-owned enterprises. Policies in this area involve restructuring, consolidation, and, in some cases, creation of systems to provide health services, pensions, and unemployment insurance and to establish economically efficient arrangements for their financing. Although their discussion is beyond the scope of this study, efforts to reform the tax system and to increase revenue resources are also ultimately critical to the success of the overall enterprise reform effort.

... and provide supporting institutions and infrastructure

Finally, the complexity of enterprise reforms, particularly their multidimensional character, makes it difficult to arrive at any precise overall assessment as to the degree of overall progress. However, the analysis in this study does underscore a fundamental message: the enterprise reform process is now at a critical juncture. As emphasised in the coming chapters, this message has three aspects.

The overall message: reforms are at a critical juncture

- *Significant progress is being made in a wide range of areas essential to the ultimate success of the reform effort.* Within the constraints set by present social objectives and despite some limitations, the official plans for reform, if fully and effectively implemented, offer a good prospect of substantially improving the performance of the economy over the long term.
- *But much more remains to be done and success in the overall reform effort is not yet assured.* Implementation of reforms already planned or officially endorsed comprise much of this unfinished agenda; but the remaining steps in some cases are likely to prove more difficult than those undertaken so far.
- *Furthermore, the next several years will be crucial: there needs to be fairly rapid progress in key areas if the reform process is to be sustained and the gains that have been made preserved.* Rapid progress is necessary because of the very serious financial problems enterprises are now facing and their adverse impact on aggregate real growth; growing demands on scarce fiscal resources; the need to break through the “vicious circle” of enterprise and banking sector financial problems; and the imperatives flowing from WTO entry. Together these considerations mean that another major leap is needed to sustain the reform process and assure its ultimate success.

II. THE CURRENT SITUATION OF CHINA'S ENTERPRISE SECTORS

China's economy has become increasingly diversified over the past two decades as the importance of state-owned enterprises has progressively declined. Non-state enterprises now account for nearly three-quarters of industrial output and have been the dominant contributors to overall economic growth and the main source of new jobs during the past ten years.

The financial performances of enterprises have deteriorated markedly in recent years. The majority of SOE are at best marginally profitable and a large portion of collective enterprises are also in serious financial difficulties. The poor financial performances are attributable to a range of factors. These include excess capacity built up during the investment boom earlier in the 1990s; and heavy financial burdens from high debt loads, surplus labour, and social welfare expenses normally borne by government or society at large in other countries. SOE as well as large numbers of non-state enterprises are also suffering from extensive operating inefficiencies due to sub-optimal scale and scope in their operations, outmoded equipment and technology, and poor product quality.

China's enterprise sectors include four main ownership classes: state-owned enterprises (SOE); collectives, comprising township and village enterprises (TVE) in rural areas and urban co-operatives; foreign-funded enterprises; and individually owned or other private enterprises (Box II.1). The oldest class, SOE, are confined to urban areas. These enterprises are still mainly wholly government owned and subject to the direction of government agencies, although these situations are changing. The majority of large SOE are controlled by central government authorities, while nearly all medium - size and smaller SOE are under the control of municipal or other local authorities. Collectives are usually legally owned by their workers and/or management, but in practice local governments often have a controlling or at least major role in their management (Che and Qian, 1998; Chang and Wang, 1995). However, many of these enterprises are effectively privately owned but registered as collectives ("red hats"; see IFC, 2000). Production of collectives is heavily concentrated in consumer and, to a lesser extent, export products. SOE and collectives together make up the public enterprise sector.

There are four major ownership groups

Foreign-funded enterprises refer to businesses wholly or partially owned by residents outside of the mainland of the PRC, including those funded by residents of Hong Kong, China; Macao, China; and Chinese Taipei. These enterprises are heavily specialised in export production. Domestic private enterprises are typically quite small.¹¹ Only the foreign-funded and private domestic enterprises have ownership forms similar to those prevailing in OECD countries. Together the two classes can be regarded as comprising China's private sector.

Foreign-funded firms specialise in exports

As indicated in Table II.1, SOE contributed 28 per cent of total industrial output in 1998, while collective enterprises, which are dominated in output terms by TVE, contributed nearly 38 per cent of the total.¹² The SOE share of industrial output has declined steadily throughout the reform period (Figure II.1A), giving way during the 1980s to the rapidly growing TVE; and during the 1990s to the even more explosive growth of

The SOE share of industry output has fallen...

Box II.1. Categories of enterprises in China

Since the economic reform started, China has developed a highly diversified and complicated enterprise sector. In general, enterprises can be classified according to two basic criteria: by ownership and by legal form. This box provides a brief description of the definitional categories of enterprises according to these two criteria

Categories by ownership

State-owned enterprises (SOE). Although the oldest ownership form, SOE existed without a legal basis until 1988. The legal basis was established in 1988 with the promulgation of the *Law on Enterprises Owned by the Whole People*, which defined an SOE as a legal person with the state as the sole (or majority) owner. Its liability is limited to the amount of assets authorised by the state.

Collectively-owned enterprises (COE). The COE are subject to the *Law on Collectively-Owned Enterprises* (1991). A COE is defined as a legal person with assets owned by workers and other economic entities.

Private enterprises. Although their existence and growth were allowed after 1978, the legal status of private firms was not established until 1988, when the National People's Congress passed an amendment to the Constitution of the PRC recognising their positive role in the national economy and promulgated the *Provisional Regulations on Private Enterprises*. The regulations defined private enterprises as economic entities with eight or more employees and whose assets are owned by individuals. The regulations further distinguished between three types of private enterprises: 1) *individually-funded enterprises* funded and managed by one person; 2) *partnerships* funded and managed, and profits shared and losses borne jointly, by two or more persons under a legal contractual agreement; and 3) *limited liability companies* in which the liability of investors to the company is limited to their respective contributions and the company's liabilities are limited to the extent of its assets.

Foreign enterprises. Foreign enterprises include joint ventures, sino-foreign co-operation enterprises and wholly foreign-owned enterprises. Each of the three types of enterprises is subject to a separate set of laws. Where these foreign enterprises are incorporated as limited liability companies or limited joint-stock companies, they are also subject to the Company Law (see below).

Legal forms

Prior to 1994, limited liability corporate legal forms of the type dominant in other market economies were largely unavailable to Chinese domestic enterprises. This situation was changed by the Company Law enacted in 1994, which provided for the establishment of limited liability companies (LLC) and limited joint-stock companies (JSC). Both types are defined as enterprise legal persons and shareholders enjoy limited liability.

Limited liability companies (LLC). In a LLC, shareholders are liable towards the company to the extent of their respective capital contribution, and the company is liable for its debts to the extent of all its assets. A LLC is established by capital contributions made jointly by between two and fifty shareholders, with the registered capital not less than 100 000 yuan for consultancy and services companies, not less than 300 000 yuan for retailing companies and not less than 500 000 yuan for manufacturing or wholesale trade companies.

A wholly state-owned company (SOC) is a special kind of LLC. SOC are essentially SOE in the guise of a modern corporation – subject to the Company Law rather than to the Enterprise Law. The SOC can be established only by an organisation, institution or department explicitly authorised by the state to make state-approved investments. This corporate form applies mainly to companies engaged in special lines of production or trade, such as infrastructure and other strategic industries, specifically designated by the State Council.

Limited joint-stock or share-holding companies (JSC). Ownership of JSC is divided into shares of equal value, with the shareholders liable towards the company to the extent of their respective shareholdings and the company liable for debts to the extent of all its assets. Normally, the establishment of a JSC requires a minimum of five “promoters” (founding shareholders). However the law permits a single promoter when that promoter is an SOE.

The LLC and JSC forms are available to non-state enterprises that were formed under the earlier laws based on ownership described above. Many COE are being converted into a hybrid form, known as “joint-stock collectives” in which ownership shares are distributed to workers and other stakeholders, but where the shares generally cannot be held by outsiders.

Source: Lin (2000).

Table II.1. Ownership profile of Chinese industry, 1998

	Number of firms (thousands)	Gross industrial output (billion yuan)	Share of industrial output (%)	Share of fixed investment (%)	Output/firm (billion yuan)
Total	7 975	11 905	100	100	1.5
SOE ¹	65	3 362	28	54	52.0
Collectives	1 798	4 573	38	15	2.5
Foreign-funded enterprises ²	63	1 775	15	} 31	28.4
All others ³	6 050	2 195	18		
<i>Memorandum:</i>					
Share of output value (%)					
	Construction	Wholesale and retail trade (sales)			
SOE	50	48			
Collectives	43	21			
All others	7	31			

1. Including share-holding companies in which the state holds the controlling share.

2. Including enterprises funded from Hong Kong, China; Macao, China; and Chinese Taipei.

3. Including individually owned or privately owned firms and share-holding companies in which the state does not hold the controlling share.

Source: *China Statistical Yearbook*, 1999, Table 13.1.

foreign-funded and private enterprises. Thus from an aggregate point of view, SOE in no sense dominate the industrial economy, although they are much more important in wholesale and retail trade, and do dominate transportation, utilities, finance, and education.

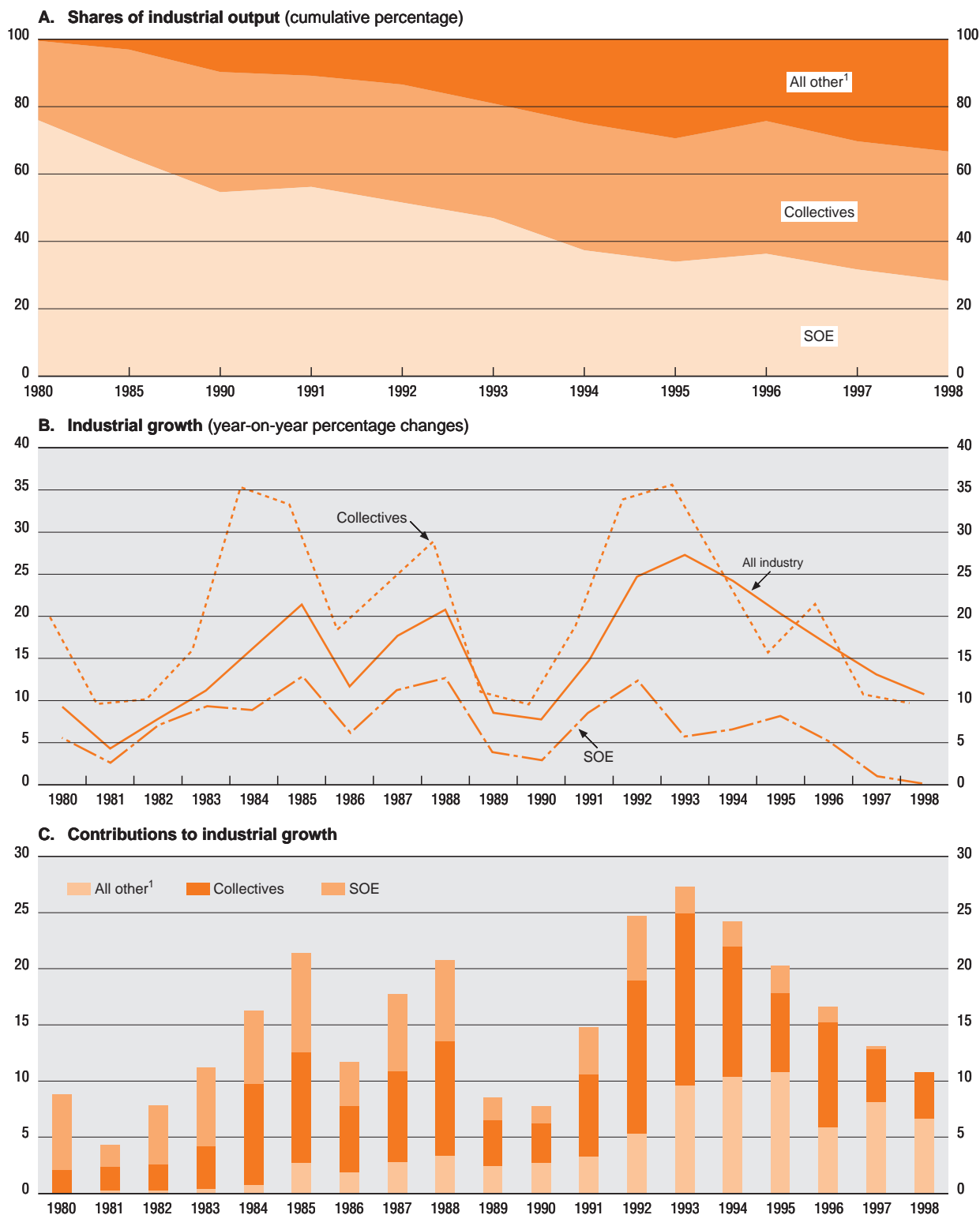
In several key respects, though, the importance of the SOE sector in the economy is greater than its aggregate share of industrial output indicates. First, SOE account for nearly half of total urban employment (Table II.2). Second, SOE dominate output of large enterprises and their share of heavy industry is also considerably higher than that of industry as a whole. Partly because of their concentration in heavy industry, the SOE shares of industry fixed assets and investment¹³ are significantly greater than their share of output. Third, the SOE share of industrial output is well above the national average in the majority of Chinese provinces (Table II.3). SOE shares are lowest in the coastal provinces. These provinces have been the most rapidly growing regions; and have the largest share of overall industrial output. TVE and other non-state enterprises have generally received the most favourable treatment from local governments in the coastal provinces.¹⁴ Finally, partly because of their past historical dominance but also because authorities have given more favourable tax treatment to non-state enterprises, SOE supply the largest share of tax revenues coming from the enterprise sectors.

From the perspective of their contribution to growth in aggregate output and employment, however, SOE have been even less prominent than their share of total output would suggest. Real growth of SOE output has consistently lagged that of collective enterprises since the early 1980s (see Figure II.1B) and since 1990 has been the slowest among the four major ownership classes. Collectives have been the largest contributors to overall industrial sector growth for most of the period since 1985 (Figure II.1C), although they have been nearly overtaken in this respect in recent years by the private enterprise group. The decline in the contribution of SOE to

... but SOE still dominate investment and urban employment

Output and employment growth have come mainly from non-state enterprises

Figure II.1. Industrial output



Note: Figures refer to gross industrial output of all industrial enterprises, with or without independent accounting systems.

1. Other firms include private and foreign-funded industrial enterprises.

Source: China Statistical Yearbook, 1999, Tables 13.3 and 13.4.

Table II.2. **Employment by type of ownership, 1998**

	Total employment (in millions)	Per cent of total
Urban employment – Total	206.8	100
SOE	90.6	43.8
Urban collectives	19.6	9.5
Private and individually owned	32.3	15.6
All others	64.3	31.1
Rural employment – Total	492.8	100
TVE	125.4	25.4
Private and individually owned	46.0	9.3
All others	321.4	65.2

Source: *China Statistical Yearbook*, 1999, Table 5.4.

Table II.3. **SOE shares of industrial output by region and province, 1997**

Region	Province	SOE share of gross industrial output (per cent)
	National total	25.5
Coastal	Beijing	49.4
	Fujian	11.2
	Guangdong	12.7
	Guangxi	27.9
	Hainan	35.3
	Hebei	23.2
	Jiangsu	17.7
	Shandong	25.2
	Shanghai	29.2
	Tianjin	22.4
Zhejiang	9.4	
Central	Anhui	19.8
	Guizhou	56.0
	Henan	27.6
	Hubei	24.1
	Hunan	24.8
	Inner Mongolia	43.2
	Jiangxi	41.0
	Shaanxi	51.2
	Shanxi	32.0
Northeastern	Heilongjiang	54.3
	Jilin	59.5
	Liaoning	31.4
Western	Chongqing	40.9
	Gansu	54.1
	Ningxia	59.2
	Qinghai	72.8
	Sichuan	33.4
	Tibet	66.3
	Xinjiang	75.3
	Yunnan	54.5

Note: Figures refer to industrial enterprises at the township level or above.

Source: *China Statistical Yearbook*, 1998, Table 13.6.

employment is even more stark. SOE accounted for nearly 35 per cent of the total growth in urban employment between 1985 and 1990, but less than 20 per cent of the overall increase between 1990 and 1997. SOE employment virtually stagnated between 1994 and 1996 and fell by nearly three million in the

subsequent two years. With employment in urban collectives also on the decline, the private enterprise sector is supplying virtually all of the net growth in jobs that is occurring in the urban economy. TVE together with private enterprises are also the main source of employment growth in rural areas.

Government policy has encouraged growth of non-state enterprises...

The rapid growth of non-state enterprises is partly the result of deliberate government policies to encourage their development. Beginning in the early 1980s, TVE were largely detached from central planning requirements and their growth was promoted by local authorities in order to bolster rural employment and to provide revenues to local governments. The creation of special economic zones (SEZ) in the late 1980s and relaxation of restrictions on foreign investment has fostered the rapid growth of foreign funded enterprises. Legal changes sanctioning the growth of private ownership have been essential to the development of private enterprises. However, other government policies, notably those governing access to bank financing and financial support from government agencies, have favoured SOE over non-state enterprises. The ultimate success of non-state enterprise derives from their more effective economic performances. In particular, the growth rate of productivity of collective enterprises has been higher than that of SOE.¹⁵ This economic success is attributable in large part to the relative freedom of non-state enterprises from government interference in their management and their harder budget constraints (Che and Qian, 1998).

... but distinctions between state and non-state enterprises are blurring...

While important, the distinctions among the various ownership classes are not as clear cut as is sometimes supposed. This is particularly true of TVE and SOE. While their performance and behaviour is often contrasted, in practice their relations are partly complementary and partly competitive. In particular, SOE have fostered the growth of TVE as a means of getting around central planning constraints and to lower costs. TVE and other collectives serve as suppliers to SOE or provide other complementary productive facilities, while SOE often provide financing for TVE operations. Moreover, as discussed further in later chapters, distinctions among the ownership types are becoming even more blurred with economic reforms, with both TVE and many SOE moving toward forms that more closely resemble private ownership.

... and many non-state enterprises also now have serious problems

The past ability of the non-state sector to flourish largely on its own partly explains why it so far has been given only limited emphasis in enterprise reform plans. However, as noted below, many non-state enterprises are now experiencing serious economic performance problems.

Deteriorating enterprise financial performances

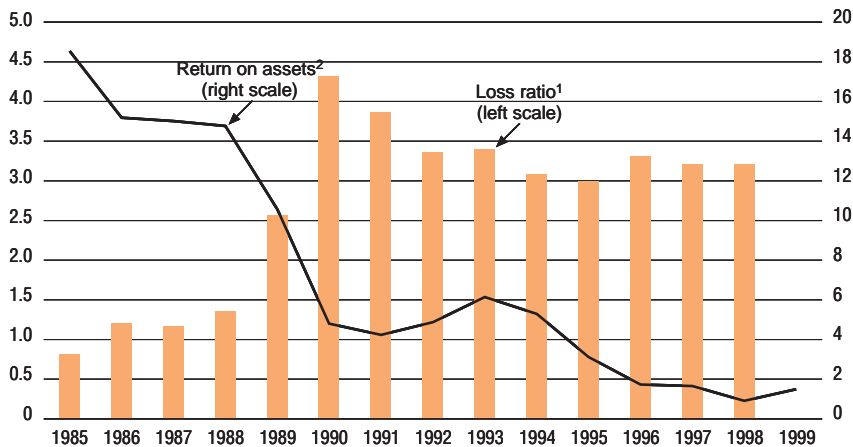
SOE are facing serious financial problems

As is well known, SOE are facing very serious problems in their economic and financial performances. Detailed examination of available data on enterprise performances through 1998 amply confirms this impression, but also reveals weaknesses in other sectors of industry, notably among collectives.

Profit rates have been declining since the 1980s...

A first observation is that profit rates of SOE along with much of the non-state sector have been declining since the early 1980s (Figure II.2). The SOE after-tax profit rate (relative to fixed assets) was nearly 18 per cent in 1985 but had fallen to below five per cent by 1990 – a level more typical of that found in OECD countries. This secular decline is substantially attributable to the

Figure II.2. **Losses and profits of SOE**
In percentage



Note: Figures refer to all industrial SOE with independent accounting systems.

1. Loss ratio: total losses of loss-making firms divided by net fixed assets.

2. Return on assets: after-tax profits (before deduction of corporate income tax) divided by net fixed assets.

Figure for 1999 is an estimate based on partial data.

Source: China Statistical Yearbook, 1998, 1999.

increasing competition engendered by the entry of non-state firms. Initially, SOE and the new entrants, which were primarily TVE, enjoyed substantial monopoly rents that were progressively eroded over time as competition intensified and as constraints on prices were relaxed (see Jefferson and Rawski, 1994a; Naughton, 1994). SOE and TVE profitability have come under further pressure from the rapid growth during the 1990s of foreign-funded and domestic private firms. However, it has been SOE that have been most severely affected by increasing competition.¹⁶

Profit rates continued to decline throughout the 1990s and have now reached very low levels. The SOE after-tax profit ratio to fixed assets fell to 1.7 per cent in 1996-1997, and then dropped further to about 0.9 per cent in 1998,¹⁷ although there was some rebound in 1999. The after-tax profit rate of collective enterprises has also fallen but it remains higher than that of SOE. These profit ratios are low, at least in after-tax terms, compared to OECD countries, and particularly low given that China is a rapidly developing country.¹⁸ These low profit rates suggest serious structural problems in SOE performances.

Other indicators of SOE performance have also deteriorated over time. Total losses of loss-making SOE rose sharply during the latter half of the 1990s and reached their peak in relation to output in 1990 (Figure II.2); the ratio then fell through 1995, but has since risen back. SOE losses now account for about half the losses of all industrial firms but are only slightly more than 1 per cent of GDP.¹⁹ The ratio of total liabilities to assets for SOE increased from a fairly low level in the early 1980s to reach a peak of nearly 70 per cent in the mid-1990s, although it has since fallen back somewhat. The current average ratio (62.4 per cent) corresponds to a debt-equity ratio of nearly two and is high compared to those of most OECD countries, although not out of

... and are now quite low

Other financial indicators have deteriorated...

line with the ratios in Korea, Thailand, and a number of other Asian countries. Moreover, a substantial fraction of SOE as well as collectives have liability-asset ratios of 70 per cent or more. Nearly 10 per cent of all enterprises, and a greater portion of SOE, have ratios above 100 per cent, indicating that equity is technically negative.

... particularly the incidence of loss-makers

The deterioration in SOE performance appears particularly stark when viewed in terms of the incidence of loss-making firms. The proportion of industrial SOE incurring (after-tax losses) has risen from 31 per cent in 1994 to 42 per cent in 1997 and nearly 50 per cent in 1998 (Figure II.3).²⁰ Although a substantial number of enterprises in even very strong economies incur losses from time to time,²¹ the loss ratio for China's enterprises is quite high compared to most OECD countries.

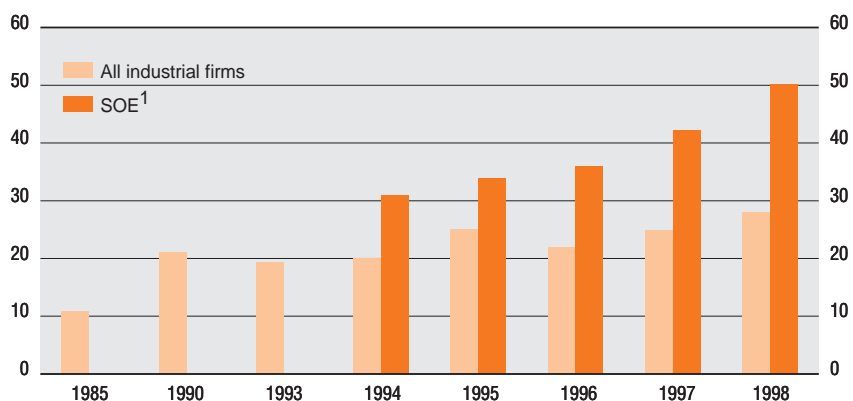
Conditions of non-state firms have also worsened

SOE are not alone in experiencing weak financial performances. As noted earlier, profit rates for collective enterprises as whole are also low by international standards. A high proportion of collective firms are also experiencing losses, although the fraction is only about half that of SOE. Urban collectives, however, appear to be doing significantly worse than the group as a whole (World Bank, 1999). Liability-asset ratios are higher for collectives than for the SOE (see Table A1 of the Annex to this study). Furthermore, the profitability of foreign-funded enterprises, while it has been substantially higher than that of the other segments, has fallen markedly: from 15 per cent of assets in 1995 to 4 per cent in 1996-1997 (World Bank, 1999).

The majority of SOE are at best marginally profitable

The pattern of declining profits and increasing incidence of losses for SOE as well as much of the non-state sector suggests a more general characterisation: a large proportion of all enterprises, including the majority of SOE, are at best marginally profitable. That is, in addition to those making losses, a further significant portion of firms are making only small profits.

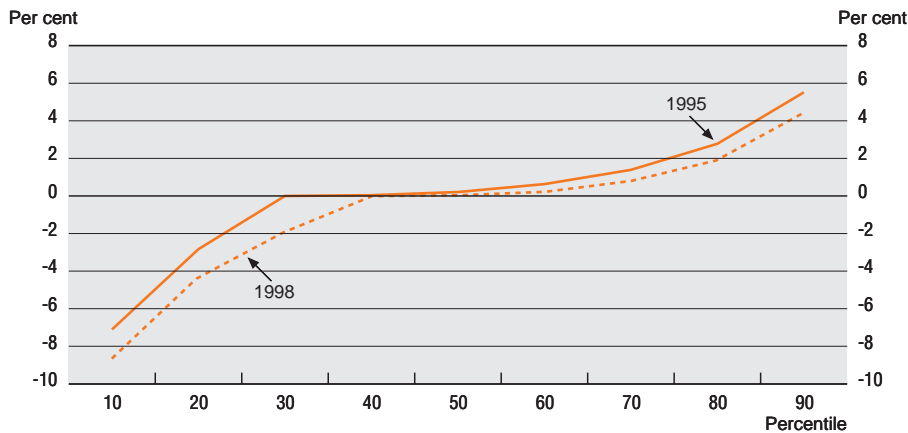
Figure II.3. Incidence of firm losses
Per cent of all firms



1. Comparable figures for SOE before 1994 were not available.

Source: China Industrial Statistical Yearbook, various issues; World Bank, 1999; OECD estimates.

Figure II.4. **Distribution of after-tax profit rates¹**
Medium and large industrial enterprises



1. After-tax profit rates: after-tax return on total assets. After-tax profits are total profits net of sales value-added, corporate income and other business taxes.

Source: China National Bureau of Statistics and OECD calculations.

Such firms are vulnerable to becoming loss-making even in the face of fairly mild setbacks.

This impression is supported by results from a recent OECD statistical analysis with the assistance of the China National Bureau of Statistics (CNBS). The analysis is based on a panel data set on the financial conditions of roughly 20 000 large and medium-sized industrial enterprises of all ownership types for the years 1995 through 1998 compiled by the CNBS²² (some of the results of the study are summarised in the Annex to this study). As indicated in Figure II.4, the middle range of the distribution of after-tax profits (as a ratio of total assets and after deduction of corporate income as well as other taxes paid) of the full sample of enterprises is very close to zero. The situation for SOE (not shown) is similar but worse, in the sense that their mean return is below the average for the entire group of enterprises. As these observations suggest, the marked increase in the incidence of losses since 1995 is partly the result of the migration of marginally profitable firms into the red. However, while losses of many unprofitable enterprises are fairly modest, the majority are large in the sense that the firms are incurring losses even before payment of their sales and other business taxes.

Statistical analysis supports this impression

As discussed further in the Annex, financial problems are significantly worse for some industries and regions than others but they are also quite pervasive. The incidence of SOE losses is noticeably above the industry average in textiles (which is the single biggest loss-maker) as well as several heavy industries including steel. SOE financial performances are also typically worse for central and western provinces than for those along the coast. At the same time, a large number of industries and regions are experiencing low or negative profit rates. While the worst performing industries account for a disproportionate share of total SOE losses, a substantial fraction of the losses are in relatively better performing sectors. This indicates that measures to restore the financial health of SOE need to

Financial problems are pervasive

be broadly applied: concentration on only the worst performing industries or regions will not be sufficient by itself.

The figures need to be regarded cautiously

All of these figures must be regarded with great caution. In particular, there are reasons to believe that official statistics significantly exaggerate SOE profits and understate their losses (*e.g.* Lardy, 1998; Steinfeld, 1998). Under the cash-basis accounting standards employed in China and most other developing countries, interest due on loans to enterprises that goes unpaid is not included in the calculation of profits and losses. Since, judging by the reported level of non-performing loans in the banking system, unpaid interest is sizeable, the biases in the reported profit and loss figures could be quite large. However, there may be some partially offsetting biases in the data. Costs of goods produced are attributed to the year in which they are sold and so inventory accumulation in a period of high inflation tends to overstate profits (Hussain and Zhuang, 1996). This overstatement should be smaller when inflation is low, as it is now, and to this degree the fall in profits since the early 1990s may be somewhat exaggerated. Moreover, there are incentives for firm management to appropriate profits that would otherwise go to the state and to exaggerate losses to obtain tax forgiveness and soft loans from banks (Zhang, 1998; Hussain and Zhuang, 1996). The scope for such behaviour has probably increased as the result of reforms to increase management autonomy (World Bank, 1997*b*; and 1999).²³

Factors behind the worsening financial performances

Several factors are behind the poor financial performances

A number of factors, rather than any single explanation, account for the poor performances of SOE as well as the growing problems of many non-state enterprises. The following can be cited as the main proximate sources of these problems:

- cyclical developments;
- imbalances created during the early 1990s investment boom;
- high debt burdens;
- policy-imposed burdens on SOE;
- chronic inefficiencies in enterprise operations, particularly of SOE.

However, in many cases these proximate causes reflect more fundamental structural weaknesses in enterprise governance and external discipline.

Slowing real growth has contributed modestly

Cyclical developments, in particular the credit tightening in 1995-1996, the Asian crisis in 1997, and the resulting slowdown in economic growth have contributed to the decline in profit rates throughout industry. However, the impact on SOE has probably been modest, particularly given that the growth slowdown has been comparatively mild. Moreover, the downturn has been most pronounced for exports – due to the sharp fall in regional demand produced by the Asian crisis. This has led to a sharp reduction in profit rates for foreign-funded enterprises, but SOE should have been less affected.²⁴ The current growth slowdown does not explain why SOE profit rates were higher at the trough of the much sharper cyclical downturn in 1989-1990. Nor does it explain why those profit rates were falling through the first half of the 1990s, when real growth was considerably higher than now.

Imbalances created during the 1993-1996 investment boom very likely have been important contributors to the low profit rates throughout Chinese industry over the past several years. The boom left many industries with capacity utilisation rates of 50 per cent or below and large overhangs of excess inventories that in turn have contributed to declining prices in much of the industrial sector since 1997. Although the overall impact is difficult to assess, the problems now being experienced by other Asian countries that underwent similar investment booms earlier in this decade suggest that the imbalances in China have been a major factor depressing current profits.²⁵ Over-investment in China and the resulting excess capacity are more fundamentally traceable to weaknesses in corporate governance and in external financial discipline. As in a number of Asian countries, the widespread availability of soft bank loans at virtually zero or negative real interest rates faced firms with a virtually zero cost of capital and resulted in strong incentives to maximise revenue by expanding capacity. In China, these incentives were reinforced by local government revenue needs and the policy imperative to maintain employment levels. The effects of the perverse external incentives were magnified by weaknesses in enterprise governance and management. Indeed, reforms undertaken beginning in the late 1980s probably made the situation worse by giving management greater autonomy to respond to the perverse incentives.²⁶

Excess capacity is more important

The 1993-1996 investment boom also further aggravated the longer-term build-up in enterprise debt levels underway since the 1980s. High debt loads help to explain the large proportion of SOE that seem to be at best marginally profitable.²⁷ Debt service charges in 1999 averaged 4 per cent of total sales for SOE.²⁸ However the burdens are considerably higher for loss-making or marginally profitable enterprises. Nearly one-fifth of large and medium-sized SOE have debt-service burdens exceeding 10 per cent of their sales (Figure II.5).²⁹ The high debt levels and their secular rise are largely due to the use of bank lending to make up for enterprise operating losses and other non-commercial objectives (practices partly attributable to the scarcity of government revenues for such purposes), and to the lack of alternatives to bank credit.

Debt burdens are heavy

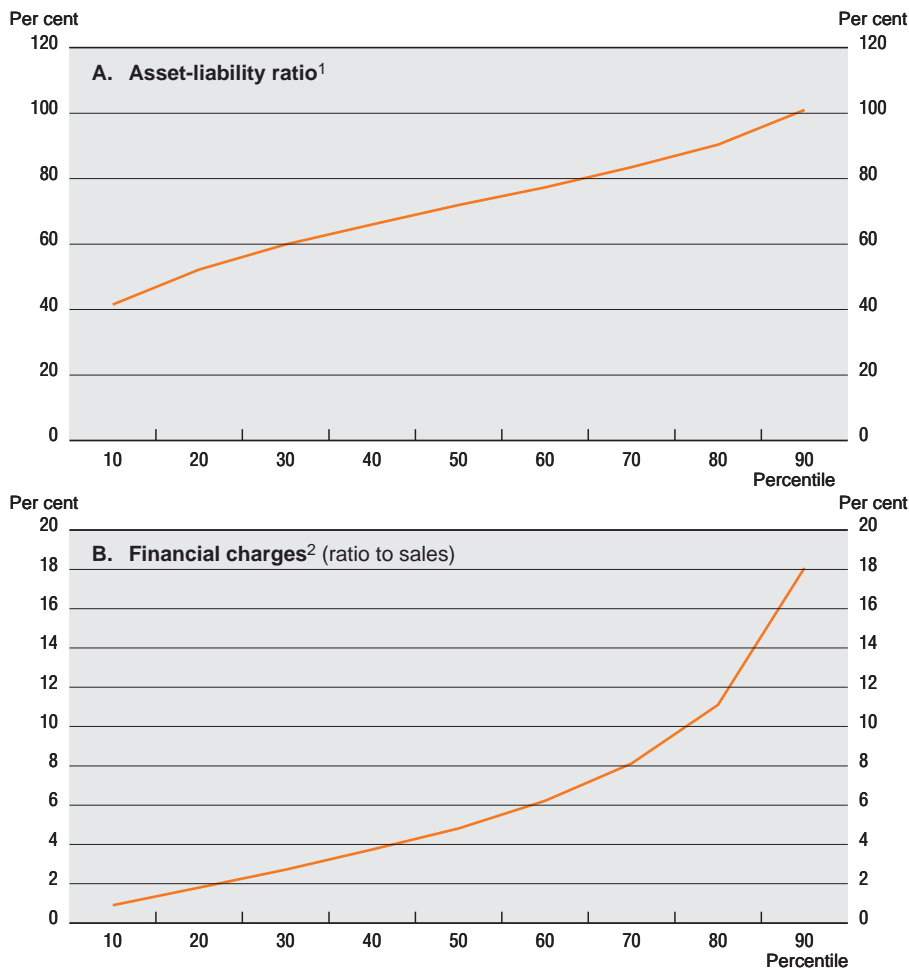
Policy burdens on SOE include surplus labour that enterprises are not free to shed, disproportionately high tax burdens, and expenses for social benefits such as medical care, pensions, housing, and education that go beyond the levels that enterprises typically provide in other economies. Higher tax rates on SOE compared to other enterprises are a further policy burden. SOE policy burdens are quite large and are a major reason why SOE profitability is low (Lin, Cai, and Li, 1998). For example, as indicated in the next chapter, surplus workers amount to a substantial portion of the employees of industrial SOE. Policy burdens are largely a legacy of prior central planning mechanisms but their persistence is substantially attributable to structural problems such as the lack of socialised social benefit programmes and (again) the scarcity of government revenue.

SOE have policy burdens...

A rough but useful further illustration of the importance of these policy burdens can be obtained by comparing profits on sales (sales revenue less expenses directly related to production) to pre-tax profits (which deduct overhead costs not directly related to production) and then to

... that lower their profits in relation to non-state enterprises

Figure II.5. Distribution of financial ratios
Medium and large industrial enterprises



1. Asset-liability ratio: ratio of total assets to total liabilities.
 2. Financial charges include interest and amortisation.
 Source: China National Bureau of Statistics and OECD calculations.

after-tax profits (Table II.4; see also Ash and He, 1998). Virtually all these profit measures have declined during the 1990s for all types of enterprises. However, sales profits, as a share of gross output, have been consistently higher for SOE than for non-state enterprises as a whole. The pre-tax profit rate is also higher for SOE, but the gap between the enterprise classes is somewhat narrower than for sales profits. The gap is reversed once taxes are deducted, with the after-tax profit rate for SOE less than half that for non-state firms.³⁰ This pattern is especially pronounced for enterprises with relatively high total factor productivity (see Annex) and reflects the fact that the SOE tax burden is concentrated on the most productive and profitable enterprises in this group. These comparisons confirm that policy burdens are a major factor behind the lower profitability of SOE compared to non-state enterprises.

Table II.4. **Alternative indicators of industry profitability**
Per cent of gross output

	SOE			Non-state enterprises		
	Sales less cost of sales	Pre-tax profits	After-tax profits	Sales less cost of sales	Pre-tax profits	After-tax profits
1993	26.9	12.9	4.3	20.0	9.7	5.2
1998	19.3	8.6	1.6	14.3	8.3	2.7

Source: *China Statistical Yearbook*, various issues.

Finally, it has been argued that, as the legacy of past central planning and years of poor governance, SOE suffer from chronic operating inefficiencies that would severely impair their profitability even if their policy burdens and heavy debt loads were alleviated. These chronic operating inefficiencies arise from poor organisation, inefficient and obsolete productive capacity, outmoded technology, and low product quality. For example, the average size of SOE operations in key industry segments, particularly heavy industry, is low by international standards (see Huchet, 1998 *a*). Technological backwardness is also a major problem impairing the operating efficiency of many Chinese enterprises. As discussed further in the next chapter, much of the equipment used is relatively old, and research and development spending by SOE is low and declining. Aggregate data appear to confirm the impression that SOE are relatively less efficient than comparable non-state enterprises. In particular, the portion of SOE industrial employment in firms with relatively low measured total factor productivity is about twice that of collectives (Figures II.6 and II.7). A recent study of the World Bank with the CNBS suggests that a significant portion of large and medium-sized SOE, accounting for 11.6 per cent of total industrial SOE employment, have total factor productivity levels that are either negative (meaning that enterprise revenues are insufficient even to cover their wage costs) or too low for competitive viability (World Bank, 1999).

Chronic operating inefficiencies are widespread...

It has been suggested that chronic operating inefficiencies are so widespread among SOE that the majority, if not most, would not be competitively viable even if their policy and debt burdens were alleviated. However, at least two considerations suggest that this impression is exaggerated. First, evidence also points to a substantial segment of SOE that appear to be relatively efficient and competitive (Huchet, 1998*a*). The figures derived from the World Bank/CNBS study indicate that SOE accounting for 78 per cent of value-added and 39 per cent of total employment have total factor productivity that is at least adequate (World Bank, 1999). Second, average productivity figures such as those quoted above very likely overstate the extent of chronic efficiency problems in the SOE sector. In particular, firms that are otherwise efficient but forced to carry large numbers of excess workers are likely to exhibit low measured factor productivity even though they would be more competitively viable if the excess labour could be shed. Given the substantial portion of excess workers in relation to total employment, the resulting understatement of SOE productivity could be quite substantial. Moreover, chronic operating inefficiencies are not confined to SOE but are also probably widespread among collective enterprises – although their full extent is again not known.

... but their extent may be exaggerated

Figure II.6. Employment distribution by productivity group¹
1998

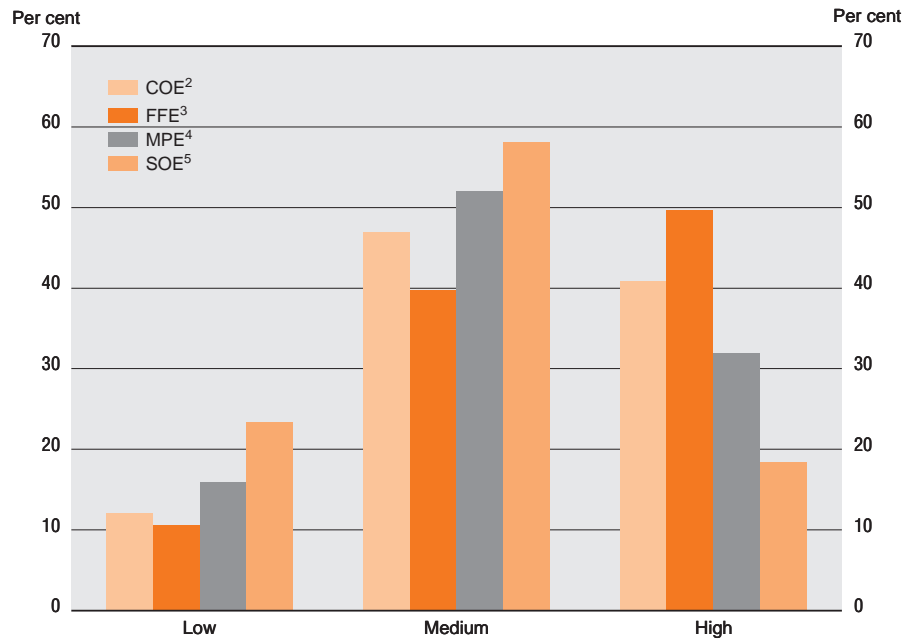
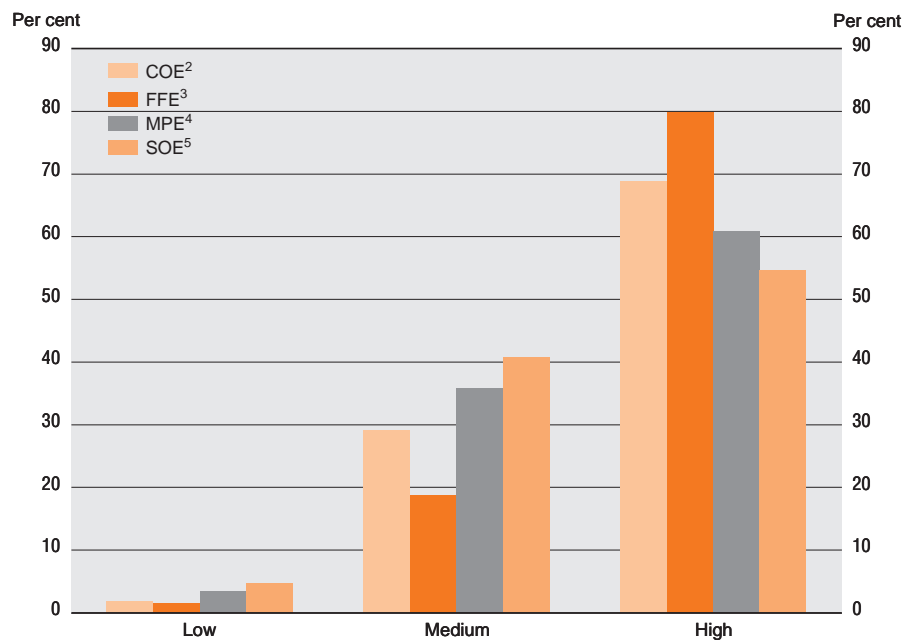


Figure II.7. Value-added distribution by productivity group¹
1998



1. Productivity groups: low = 1st quartile; medium = 2nd and 3rd quartiles; high = 4th quartile. For further details, see Annex.
 2. COE = collectives.
 3. FFE = foreign-funded enterprises.
 4. MPE = enterprises with mixed or private ownership.
 5. SOE = state-owned enterprises. Figures refer to large and medium-sized industrial SOE.
- Source: China National Bureau of Statistics and OECD calculations.

On balance, it appears that much of the decline in profitability of SOE since 1995 can be attributed to the combined effects of the excess capacity created during the prior investment boom and subsequent slowdown in aggregate real growth. Policy and debt burdens are major factors, possibly the most important contributors overall, to the low level of profitability of SOE as a whole and to the high incidence of loss-making firms. High debt burdens are also an important factor behind the low or negative profitability of many collective enterprises. The extent of these problems differs considerably across ownership classes, industries, as well as individual firms. A major challenge in this regard is to identify the extent of chronic operating inefficiencies of firms which, because of policy burdens or other factors, have been unable to operate as efficiently as they are technically capable.

The relative importance of the factors varies

Concluding observations

There has been a remarkable transformation in China's enterprise sectors over the past two decades that has sharply circumscribed the state sector in terms of its share of output and broader role in the economy. However, enterprise financial conditions have deteriorated to the point that they are jeopardising macroeconomic performance. While attention has focussed on SOE, the problems are shared by much of the non-state sector.

There has been a major transformation

Available evidence leaves important questions about the precise causes of enterprise problems and therefore about the payoff in terms of improved performance that can be expected from particular policies that are being undertaken or planned. However several conclusions seem reasonable based on the evidence cited in this chapter.

Several generalisations can be made

First, non-state enterprises have been the main contributors to overall growth in output and employment in China's economy over the past ten years and they are likely to remain the key to the economy's performance in the future. Reforms to the SOE sector are essential to improve its efficiency and release resources to more productive uses. But the extent to which these reforms result in improved performance of the economy as a whole depends on the degree to which the problems of the non-state sectors are alleviated, or at least do not get substantially worse.

Non-state enterprises will be crucial...

Second, the majority of SOE and a substantial portion of collectives are presently at best marginally profitable. Restoring the competitive viability of these enterprises is not simply a matter of reducing the number of loss-makers, but requires sustained increases in the cash flow and profitability of firms that are presently making only very small profits.

... as will marginally profitable firms...

Third, the financial problems of SOE as well as collectives stem from a range of factors including excess capacity, various overhead burdens, and chronic operating inefficiencies. Measures to reduce excess capacity and lower SOE overhead burdens have the potential to significantly improve financial performances over the next several years and could also help ailing non-state enterprises by bolstering aggregate real growth and output prices. However, extensive further measures to upgrade efficiency, improve product quality, restructure enterprises into more competitive units, and to improve the effectiveness of financing mechanisms for the enterprise sectors, are

A range of measures is needed...

likely to be necessary over a longer period. These reforms, together with longer-term measures to reduce SOE social welfare costs, are essential to raising SOE out of the marginal and precarious financial state they are now in.

... including reforms to corporate governance and the external environment

And fourth, fundamental improvements in corporate governance and in the external environment within which enterprises operate need to progress in parallel with the direct efforts to bolster enterprise financial performance. Much of the current financial problems of enterprises reflect past mistakes in investment and other business decisions arising from weaknesses in management and in external discipline. Enterprises will need to respond more effectively to market forces than they often have in the past if reductions in policy burdens and other measures to boost profitability in the medium-term are to result in lasting improvements in performance. Otherwise, these gains are likely to be eroded and there will remain a serious risk that excesses, such as those that occurred in the early 1990s, will recur.

III. ECONOMIC RESTRUCTURING

Economic restructuring in China seeks to bolster enterprise financial performances in the medium term and to improve their efficiency over the longer term. Restructuring policies are focused on larger state-owned enterprises, and are primarily directed and controlled by government authorities. The major focus is to alleviate overhead burdens by reducing excess capacity, shedding surplus labour, and lowering debt burdens in the medium term. Efforts are also being made to upgrade productive facilities and to achieve more efficient scale and scope of operations through mergers and acquisitions.

Policies to reduce SOE overhead burdens are making significant progress and should help improve financial performances, particularly of larger SOE, over the next several years. The degree to which near-term improvements in profitability will be sustained and result in longer-term gains in the competitiveness of industry as a whole is less clear at this point. Substantial improvements within the medium term – in management, governance and external incentives – will be essential if enterprises, particularly SOE, are to make effective use of their resources in a rapidly changing market environment. Moreover, current efforts are subject to several important constraints that limit their immediate benefits and which, if not addressed, could jeopardise their ultimate effectiveness. These constraints include: the lack of market driven processes to facilitate mergers and acquisitions; limitations on bankruptcy and other forms of exit; as well as scarce government financial resources. There is also a risk that the current policy of focusing government resources on loss-making large SOE will not sufficiently address the problems of other SOE and of non-state enterprises, whose performance is essential to sustaining adequate growth in the overall economy.

Economic restructuring policies are aimed at improving the technical capabilities of enterprises to operate profitably. These policies are largely directed at problems caused by past defects in enterprise behaviour and distortions in the external environment that corporate governance and other reforms discussed in later chapters seek to correct. Economic restructuring policies have become increasingly important to the overall reform process during the 1990s as the financial conditions of enterprises have deteriorated and have begun to depress aggregate real growth. Restructuring has acquired further urgency with China's prospective entry into the World Trade Organisation.

Objective: improve capacity to operate profitably

Explicit restructuring efforts are mainly directed by the central government and implemented by various central, provincial, and local government agencies. The policies are mainly focused on SOE, even though, as seen earlier, there are serious performance problems in the non-state sector as well. This emphasis reflects the severity of SOE problems and their role as the major urban employer; it also reflects the commitment to retain substantial state ownership in the business sector and the role envisaged for SOE in China's strategic industries. Policies by the central government to bolster performance of the non-state sectors have largely been confined to efforts to improve their access to financing (see Chapter VI).³¹

The focus is on SOE

As indicated in Chapter II, the problems impairing the economic performances of enterprises can be grouped under two headings. The first are overhead burdens. These include policy burdens and high debt loads that

The main problems are: overhead burdens...

are especially heavy on SOE but also a serious problem for collectives. Excess capacity and inventories, which, in addition to depressing cash flow of individual firms, reduce profits throughout industry by pushing down output prices and slowing aggregate real growth, can also be considered under this heading. Overhead burdens lower the profitability and impair the competitiveness even of enterprises whose operations are otherwise efficient.

... and chronic operating inefficiencies

The second set of problems are chronic operating inefficiencies arising from sub-optimal scale or scope of production operations; obsolete equipment and outmoded technology; low product quality; along with general inefficiencies in organisation and co-ordination of operations. Enterprises suffering from these problems are likely to remain at best marginally profitable even if their overhead burdens are alleviated. Such enterprises will require extensive restructuring of their operations to survive on their own; or, where restructuring is not economically justifiable, will need to be shut down. Alleviation of operating inefficiencies will also require extensive reallocation of resources among firms and industries.

Both sets of problems need to be addressed

While important to the design of specific restructuring policies, the distinction between overhead burdens and chronic operating inefficiencies is not easy to make in practice. Some overhead burdens, in particular high debt loads, are partly the reflection of underlying operating inefficiencies. However, excessive overhead expenses have contributed to operating inefficiencies by limiting the funds available to firms to upgrade technology and make other adjustments to improve operating efficiency. Both sets of problems need to be addressed if there is to be a sustained improvement in enterprise performances. Reduction in overhead burdens is necessary to provide the resources enterprises need to improve and sustain their competitiveness. However, it is only a first step and cannot itself guarantee success over the longer term without substantial accompanying improvements in scale and scope, technical capabilities and organisation – as well as the quality of enterprise decision-making.

Overhead burdens are the main focus now

Partly because they offer the greatest near-term improvement in profitability, the main focus of restructuring policies has been on the reduction of SOE overhead burdens. These efforts are heavily targeted on large SOE, particularly those destined to remain under state ownership. However, reductions in capacity and inventories should also benefit other SOE and non-state firms by reducing industry excess supply and by alleviating downward pressures on output prices. Policies to address operating inefficiencies are being pursued in part through measures to upgrade productive capacity and improve technology and product quality that are being undertaken in conjunction with the industry-wide efforts to reduce excess capacity. Mergers and acquisitions (M&A), liquidation, and the enterprise groups discussed in Chapter IV, are intended (in part) to improve economies of scale and scope and to re-deploy resources. Ultimately, though, the key to sustained improvement in operating efficiency is the ability of enterprises to marshal and effectively deploy the investment and other resources needed to upgrade the quality of their productive capacity and organisation.

The near-term goal: raise SOE profitability by end-2000

The current target of industry restructuring, as first announced by Premier Zhu Rongji in March 1998, is the “substantial restoration” of SOE profitability by the end of 2000. Although precise targets have not been specified, recent

statements suggest that the goal is to substantially reduce the number of loss-making medium and large SOE (about 7 500 in 1998) as well as the total amount of SOE losses.³²

Reducing overhead burdens

Extensive efforts to reduce SOE overhead burdens have been underway since the mid-1990s and have been directed at reducing surplus labour, excess productive capacity, and enterprise debt loads. These efforts were further reinforced in 1999 by the introduction of the programme to swap enterprise non-performing loans for equity. Programmes to transfer social welfare burdens from enterprises – which are discussed in Chapter VII – are proceeding more gradually, while concrete policies to achieve a more even distribution of tax burdens among enterprises have not yet been formulated.³³ While progress has been substantial it also has been uneven, in large part because of constraints on public revenues needed to facilitate the efforts and on the ability of the economy to re-deploy workers displaced from SOE.

Extensive efforts are underway

Eliminating excess and obsolete capacity

Since 1998, various industry-wide restructuring programmes have been implemented to reduce excess capacity in key industrial sectors, particularly those suffering large losses. The restructuring programmes generally comprise across-the-board reductions in output applying to most or all enterprises in a given industry, along with more targeted efforts aimed at retiring obsolete capacity and stimulating technological upgrading. The programmes began in the textile and coal industries, which were designated as “pilot” programmes for efforts in other sectors. The overall target in the three-year restructuring programme launched in early 1998 for the textile industry was to return the industry to profitability by the end of timeframe through the retirement of 10 million obsolete cotton spindles (comprising roughly one-quarter of total capacity) and the shedding of 1.2 million workers (one third of total employment). The restructuring programme for the coal industry launched in late 1998 aimed to reduce industry losses by 50 per cent through the closure of 25 800 small and inefficient mines and reduction in industry production of 250 million tons by the end of 1999; in addition the programme involved outlays of 15 billion yuan (about US\$ 2 billion) for technical upgrading projects to improve efficiency in remaining mines.

Reduction of excess capacity is one focus

Considerable progress has been made toward achieving these targets. In fact, the targets in the textile industry were reported to have been largely achieved within two years, one year ahead of schedule. By the end of 1999, state-owned textile enterprises had reduced the number of cotton spindles by nearly 10 million and laid off about 1 million workers. The coal industry also mostly achieved the targets set for 1999. As summarised in Box III.1, programmes in other industries are being broadened and intensified, with timeframes for attainment of their main targets ranging over the next three to five years. During 2000 the main efforts are to be directed at the coal, iron and steel, and sugar-refining industries.

Programmes in other industries are being intensified

Box III.1. Restructuring programmes in selected industries

The Chinese government has implemented a series of industry-wide restructuring programmes, targeted mostly at the basic industries, such as textile, coal, metallurgy, oil refinery, sugar refining, power generation, cement, glass, caustic soda, alcoholic beverages, where excess capacity and industrial losses are the most severe. The restructuring programmes have generally been aimed at reducing excess capacity and rationalising the industrial structure through various measures such as closing down small and inefficient firms; encouraging output restraints; restricting new investment; eliminating outdated equipment and obsolete products; and upgrading of production technology. The following summary of the restructuring programmes in several selected industries provides an indication of the extent of these efforts and their modalities.

Coal

China's coal industry, the largest in the world, has been plagued by excess capacity, bloated inventories, declining prices, and chronic industry losses. The oversupply has been attributed to the large number of small and technologically outmoded mines, which produce about half of national coal production. In November 1998, the State Council decided to overhaul the coal industry by shutting down a large number of such mines and reducing total output and stockpiles. The targets for the period up to the end of 1999 were to close 25 800 small mines to reduce production by at least 250 million tons; to lay off 400 000 workers from key state coal mines; and to reduce industry losses by 50 per cent in 1999. The restructuring programme also included outlays of 15 billion yuan to implement 282 technical upgrading projects aimed at improving the industry efficiency.

The target for reducing production capacity was largely achieved in 1999. Some 31 000 small coal mines were closed down and the output of raw coal was reduced by 12 per cent in 1999. Nevertheless, the industry still suffered 3.8 billion yuan in losses (US\$ 467 million) in 1999 as over-supply in both domestic and international markets reduced profitability and the prices continued to fall.

The government's current plan is to continue to close old, smaller coal mines, cut the production of sulphur coal, and reduce inventories in order to end the loss-making situation. The target for the year 2000 is to cut annual production by a further 15 per cent by shutting down an additional 18 900 small coal mines. Efforts are also being made to reduce the large domestic stockpile by expanding coal exports in 2000.

Steel

China has the world's largest steel industry with 3.2 million workers employed and a combined annual production capacity of 134 million tons. However, steel is currently in structural oversupply in China: on the one hand, and output of high quality and high value-added varieties cannot meet domestic demand and, consequently, a large amount has to be imported annually; on the other hand, low quality products are in excessive supply. In order to reduce overcapacity and stabilise prices, a series of measures have been implemented in accordance with the principle of shutting down small and inefficient steel works and limiting production at large and medium-sized ones.

The target for 1999 was to reduce production capacity to about 11.8 million tons or by 10 per cent; and to achieve a total profit of 5 billion yuan with all of the 46 key loss-making SOE in the industry returning to profitability. Key SOE were asked to cut the production of products with low market demand, and reduce their inventories by 30 per cent. More than 2 500 steel smelters and mills with annual capacity below 100 000 tons were to be closed. The government also aimed to accelerate restructuring of enterprises by shutting down small enterprises that are technologically inefficient and heavy polluters; and by establishing large enterprise groups through mergers, *e.g.* the Shanghai Baosteel Group Corporation.

In the past two years, 46 steel firms were merged and 18 were closed down. Many of large steel firms also recently embarked on a programme of technological renovation with strong financial support from the government. Although the metallurgical sector recorded an increased profit in 1999, it failed to accomplish the goal of reducing steel output by 10 per cent. The failure was due largely to the fact that small iron and steel plants continued to increase production in defiance of the government policy to cut output.

The restructuring programme in the steel industry is being intensified, in particular, in preparation for the prospective entry of China to the WTO. The State Bureau of Metallurgical Industry has set the steel production targets for 2000 at 110 million tons for crude steel and 100 million tons for steel products. Other targets include: a drop in the proportion of loss-making large and medium sized steel enterprises to 20 per cent; establishment of a modern enterprise system (*i.e.* "corporatisation") by 80 per cent of the enterprises; and restoration or maintenance of profitability by 46 of the key metallurgical enterprises. It is expected that the steel sector will lay off more than 200 000 employees by 2002, reducing the employees directly engaged in steel production from more than 1 million to 800 000.

Box III.1. **Restructuring programmes in selected industries** (cont.)**Sugar**

In early 1999, the sugar industry was identified as one of the key industries for restructuring. More than 90 per cent of state-owned sugar refiners have been making losses in recent years, due largely to overcapacity, outdated refining technologies and inefficient operations. The government planned to merge hundreds of small sugar producers and merge other small refiners with larger ones, in order to cut down total production capacity by 300 thousand tons in 1999. The restructuring programme also included plans for upgrading production technology.

The target for the year 2000 is to close 140 bankrupt sugar refineries, which will reduce sugar production capacity from 10.5 million tons to 8.18 million tons. In order to achieve this target, the government plans to offer 12.6 billion yuan to offset the debts owed to commercial banks by the bankrupt sugar plants. The government will also curtail the planting areas of sugar cane and sugar beets. In addition, nine of the current fourteen saccharine factories are to be closed down in order to expand the market for natural sugar.

Oil

The government's restructuring plan for the oil industry aims at tightening control of crude oil processing and production of saccharin and pure caustic soda; and reducing excess production capacity by closing down 200 small and inefficient refineries between 1998 and 2000. This will amount to reducing as much as a tenth of the China's oil refining capacity. In general, smaller refiners relied on smuggled crude oil and the hoarding of inventory to ensure a profit. By the end of 1999, 70 small oil refineries had been closed down. At the same time, the government will continue to support the larger refineries as an important step toward improving market efficiency as well as the regulation of the total amount of refined oil in China.

The rapid pace of the capacity reduction programmes, while understandable given the extensive over-supply in industry, nevertheless raises two concerns. First, the use of across-the-board production cuts in industry such as steel tends to penalise efficient producers and limits the gains in efficiency for industry as a whole. Second, production allocation measures create a risk of fostering cartel or other anti-competitive behaviour, even after the conditions of over-supply are alleviated. This risk is increased by the close relations between SOE and government agencies and the lack of independent bodies to enforce competitive rules. Both concerns argue for more emphasis on closing low efficiency or outdated facilities and less reliance on industry-wide production allocation quotas.

But a more targeted approach is needed

Reducing surplus labour

Various estimates have suggested that surplus workers in SOE – in theory employees above the level a profit-maximising enterprise would employ if unconstrained – amounted to at least 20 million, and perhaps as many as 35 million, at the end of 1996.³⁴ These figures represent between one-fifth and one-third of the total SOE workforce, and between 10 and 17 per cent of total urban employment. Nearly all SOE industry segments have substantial amounts of excess workers. Although figures for individual industries are not available, the incidence of surplus workers has been particularly great in textiles, machinery, and steel, which also have considerable excess productive capacity; and natural resource sectors such as coal and forestry products. The ability of SOE to shed excess labour is sharply circumscribed by the requirement that workers normally can be laid off only if alternative employment or other support can be found.

SOE have extensive surplus labour

SOE labour shedding is passing the half-way point

Since 1996, authorities have been making strenuous efforts to separate surplus workers from SOE production line payrolls. These efforts were made possible by the establishment of "reemployment centres" (REC) to provide income support and other assistance for the laid off workers (see Chapter VII). Official figures indicate that at least 15 million workers had been laid off from SOE by the end of 1999.³⁵ Officials have indicated that the pace will be maintained, with another 5 million SOE workers expected to be laid-off during 2000. These figures suggest that reduction of surplus SOE labour is now passing the half-way point and could be largely completed within the next three years. In a further effort to reduce surplus labour in core activities, a substantial portion of SOE production workers are reported to have been transferred to ancillary subsidiary companies, such as delivery or travel services within the same enterprise group.³⁶ Many of these ancillary operations will probably be sold off or otherwise separated from the SOE in the future. There also has been substantial labour force shedding from collective enterprises.

... and is very intense in certain regions and industries...

Underlying the nation-wide figures are even more intense efforts to relieve SOE of surplus labour in particular industries and provinces (Table III.1). Nearly one-sixth of the total SOE workforce in textiles had been laid-off by the end of 1998. In Shanghai, 1 million workers out of a total SOE industrial employment of 3.5 million (including half of the textile workforce) were laid off between 1996 and 1998; authorities projected that another 223 000 workers would leave their SOE posts in 1999 and a smaller number in 2000. Reductions have been slower in economically less well-off regions. For example, nearly 10 per cent of SOE workforce in Hubei had separated from SOE by the end of 1998, but nearly twice that number were expected to leave in subsequent years.

Table III.1. **Estimated number of laid-off SOE workers**
As of end-1998

Rank	Province	Number laid-off
1	Liaoning	589 000
2	Heilongjiang	528 000
3	Hunan	481 000
4	Hubei	386 000
5	Jilin	340 000
6	Shaanxi	306 000
7	Sichuan	288 000
8	Anhui	249 000
9	Jiangxi	247 000
10	Gansu	137 000

Source: Mo, R. (1999).

But SOE savings have been limited so far

Despite the impressive amount of labour shedding, data on reported profits suggest that savings to SOE have been only modest so far. This is probably largely attributable to the fact that SOE continue to be responsible for much of the initial support of the laid-off workers. In principal, SOE are supposed to pay one-third of the expenses of the reemployment centres, with local governments and other sources supplying the remaining funds. In practice, the share is probably much higher, since, as explained further in Chapter VII, profitable SOE are very often forced by local governments to pay for most, if not all, of the welfare benefits for former workers. However the

savings to SOE should grow as the laid-off employees find jobs or exit the reemployment centres at the end of the maximum stay, and should be quite large ultimately.³⁷

Two factors will condition the pace of further reductions in surplus workers and the extent to which SOE expenses are reduced. The first and most immediate is the financial resources available to government to fund the redeployment centres. The second, and ultimate, constraint is the capacity of other enterprises, primarily in the non-state sector, to generate jobs to absorb the workers separated from SOE. These constraints are least binding for regions, primarily those on the coast, that have enjoyed the most rapid growth during the 1990s; while they are much more of a limitation for provinces with less favourable fiscal and economic conditions.³⁸

Further reductions depend on two factors

Debt reduction

Total liabilities of all SOE amounted to 9.9 trillion yuan in 1998, with 4.1 trillion in industrial SOE with independent accounting units. Large SOE accounted for 2.4 trillion, or 60 per cent of these liabilities. SOE liabilities amount to nearly 65 per cent of their assets. This ratio is down from the peak level of just above 70 per cent in 1993 but is still high by international standards. Despite a substantial fall in interest rates since 1995, the financial costs of servicing the debt remain substantial, averaging nearly 4.8 per cent of total sales revenue of large and medium-sized SOE in 1998.³⁹ As noted in Chapter II, debt loads and their servicing burdens are considerably worse than these average figures for a substantial portion of enterprises.⁴⁰ A reduction in the debt burdens of otherwise efficient SOE – provided it was fairly substantial – would help significantly in improving their cash flow and in restoring their profitability.

SOE have heavy debt burdens

Efforts to alleviate SOE debt burdens have taken three major forms. The first, which began in 1996, was direct debt write-offs, typically as part of broader efforts to restructure enterprise operations through internal reorganisation, mergers and acquisitions and, in some cases, bankruptcies. A cumulative total of 90 billion yuan, amounting to about 2.2 per cent of total liabilities of industrial SOE, was allocated for this programme over the years 1996-1998. These outlays contributed to the reduction in SOE debt-asset ratios during this period, although their impact on total debt-service obligations of SOE was modest.

A limited amount has been written off

A second means of lowering debt loads and increasing equity is listing on the domestic stock markets. Stock market listing is presently confined to a relatively limited segment of China's largest and more successful SOE. Other SOE are being encouraged to undertake reforms necessary to qualify for listing, in part as a means of raising equity and improving their capital structures – but again the prospective entrants are primarily larger enterprises. Stock market listing thus is not an important source of equity injections for small and medium-sized SOE.

Stock market listing has increased equity

In 1999, authorities began a third and more extensive effort to reduce debt burdens of SOE through debt-equity swaps. The debt-equity swap programme is linked to the broader effort to deal with the non-performing loans of the banking system that is discussed in Chapter VI. The swap programmes

Debt-equity swaps emerged in 1999...

are being undertaken by the four major bank asset management companies (BAMC) set up in 1999. These companies are taking on nearly 1.2 trillion yuan of loans (about 18 per cent of their total loans) held by the four major state commercial banks.⁴¹ Under the swap programme, non-performing bank debt of eligible SOE is converted to shares held by the BAMC, which in principle may ultimately sell the shares to other investors, or back to the issuing companies once their profits are restored.

... and will reduce debt loads substantially

The debt-equity swap programme gained considerable momentum during 1999. By March 2000, agreements involving 89 SOE and totalling 125.5 billion yuan (US\$ 15.1 billion) had been reached.⁴² Many more enterprises are reported to have qualified (or to be working hard to qualify) for the swaps. Authorities have indicated that priority will be given to loss-making large SOE that are deemed to be competitively viable. By January 2000 the SETC had approved 601 SOE for participation in the programme with an estimated 459.6 billion yuan (US\$ 55 billion) allocated for conversion into equity. Such an amount (which amounts to nearly 15 per cent of the total liabilities of large industrial SOE), together with the targeted approach, would allow for a substantial reduction of the debt burdens and improvement in cash flow of participating enterprises.⁴³ Deals completed so far have generally involved a reduction in debt-asset ratios by one-fifth to one-half from their original levels.

The focus is on large loss-making SOE...

The targeting of debt-equity swaps on large loss-making SOE indicates that they are intended as a key element of the overall strategy to establish the "strategic core" of larger SOE discussed further in the next chapter. The swap programme has also become an important means to help achieve the target of substantially reducing the number of loss-making enterprises by the end of next year.

... but the impact on the enterprise sector as a whole is less clear

However, although likely to significantly help the most financially troubled large SOE, the overall effectiveness of the debt-reduction programmes in improving performance of the enterprise sector as a whole is much less clear. First, the programmes offer little or no relief to the substantial number of highly indebted medium and small SOE, who also have much less scope to reduce their debt burdens through stock market listing or other means. Indeed, the extent to which the debt-equity swaps will encompass large SOE that are now marginally profitable is unclear. Collectively, these enterprises are more important to growth in the aggregate economy than are the SOE that are the focus of the programmes. In addition, as discussed further in Chapter VI, there are questions as to whether the requirements on SOE participating in the debt-equity swap programmes have been sufficiently stringent regarding future improvements in their management and organisation.

Improving operating efficiency over the longer term

The keys: enterprise investment and resource redeployment

Improvements in operating efficiency depend in large part on investments by individual enterprises to upgrade their productive facilities and improve product quality. Efforts to reduce SOE overhead burdens are important and necessary in this regard but other efforts are needed to improve technology and product quality, and to enhance the scale, scope, and organisation of business operations. The means being used to achieve these objectives include programmes to: retire obsolete capacity; encourage technical

upgrading, and foster mergers, acquisitions, and exit via bankruptcy. The formation of enterprise groups among larger SOE as part of the broader reorganisation of the state sectors discussed in the next chapter is closely related to this effort.

Upgrading productive capacity and technology

Two conditions hamper the efficiency of the productive facilities of many Chinese enterprises and so impair their ability to operate profitably. The first is sub-optimal scale. Although there are numerous individual examples of large-scale efficient operations in steel and other key sectors, the average scale of production is relatively low by international standards in a wide range of Chinese industries (Huchet, 1998a). A widely quoted illustration is the Chinese automobile sector, which comprises nearly 200 producers whose total production is lower than that of the smallest US automobile company. Sub-optimal scale facilities are partly the heritage of the pre-reform policies to promote self-sufficiency in individual regions. However, inter-regional barriers to capital flows, the dispersion of ownership of SOE among provincial and local authorities, and the effectively zero cost of capital arising from soft budget constraints have led to further proliferation of sub-optimal scale units during the reform period.

Operating efficiency is impaired by sub-optimal scale...

The second condition depressing efficiency is the use of outmoded technology and poor product quality. Although the technology level in China has improved since the onset of the economic reforms, it still lags, often considerably, behind its competitors in the international markets. Outmoded equipment is particularly prevalent in traditional heavy industries: for example, nearly 40 per cent of metal-cutting machinery, and more than 40 per cent of industrial drills, planers, and millers were installed during the 1970s, while less than 20 per cent of this equipment was put in place during the 1990s.⁴⁴ Heavy debt and other burdens on their cash flow have prevented many SOE from making the expenditures to upgrade technology and replace outmoded plant and equipment needed to keep pace with their international competitors. As a result, outlays on R&D are low by international standards and have been declining. Expenditures on R&D by medium and large SOE accounted for only 1.4 per cent of total sales in 1992 and fell further to 1.1 per cent in 1994. These figures compare with R&D to sales ratios of 3 per cent or higher in more advanced countries such as the United States, Germany, Japan, and Korea. As a further indication of the squeeze on R&D capabilities of SOE, the proportion of large and medium-sized enterprises maintaining their own technology development institutions fell from 54 per cent in 1990 to 34 per cent in 1996.

... and by outmoded technology

Much of the effort to raise production scales to more efficient levels is being carried out via the targeting of capacity reduction measures on small-scale facilities mentioned earlier. Mergers and acquisitions are another modality for raising scale. Progress in this area is difficult to quantify, however, and is likely to take some time to be manifest in aggregate measures of industry productivity.

Smaller scale facilities are being phased out

To help further improve efficiency, government financial support is being provided for technological upgrading and the establishment of technological development institutes at key large and medium-sized SOE. The programmes for technological upgrading mainly involve around 650 key SOE and

Government support for R&D is being provided

120 enterprise groups. According to figures published by the Ministry of Finance, 13 billion yuan (US\$ 1.57 billion) of subsidised loans were given to 648 SOE for technical upgrading during 1998. This figure represents 22 per cent of the total investment by these enterprises.⁴⁵ The government expects that the measures will lead to substantial progress in technology upgrading in key industries such as metallurgy, petrochemicals, machine-building, electronics, textiles, paper, and non-ferrous metals.

Mergers and acquisitions

Industry reorganisation is essential to improve scale, scope, and organisation

Apart from measures taken by individual enterprises, substantial industrial reorganisation is needed to improve the scale, scope and organisation of business operations. In China, as in other transition economies, extensive reorganisation through mergers, acquisitions, and other types of business alliances, and through various forms of exit, are essential to correct distortions arising from the past central planning regime. Regional barriers to trade and investment in China give an added importance to these processes and also impose serious constraints on them. The processes will become even more important as China's businesses adjust to WTO entry.

M&A are a key means for these purposes

The 15th Party Congress mandated the use of M&A as an important means for rationalising and reorganising the Chinese SOE sector. M&A are being used to reinvigorate failing SOE by combining them with healthy enterprises, to restructure smaller and medium-sized SOE preparatory to their "letting go" from the state sector, and to reduce unproductive and excess capacity by splitting-off and combining the economically viable portions of enterprises. According to central government figures, there were roughly 3 000 M&A nation-wide in 1997, of which about 1 000-2 000 were among SOE controlled directly by the central government. The number of M&A among central government controlled firms dropped to 100-200 in 1998 (and was probably roughly similar in 1999), but the average size of the firms involved was much larger: the assets involved in M&A activities rose from about 100 billion yuan in 1997 to 207 billion yuan (about US\$ 25 billion) in 1998.

M&A are constrained by their government-directed character, by regional barriers...

The M&A carried out in China are subject to several major constraints that make them rather different in character from those occurring in OECD countries. First, M&A activity among SOE is nearly entirely directed and controlled by government agencies, rather than driven by market processes in which firms seek and choose their partners and execute the transactions largely on their own. This pattern is beginning to change somewhat. Some state asset management companies have been promoting M&A with enterprises outside their own group; the bank asset management companies are also expected to encourage and facilitate M&A in the course of their asset recovery operations. Stock market listing has been an important catalyst to M&A, as illustrated by the nearly 200 M&A involving companies listed on the Shanghai stock exchange during 1998. Nevertheless, the dominance of government agencies together with the dispersion of control over SOE across many levels of government continues to circumscribe the choices in M&A and so limit the economic gains. Second, regional barriers to trade and investment maintained by local government protectionism strongly accentuate the constraints on M&A: M&A across provincial boundaries were virtually non-existent before 1995 and are still fairly rare.⁴⁶

Third, M&A in China are heavily influenced by considerations extraneous to and sometimes in conflict with the goal of maximising the long-term profitability of the newly formed entity. The most important of these considerations is limited government revenue. As with the efforts to reduce surplus labour in existing enterprises, revenue limits condition the ability of SOE to realise economic benefits from the consolidations and layoffs that usually follow M&A in other countries.

... and by revenue limits

Revenue scarcity is largely responsible for the most prevalent pattern in M&A of SOE: the combination of a financially healthy enterprise with one or more financially troubled firms ("strong-weak" M&A). M&A of this sort effectively impose part of the burden involved in supporting the weaker partners on the stronger SOE. As illustrated by the Baosteel merger discussed in Box III.2, this burden is partly offset by a range of economic benefits provided to the new entity, only some of which involve direct government outlays in the medium term.⁴⁷ In theory, strong-weak M&A can be value-enhancing if the longer-term synergies of the combination offset the short-term burdens. In practice, finding partners that meet these conditions is difficult, particularly in China given the administrative constraints on M&A and the difficulties of assessing the true competitiveness of enterprises. Experiences of Eastern European transition economies with strong-weak M&A suggest that they weaken the stronger partner more often than they enhance value of the combined entity.

Strong-weak M&A predominate

Liquidation through bankruptcy or other means, typically a key element of enterprise restructuring in other countries, is even more constrained in China than are M&A and remains one of the weaker elements of industry restructuring. Although the number has been increasing rapidly,⁴⁸ bankruptcies in China are still comparatively modest. There were reportedly about 6 000 bankruptcies in each of 1997 and 1998, but most were in the non-state sector. The current bankruptcy law has two provisions that render its implementation extremely difficult. First, it requires that new jobs be found for all the workers of the bankrupt enterprise or that indemnities equal to three year wages are paid to them; and second it mandates the full write-off of all bank debt owed by an enterprise going into bankruptcy. Similar considerations limit the ability of SOE to exit through outright closure. Thus as with M&A, the use of bankruptcy and other forms of liquidation is limited by the availability of government financial resources to support displaced workers and to pay for debt write-offs.

Bankruptcy is even more constrained

Overall impacts of the restructuring efforts

Given their generally recent onset, it is too early to expect the effects of the measures described above to be fully manifest in aggregate measures of enterprise performances. Aggregate after-tax profits of SOE (including those in which the state had a partial but controlling interest) did rise by 78 per cent in 1999 compared to 1998, the first such increase since 1993; a further increase in profits has been reported for the first quarter of 2000. A large number of previously large loss-making SOE reported profits in 1999 and the overall proportion of large loss-making enterprises dropped back to 41 per cent from 50 per cent in 1998.⁴⁹ Profit rises and reductions in the incidence of loss-makers were also reported in several key industries, including textiles, construction materials, and non-ferrous metals that have been chronic loss-makers for much of the 1990s. However, while a positive development, these figures

SOE profitability has begun to recover...

Box III.2. Mergers: the case of Shanghai Baosteel Group Corporation^d

Since 1996, China has been the world's largest steel producer, with an annual output of nearly 100 million tons. Despite this major achievement, the industry is suffering from a serious structural imbalance in its output: production of low-grade steel exceeds demand; while production of higher-grade steel is insufficient to meet domestic demand and requires imports to fill the gap. The industry also suffers from problems of surplus labour, high debt loads, and inefficient production facilities common to much of the SOE sector. Authorities have made restructuring of the steel industry a major priority for during 1999-2000. This restructuring is focused on: upgrading equipment and technology; reducing the proportion of lower-technology products in the overall product mix; and improving production scale.

In Shanghai, whose regional iron and steel industry occupies a key position in the nation as a whole, restructuring is being carried out through the merger of its three main producers. In November 1998, China's State Council approved the reorganisation of Baoshan Iron and Steel (Group) Corporation as the core of a new and larger group including the two other Shanghai producers, Shanghai Metallurgical Holding Company Group and Meishan Iron and Steel Group Company, both controlled by Shanghai municipality. The new group, Shanghai Baosteel Group Corporation, with net assets of nearly 70.5 billion yuan (about US\$ 8.2 billion) and production capacity of 10 million tons, is now the largest iron and steel enterprise group in China. The factors behind the creation of Shanghai Baosteel and the conditions that have accompanied it provide revealing insights into the merger and acquisition process in China.

Factors shaping the merger

The conditions of the three companies prior to the merger were quite different. The Baoshan Iron and Steel Group Company was one of the first groups chosen to participate in the pilot programme to develop enterprise groups that began in 1992. By 1998 the group had 37 wholly owned subsidiaries, 18 holding subsidiary holding companies, including four joint ventures with foreign enterprises in China and 15 joint-ventures overseas. Its activities ranged well beyond its core business to include businesses in trade, finance, information, transportation, construction, real estate, and services. In its core operations, Baoshan Steel has achieved a pre-eminent position in the industry in terms of its efficiency and the high quality of its products. Although profits fell steadily from 1993^b through 1998, due in large part to sluggish world demand conditions and increasing competition from Eastern European producers, Baoshan Iron and Steel has remained in the black.

In contrast, Shanghai Metallurgical Holding Company and Meishan Iron and Steel have had poorer financial performances reflecting substantial levels of excess workers, heavy debt loads, and outmoded productive capacity and technology. The majority of their original workforces are likely to be ultimately redundant to the core iron and steel business of the new group.^c Asset-liability ratios among the groups' companies were over 90 per cent in the worst cases. At the same time, these enterprises had certain advantages to contribute to the merger; in the case of Shanghai Metallurgical a relatively varied product mix and a strong position in certain specific ("niche") steel products.

Underlying the decision to create Shanghai Baosteel were two basic objectives fairly typical of mergers and acquisitions in China. The first was to help the two weaker members to raise productivity and augment their capital by giving them access to the backing and skills of Baoshan Steel. The second was to reduce current as well as potential future burdens on the government of supporting the operations of Shanghai Metallurgical and of Meishan Iron and Steel. The ultimate rationale of the merger is that it will rescue and revitalise the viable portions of the operations of the weaker companies so that the ultimate value of the three companies as a whole is greater than if they had remained separate.

Aftermath of the merger

The merger has imposed a substantial near term increase in demands on resources of the group's lead company, Baoshan Corporation. Baoshan Corporation provides technical assistance to the other two companies as well as financial support in the form of direct loans and guarantees on bank loans; and has also taken on some of the social welfare burdens of the other two companies. The responsibility for funding the Shanghai R&D institution has also been transferred from the Shanghai municipal government to Baoshan. Baoshan has also taken on much of the debt of the other companies; largely as a result, its net debt has risen to 39.2 per cent of its equity at the end of 1998 compared to only 17.8 per cent in 1996. The flexibility of the Baoshan management in restructuring the overall group's operations has also been hampered by the fact that it is not yet fully autonomous in its operational decisions; new projects still require government authorisation. Baoshan has also been adversely affected by the 10 per cent production cut by China's steel producers ordered by the government in the first quarter of 1999 to reduce excess supply. Unlike capacity reduction measures in some other industries, the cut was applied across-the-board and thus treated Baoshan, one of the industry's best performers, the same as more poorly performing companies.

Box III.2. Mergers: the case of Shanghai Baosteel Group Corporation (cont.)

Despite these burdens, both the Baosteel group and its core company, Baoshan, reported increased profits in 1999 compared to 1998, but the increases were mainly attributable to a moderate improvement in demand conditions rather than to effects of the merger. In February 1999, the foreign currency credit rating of Baosteel was downgraded to below investment grade by Standard and Poor's. The report of the rating agency cited the near-term adverse effects on the group's financial position of the costs of restructuring newly acquired steel operations and of raising capital needed for that purpose as an important factor in the downgrade.

To help the new group make the adjustments and to bolster its longer-term competitive prospects, government authorities, as part of the merger agreement, have given permission for Baosteel to list on the domestic stock exchanges, the preparations for which are now underway. The group, along with four others, has also been authorised to list on the Hong Kong, China and United States equity markets. These decisions are aimed at helping the companies to raise capital for technological upgrading, but also reflect authorities' view that diversified ownership helps to improve SOE management. The overseas listings were originally expected to occur by the end of 2000 but earlier attempts were twice postponed due to investor concerns about the health of Chinese companies sparked, in part, by the problems that emerged with China's International Trust and Investment Companies in 1998. In any case, Baosteel's below investment grade rating represents a significant obstacle to its overseas listing.

Baoshan Iron and Steel Group: summary of operations¹

	1997	1998
	Unit: 1 000 yuan	
Sales	25 862 645	28 797 401
Operating cost	22 982 508	25 578 570
Operating taxes	150 968	200 705
Operating income	2 729 151	1 295 038
Pre-tax income	2 200 463	1 023 885
Depreciation expense	4 655 556	5 166 630
Net interest expense ²	746 848	719 709
Total assets	83 704 105	90 482 354
Total owners' equity	56 659 801	57 214 975
	Unit: 1 000 tons	
Crude steel outputs	8 863	10 179
Output of steel product	7 696	9 122
Sales volume of steel product	7 637	9 064
Average steel output per capita	0.734	0.680
	Unit: people	
Number of staff ³	11 414	14 308

1. All data in this summary are unconsolidated.
2. Excluding the portion of capitalisation.
3. Number of staff in production system on the last day of the year.

Baosteel stands to gain more in the near-term under the debt-equity swap programme begun in 1999. Baosteel Group has sought central government approval to swap a substantial portion of the debt it acquired from the merger into equity as part of its overall effort to restructure the group's operations. In November 1999, the China Huarong Asset Management Corporation (the corporation taking on non-performing loans of the Industrial and Commercial Bank of China) and the China Development Bank signed agreements to swap more than 3.3 billion yuan of debt of three subsidiary companies of Baosteel into equity. This deal, once implemented, is expected to reduce the liability-asset ratio of the three companies by nearly 20 per cent, and to lower debt-service costs by a corresponding proportion.

- a) This box was prepared by Ms. Zhang Qi, Deputy Division Chief of the Foreign Economic Relations Department of the Development Research Centre of the State Council of China, with editorial revisions made by the authors of this study.
- b) After-tax profits averaged 3.05 billion yuan in 1993-1994 but have fallen steadily thereafter. The profits dropped to 2.11 billion yuan in 1996 and further to 1.02 billion in 1998. The 1998 figure represents an after-tax return on equity of about 1.7 per cent.
- c) Of the original combined workforce of 120 000, only about 20 000 would be needed to sustain existing production levels if the productivity levels of the former Baoshan company also prevailed in the two other companies.

need to be interpreted somewhat cautiously. The 1999 profit increase mainly offsets the large drop in 1998: the average (after-tax) profit rate for SOE in 1999 was roughly equal to the level of 1996-1997, which is still quite low. Furthermore, listed SOE reported virtually no increase in profits in 1999, which may indicate that the figures for all SOE are somewhat overstated.⁵⁰ It is also unclear to what extent enterprise reforms are responsible for the profit improvement, since fiscal stimulus and the crackdown on smuggling beginning in the latter half of 1998 very likely also were important contributors. Nevertheless, the improvement in profitability in the textile industry suggests that reductions in surplus labour may have begun to help improve financial performances.

... and excess capacity is beginning to decline

There are also some signs that efforts to reduce industry excess capacity are beginning to take hold. Diffusion surveys taken by the People's Bank of China suggest that excess capacity conditions worsened through early 1998 but has since begun to ease (Figure III.1). However although the pace of inventory accumulation has slowed, aggregate data give little indication that the inventory sales ratio has yet fallen appreciably (Figure III.2).

Concluding observations

Significant progress has been made on overhead burdens...

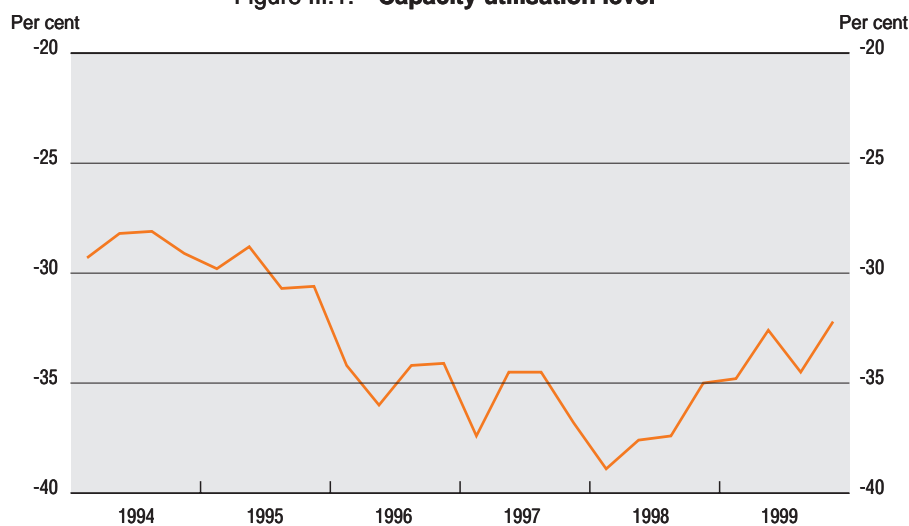
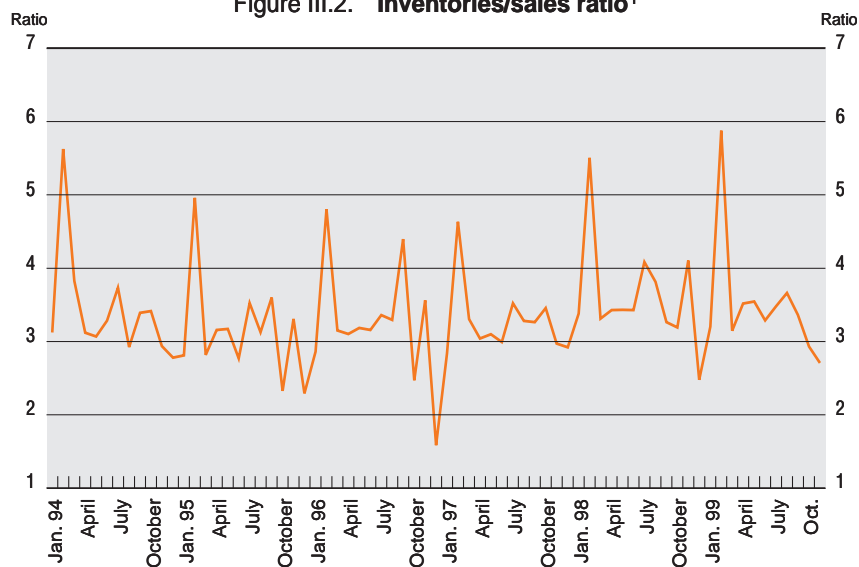
Significant progress has been made in reducing enterprise overhead burdens during the past several years. The burden of surplus labour on SOE payrolls has been reduced substantially and planned measures to remove excess capacity should improve the balance between industry supply and demand over the medium-term. Admittedly, there is some uncertainty about the precise magnitude of what has been accomplished in these areas. However, even under conservative estimates, the progress in these areas, together with the debt reductions for larger SOE, should provide a significant boost within the next several years to the profitability of the enterprises directly benefiting from the programmes. This progress should also provide a modest boost to financial performances in industry as a whole.

... but more needs to be done and timely progress is essential

But while reduced overhead burdens will help provide the resources enterprises need to upgrade their operations, it will not be sufficient alone to ensure a lasting improvement in enterprise competitiveness. The efforts to reduce overhead burdens still have some further way to go and the financial gains to enterprises depend on progress in absorbing laid-off SOE workers in other activities. Measures to upgrade technology and product quality and to improve industry organisation are the keys to lasting improvements in enterprise efficiency. As indicated in this and the following chapters, reforms in these areas are in some respects more difficult and subject to greater constraints than reforms to reduce overhead burdens; and for this reason their ultimate success is less clear. Without substantial progress in the next several years in these areas, the improvements in profitability and financial conditions that are now beginning to be manifest are likely to be eroded.

The preoccupation with larger SOE could limit the overall benefits...

In addition, there are reasons for concern that the effectiveness of current restructuring efforts for the performance of the overall economy will be limited by the concentration of government resources on a relatively narrow segment of enterprises, namely large loss-making SOE. This concentration seems disproportionate to the relative severity of the problems of this segment or

Figure III.1. Capacity utilisation level^{1, 2}Figure III.2. Inventories/sales ratio¹

1. Indicators based on a survey of 5 000 principal industrial enterprises.
 2. Diffusion index: per cent of responses indicating sufficient or less than sufficient capacity, *minus* those indicating excess capacity, expressed as per cent of total responses.
- Source: *The People Bank of China Quarterly Statistical Bulletin*, various issues.

their importance to overall economic performance. Marginally profitable large SOE are also likely to have difficulty in generating the funds needed to upgrade facilities to remain competitive. Debt burdens and outmoded facilities are if anything worse for small and medium-sized SOE and collectives. In effect, the debt reduction and several of the other government programmes amount to an “emergency room” approach to enterprise care: severely afflicted large state enterprises receive most of the attention and resources. There is little in the way of “preventive medicine” for enterprises with serious

but less severe problems; and the majority of enterprises that constitute the bulk of output and employment, and whose importance will continue to grow, are largely uncovered.

Broader programmes could have greater payoff...

These considerations suggest that the benefits of present programmes would be increased by a broader horizontal approach in which priorities are based less on current and prospective ownership and more on the severity of the problems of particular enterprises and their importance to the economy as a whole. Possible measures that could have a significant payoff include the following.

- Allowing participation of small and medium-sized SOE in debt-equity swaps with strict conditionality on organisational reforms and future performance. This could be done in large part through the bank asset management companies with little if any budget outlays. Extension of debt reduction programmes to collectives, again subject to conditionality, could also have a high payoff, even if it were to involve a modest reduction in resources now going to large SOE.
- Establishment of credit guarantee or other mechanisms to make it easier for smaller SOE and non-state enterprises with good competitive prospects to obtain bank loans for technical upgrading. At least in part, this may be accomplished as existing pilot programmes to provide such guarantees are expanded.

... as would efforts to liberalise M&A...

A second important limitation on current restructuring efforts are the present constraints on mergers, acquisitions, and other forms of reorganisation. The government domination of M&A for SOE, the barriers to these transactions across provinces in China, and constraints on the ability of reorganised enterprises to dispose of assets or downsize workforces limit the economic gains from M&A and slow the overall process of economic restructuring. Constraints on enterprise liquidation, including bankruptcy, further limit the ability to move resources to more efficient uses. Judging from experiences of OECD countries, trade liberalisation entails fairly extensive industry reorganisation. Greater priority to developing more flexible market-based mechanisms for reorganisation are likely to be needed to facilitate industry adjustment to WTO entry.

- At the least, rules governing M&A activities should be made more transparent. This would provide greater incentives and allow greater scope for those directly responsible for enterprise operations to develop opportunities for business alliances that offer good prospects for enhancing competitiveness over the long term.
- Given their potentially high risks, very high priority needs to be given to ending government-imposed "strong-weak" M&A, the only exceptions being where there are compelling reasons to expect that they will be value-enhancing in the long term. Direct government financing, to liquidate or otherwise deal with unviable enterprises, is likely to involve lower costs to society than combinations of this sort.

... particularly by reducing regional barriers

Reduction of regional barriers is of key importance to improving the industry reorganisation process. In this context, more active and systematic efforts by the central government to eliminate regional barriers to capital mobility and competition could greatly improve the economic effectiveness

of current industry reorganisation programmes. Specific suggestions include the following.

- Strengthening of legal provisions to explicitly provide for free movement of capital and goods among provinces and to prohibit protectionist measures. This might be done in the context of an overall constitutional provision (*e.g.* along the lines of the “interstate commerce” clause of the United States constitution) enjoining provincial or local governments from establishing barriers to free trade.
- Consolidation and strengthening of existing institutions responsible for competition policy to provide a central government-level body with primary responsibility and capabilities for enforcing laws and regulations concerning inter-provincial trade and investment.
- Review of existing tax provisions, rules governing division of enterprise profits, and other regulations that tend to discourage mergers, acquisitions, and other business alliances across provincial boundaries. The objective would be to find alternative means that would reduce the obstacles and increase the incentives for such activities.

Finally, while the reforms discussed in this chapter are doing much to address problems that have accumulated over the past, for the most part they do not themselves directly address the conditions that caused those problems to arise. Sustained improvement in economic performance depends on how effectively enterprises use the resources generated by the current measures. The experiences of former command economies in Eastern Europe (FCE) suggest that this second step does not automatically follow from the first and is even more difficult. While “defensive” adjustments to improve cash flow and profits in the near term were widespread during the initial stages of transitions in these countries, except among foreign-controlled firms, development of long-term business plans, fundamental reorganisations of operations, and genuine improvements in governance were comparatively rare (Carlin and Landsmann, 1997; OECD, 1999*a*). These experiences underscore that the effectiveness of reforms to improve enterprise behaviour will ultimately determine whether the gains that have been made in dealing with problems accumulated in the past lead to lasting improvements in the future competitive viability of China’s enterprises.

And restructuring is only one step

IV. SOE REORGANISATION

Reorganisation of the SOE sector is intended to concentrate state ownership and control on a core of large enterprises in strategic industries while withdrawing state ownership and support from small and medium-sized enterprises. SOE reorganisation is closely linked to the economic restructuring of the enterprise sector as a whole and to corporate governance reforms. Creation of the strategic core of large SOE involves their conversion into modern enterprises and the formation of large enterprise groups that will be able to compete against large foreign multinationals. These groups face important challenges in overcoming the present problems of their SOE and in sustaining the efficiency and flexibility that will be needed to compete successfully in international markets.

The withdrawal of state control from SOE outside the strategic core does not amount to wholesale privatisation along the lines pursued in European transition economies. The majority of medium and smaller SOE are being transferred to insiders and converted into co-operative or other ownership forms that are intermediate between public and private ownership. Economic performances of these enterprises have so far been mixed and their structures are likely to continue to evolve.

The overall purpose of SOE reorganisation is to establish state enterprises as commercially viable entities in those industries where continued state involvement is seen as necessary to the longer-term development of the economy. The specific objectives are to transform SOE into modern corporate enterprises, concentrate their activities, improve their economic performances, reduce their burdens on government finances, and enhance China's ability to compete with foreign multinationals in international markets. In these respects, SOE reorganisation is both complementary and closely related to economic restructuring of enterprises and to corporate governance reforms. SOE reorganisation is similar to the privatisation programmes of FCE countries during their transitions in that it involves large-scale reallocation of assets from the state to non-state sectors. However, it differs from the European programmes in two key respects: first, SOE will remain more important in the overall economy; and the exit of firms into the non-state sector does not amount to their wholesale privatisation.

Objective: establish a commercially viable SOE sector

Starting in the early 1990s, authorities began to experiment with reforms to SOE control structures that have now become a key element in the SOE reorganisation strategy. The current phase in reorganisation was officially launched by the *Decisions on Issues Related to State-Owned Enterprise Reforms and Development* issued by the 15th Party Congress held in September 1997. In addition to restating the principle that the state and state ownership would continue to have a major role in the economy, the Party document defined three specific principles governing the strategy of SOE reorganisation.

Reorganisation is based on the principles of...

- China is a “mixed” economy in which a variety of ownership forms, including private ownership, co-exist.
- The state will retain full control of defence industries and the dominant position in “strategic” industries deemed critical to economic development.

- State ownership will be progressively divested in other (“competitive”) industries. Ownership in these industries will be broadened through a variety of means, and private stakes in even large enterprises will be allowed in principle.

... keep only large SOE and let smaller SOE go

The latter two principles are typically summarised as “seize the large” while “letting go and enlivening” of the others (Zhua Da Fang Xiao); and transforming the distribution and structure of state owned assets (Zhan Lue Tiao Zhen). “Seize the large” means that state ownership will ultimately be restricted to large SOE in the strategic industries. Although they have not yet been fully identified, these industries are expected to include all or most of: utilities, energy, natural resources; transportation and other major infrastructure; and industries requiring very large-scale investment projects, such as steel, ship building, and petrochemicals.⁵¹ Certain key services, such as grain distribution, finance, and some foreign trade activities are also likely to remain under state control. However, while the state will retain the controlling interest, ownership of SOE in strategic industries is to be diversified to allow non-state (including foreign and private) equity shares. State ownership in the “competitive” industries is to be progressively withdrawn and ultimately curtailed.

The non-state sector's status has been upgraded

While reflective of the status quo, the first principle represents the first official acknowledgement of the legitimacy of non-state ownership in industry. It also allows in principle for private ownership in sectors previously reserved for SOE, including private equity stakes in even large SOE. The status of the private sector was further strengthened in March 1999 by the Ninth National People's Congress, which approved a constitutional provision upgrading the non-state sector from an “important complement” to a state dominated economy to an “essential component” of a mixed economy.

The modalities have been specified

While the *Decisions* made a clear distinction between large, strategic SOE and small SOE, the treatment of medium-sized enterprises remained somewhat ambiguous. In 1999, however, the formal decision was taken to withdraw state control from medium-sized SOE. Under these plans, the number of industrial SOE is expected to fall from the existing nearly 75 000 to at most one or two thousand.

The time framework is long, extending to 2010

The complete transformation of the SOE sector is envisaged to extend through the current decade. Much of the conversion of SOE into corporate entities is supposed to be completed by 2005. Completion of the programmes to establish large enterprise groups and to consolidate industries is not expected before 2010.

Formation of the SOE core

“Seizing the large” involves three modalities

The transformation of the large SOE into commercially viable entities has become the major objective of recent SOE reform under the programme of establishing a “modern enterprise system”. Three complementary modalities are being used to create the strategic core of large SOE that will remain under state control. These modalities are: corporatisation; ownership diversification; and formation of large enterprise groups.

Corporatisation

Under the pre-reform central planning system, Chinese SOE existed as an integrated part of government departments. Although early reforms attempted to dilute the ties between the government and the SOE, Chinese SOE have remained closer to government agencies than to commercial business entities in terms of their control structures. The major problem arising from this arrangement has been the ambiguous property rights and ownership of the SOE, as the assets of the SOE are subject to the control of a range of government departments or agencies but ultimately belong to no one in particular (although in principle the SOE assets belong to the Chinese people, they do not have direct control rights). The “corporatisation” programme is an attempt to clarify property rights of SOE by making them separate legal entities with a defined sphere of autonomy. The overall objective is to transform SOE into “modern corporate enterprises” with commercial objectives and clearly defined rights and obligations under the law, so that they can be held accountable for their performance.⁵² This “corporatisation” process is seen as a necessary precondition for the creation of the strategic core. It entails separating government functions from enterprise operations and allowing the introduction of governance mechanisms that establish accountability of management to the enterprise’s owners (the state). Corporation is also a necessary step to introduce diversified ownership of the SOE as well as to list them on domestic and foreign stock exchanges.

Corporatisation of SOE serves various purposes

Efforts to transform large enterprises into corporate form began in the early 1990s. The enactment of the Company Law in 1993, which became effective in July 1994, provided the national legal framework. This framework provides for SOE to become either limited liability companies (LLC) or joint stock limited companies (JSC), *i.e.* limited by shares. By the end of 1999, more than 7 000 medium and large SOE are estimated to have been corporatised.⁵³ This transformation is accompanied by the implementation of the structures mandated by the Company Law for ensuring effective corporate governance, such as the shareholders’ general meeting, the board of directors and the supervisory board.

Larger SOE have been corporatised since the early 1990s

Ownership diversification

“Ownership diversification” has become the chosen modality of ownership restructuring for larger corporatised SOE in China, in contrast to the wholesale privatisation pursued in European transition economies. In China’s context, ownership diversification for large SOE has meant the encouragement of shareholding among various state entities. While non-state interests are allowed in principle, their role has been only limited, although as indicated below, it is now increasing. The introduction of multiple ownership is intended as a way to sever more fully the direct ties between a SOE and its controlling authority; and to encourage a more commercially oriented operation of corporatised firms by subjecting them to the checks and balances of multiple shareholders.

Multiple ownership of the SOE is being encouraged

Ownership diversification has been part of the SOE reorganisation strategy since the early 1990s but, until recently, it has been largely limited to encouraging multiple ownership through the cross-shareholding among various state institutions such as provincial and local governments, local state

Limits remain on non-state holdings...

asset management companies or other SOE. As a result, state ownership has dominated even the listed companies, with about 70 per cent of the shares of the listed companies held by the state as of 1999. The scope for further expansion of non-state interests in SOE has been substantially limited by two provisions governing share listing. The first is the legal requirement that the state directly hold a minimum of 35 per cent of the shares of listed SOE,⁵⁴ these shares cannot be traded on the stock exchanges. The second stems from restrictions that largely prevent the trading of shares held by other entities under state control ("legal person shares").⁵⁵ As a result, in practice, only about one-third of a companies' shares have been actively traded. However, the scope for diversification of SOE ownership among different state owners (*e.g.* state asset management companies controlled by various localities) is somewhat greater, at least potentially; and could provide at least some of the benefits that broader diversification is intended to achieve.

... but there are signs of liberalisation...

More recently, ownership diversification through the participation of non-state investors has been given increased emphasis. It was most recently endorsed by an official statement in September 1999 that "effective methods of public ownership" will be reinforced through "mixed forms of ownership".⁵⁶ Under present plans, ownership of SOE remaining under state control will be broadened to include minority stakes by private, foreign, or other non-state investors. The recent drive for further ownership diversification through the stock markets has been motivated by two main factors. First, it is seen as a means to expand SOE equity, thereby providing funds for investment and to reduce SOE debt burdens. At the same time, participation of outside shareholders is seen as a vehicle for the much needed improvement in corporate governance of large SOE. The pressing financial needs of social security programmes have provided another motivation for relaxing restrictions on holding of state shares. In late 1999, authorities announced plans to sell a further portion of state equity in SOE.⁵⁷ It was subsequently announced that the capital raised by the sale would be used to fund the pension system. In part to facilitate these sales, authorities announced plans, in June 2000, to relax restrictions on the trading of directly state-owned shares.

... including some openness to foreign and private capital investment

There have also been signs that restrictions on the majority or full ownership of SOE by foreign or private capital are being relaxed. For example, the provincial government of Guangdong announced that it would allow private enterprises to wholly acquire the state-owned power plants, which are affiliated with the Provincial Power Bureau. In addition, private capital is being allowed to participate in investment in some infrastructure projects, such as roads, bridges, information service sector projects and sewage disposal facilities. In a rare move, the authorities also allowed one foreign company to purchase 100 per cent of a state-owned carbon plant in the northwestern Ningxia Autonomous Region.⁵⁸ Although this move might have been primarily driven by the desperate need for outside capital in an inefficient plant located in a backward region, it may indicate increased flexibility in the terms that local authorities are willing to offer to potential investors. At the same time, other cities including Wuhan, Chongqing, Beijing, Shanghai and Tianjin have announced that licences for solely state-owned firms would no longer be given in their industrial sectors. The authorities in these cities also intend to promote

diversified forms of ownership through measures such as withdrawing all or part of state capital from SOE and encouraging private companies to merge with and to reorganise SOE.

Large enterprise groups

Another modality of the current reform strategy to create the SOE core is the formation of large enterprise groups (EG) modelled after Korea's conglomerates (chaebol). Chinese EG were first established at the beginning of the reform period as horizontal associations among SOE controlled by provincial and local governments.⁵⁹ The original purposes of the groups, which often spanned several industries and localities, were to increase supplies of key products, facilitate specialisation in production, and to help co-ordinate economic activities among regions. In the process, they helped to offset the effects of regional barriers to trade and factor mobility. These groups have subsequently expanded greatly through a largely spontaneous "bottom up" process involving joint ventures and a variety of other business arrangements (Lee, 1999). By the late 1990s, there were nearly 2300 of these enterprise groups throughout industry, many of them highly competitive and profitable (Ding, 1999).

Enterprise groups have existed for some time

Beginning in the early 1990s, authorities began to establish large EG from central government-controlled SOE. As with the earlier groups, these EG typically include firms in a number of industries and regions, but they are generally much larger and they have been formed through a top-down process directed by government authorities. Their establishment was motivated by the increasing competition the enterprises were facing in domestic markets from enterprises funded by foreign multinationals.⁶⁰ Formation of the large EG is being pursued to achieve the scale, scope, and diversity of operations that authorities see as necessary to allow China's industries to compete with foreign multinationals in domestic and international markets.

The central government is creating EG...

Large enterprise groups were given a central place in the effort to establish the strategic core of SOE industries following the 15th Party Congress in 1997. The government gave preferential treatment to enterprise groups in credit access, support for technical upgrading and listing. Some of the enterprise groups are sector specific, while others are conglomerates that control companies in several industries. The number of EG has grown from 57 groups in 1991 to 120 groups directly under the central government in 1997. Together, these groups controlled 1.6 trillion yuan in assets (US\$ 192.7 billion or about 5 per cent of the assets of all large industrial SOE) and had total sales of 931 billion yuan (US\$ 112 billion)⁶¹ (see Table IV.1).

... focusing on larger groups in strategic sectors

The economic performance of enterprise groups has been somewhat mixed. In some cases, the groups have attained their goals for improved competitiveness and expanded business. Some of the groups have become strong competitors in international markets. However, many enterprise groups have experienced a decline in the competitiveness of their companies. As in other countries, "big" has not always been a guarantee of "better".⁶²

Economic performances have been mixed...

Table IV.1. General situation of pilot enterprise groups in selected industries

Type of industry	Number of groups	Total assets	Net assets	Sales income	Profits and taxes	Export income
		(billion yuan)	(billion yuan)	(billion yuan)	(billion yuan)	(million US\$)
Metallurgy	8	35.7	19.2	17.8	2.8	228.0
Energy	11	41.3	20.3	14.7	1.7	30.9
Chemical	7	7.7	2.9	3.5	0.5	25.5
Automobile	6	26.3	9.0	21.9	2.4	42.1
Machinery	14	4.4	1.3	2.5	0.3	26.2
Electronics	10	4.3	1.5	4.3	0.4	103.6
Transportation	8	23.4	8.1	10.3	0.6	256.1
Pharmaceutical	5	3.9	1.3	2.4	0.3	31.4
Construction	3	15.5	3.1	10.7	0.5	48.3
Foreign trade	8	11.9	2.3	13.6	0.3	764.7
Average of 120 groups		13.4	5.4	7.8	0.7	117.3

Note: Figures refer to enterprise groups controlled by the central government.

Source: Shen (1999).

... for four main reasons

Several reasons can be cited for the problems of these enterprise groups.

- *Weaknesses in their corporate governance mechanisms.* Many groups were formed before they were fully transformed into corporate entities, and government agencies have continued to be involved in their management. Partly as a result, the groups have often been insufficiently flexible to meet changing market demands.
- *Weak financial discipline coming from implicit government backing.* Given their important (“too-big-go-fail”) role in the economy, the government has been reluctant to allow large loss-making EG to go bankrupt and thus has continued to provide bailout loans to those on the brink of bankruptcy, as was the case in Korea before the financial crisis (OECD, 1998c). In this situation, the managers of large EG have little incentive to improve productivity or profitability, thereby increasing the burden on public finance.
- *Formation of groups by government fiat with insufficient attention to their economic merits.* As with government directed M&A, the top down process gives at best limited weight to the economic motivations (“culture”) or expertise of the management of the individual enterprises. Moreover, as the larger firms are frequently asked to absorb smaller, debt-ridden firms, the potential economic benefits in terms of profitability or efficiency are questionable.
- *Formation of groups to obtain preferential policies from the government.* In such cases, longer-term economic efficiency tends to become a secondary consideration in the formation of the group.

“Letting go” of small and medium-sized SOE

Local governments are divesting their small SOE...

The exit (“divestiture”) of small SOE from state control and responsibility was first officially endorsed by the Third Plenary Session of the 14th Party Congress in November 1993, but pilot programmes organised by the central government and initiatives undertaken by local governments were already in place a few years earlier. Following the official decision, local governments

quickly embarked on programmes to restructure and divest their small SOE. The emphasis has been on the divestiture of loss-making firms, in order to reduce the burden on local governments of supporting their workers. Divestiture of smaller SOE is part of a broader process of ownership transformations underway in the business sector, including the extensive conversion of TVE into joint-stock co-operatives (Li, Li, and Zhang, 1998; Clarke and Du, 1998; Chai, 1997). A large portion of TVE have become effectively privatised under this process, although in many cases they remain officially registered as collectives (IFC, 2000). The objectives are similar in both cases: namely to reduce government burdens and responsibilities for public enterprises, while improving their capabilities to successfully compete in a market environment.

A number of modalities are being used to move small SOE out of state control and responsibility. These include: reorganisation of the existing operations; formation of business alliances with other firms; M&A; transformation into leasing companies or contract operations; formation of “joint-stock co-operatives”, *i.e.* enterprises owned by their workers and management,⁶³ and outright sale to outsiders. Some of these modalities involve conversion into legally private enterprises, while others, notably the joint-stock co-operatives, do not. The predominant pattern has been divestiture to “insiders” in which existing management is largely retained, although as indicated below there are important differences in this respect among regions. While, in principle, transformations are subject to strong requirements on employment and compensation for separations and debtors’ claims, in practice these conditions are less strict. Enterprises and employees are free (in principle) to choose the form of transfer, but conversion of SOE into shareholding co-operative enterprises have been the most prevalent modality, particularly in industry. Creation of legally private enterprises from former SOE has been predominant only in retail and other service sectors where the average size of firms is quite small.

Divestiture by these modalities has proceeded quite rapidly since 1996. According to estimates prepared by the SETC, as much as 80 per cent of small SOE had been converted into one of the above forms by the end of 1998; although the number of enterprises formally transferred into the non-state sector seems to be substantially less.⁶⁴ Regionally, the coastal and southern provinces were reported to have transformed almost all of their smaller SOE by the end of 1998, while many northeastern provinces had also made significant progress. For example, Liaoning province, a heavy-industry centre in the northeast, had shed at least 60 per cent of its smaller state companies, while Hubei province in the middle of China divested about 84 per cent of their smaller SOE.⁶⁵

Various factors have contributed to the differences in the pace and modalities of small SOE divestiture among provinces. First, the central government did not set clear rules on the method of transfer, so local authorities have been left to formulate their own criteria and procedures. Second, local financial conditions played a role. Provinces that have long been plagued by huge losses of their SOE and limited government financial resources have had strong incentives to divest their small SOE as rapidly as possible. These provinces have given more emphasis to outright sales and other modalities entailing little or no further assistance from local authorities. On the other hand, wealthier areas with a relatively low incidence of loss-makers and more rapid economic growth have placed less emphasis on sales to outsiders. In

... employing a number of modalities

Divestiture has been rapid

The pace and means differ among regions

Shanghai municipality, the strategy has been to “support the small” SOE by facilitating their reorganisation.

Performances have been mixed

The performance of divested small SOE has been mixed. Some have become profitable within a short period. Other firms are finding it difficult to survive without state support. With no local government guarantees and increased stringency of bank lending standards (see Chapter VI), poorly performing small SOE are generally unable to obtain bank loans. Moreover, many SOE continue to be burdened by inefficient equipment, outdated technology, and poor management that impaired their performance under state control.

Problems surfaced in 1998...

The divestiture process suffered an apparent setback in mid-1998 following growing reports of widespread asset stripping and other abuses by SOE managers.⁶⁶ In addition, to make companies more attractive for sale, local authorities had written off at least 100 billion yuan in debt without consulting the creditors. In response to these problems, the central government in July 1998 ordered local governments to exercise increased care in transforming small SOE and to slow the pace of divestiture. However, the actual pace does not seem to have slowed greatly; while continuing to divest their SOE, local governments apparently under-reported their extent to central government authorities.

... but the process is now being expanded

There have been important recent developments that signal further broadening and deepening in the letting-go process. The most important of these was the decision in 1999 by the National People's Congress endorsing the divestiture of medium-sized SOE. This decision provides the official sanction for provincial and local governments to begin transforming their medium-sized SOE along the lines that have been applied to the small SOE. Most of medium-sized SOE will be transformed into joint stock co-operatives or contract management firms (rather than privatised) and the process is expected to be largely completed within the next five-year plan. The Shanghai municipal government has announced plans to sell 101 industrial companies (ranging from textile firms to fire-fighting equipment producers) worth 744 million yuan (US\$ 90 million) to foreign investors.⁶⁷ The city of Shenzhen plans to phase out state ownership of all its enterprises over the next five years to eight years, including its large SOE.⁶⁸ The Nanjing municipal government has also announced its plan to withdraw 80 per cent of the state shares from small and medium-sized SOE by the end of 2000. The city of Wuhan is promoting divestiture of its small and medium-sized SOE through the sale of shares to employees or other individuals. Under the new policy, employees can buy shares in state assets through cash or with proceeds from special loans for the purpose; they may also receive shares in lieu of their normal compensation, or through conversion of their interests in benefit funds. A number of other localities are also implementing pilot privatisation projects involving employee ownership of the shares of the small and medium-sized enterprises.⁶⁹

Concluding observations

SOE reorganisation has made much progress

Implementation of SOE reorganisation has made considerable progress. Reorganisation of large SOE that will remain under state ownership is about mid-way. Divestiture of smaller SOE is even further along although the transformation of medium-sized enterprises is just taking off. The contours of

China's enterprise sectors have become much clearer as a result. The ultimate scope envisaged for state ownership has narrowed further; while the scope for private ownership has been broadened substantially. Overall, SOE reorganisation, while stopping short of outright privatisation, leaves more room for private interests, whether individual or co-operative.

While the current SOE reorganisation programme represents a clear departure from the piecemeal reform of the past, its effects on the performances of the enterprises are less easy to assess. Experiences of OECD countries point to several potential problems from SOE reorganisation in China that are likely to require further policy attention (see Box IV.1).

First, SOE reorganisation should be based on a clearer definition than has yet been provided of those sectors where substantial state ownership and control is really necessary. Experiences of other countries strongly

But the impact on performance is less clear

Remaining issues: the breadth of the strategic core...

Box IV.1. OECD experience with the divestiture of public enterprises

Over the last two decades, most OECD countries have undergone a widespread divestiture of their public enterprises. It is estimated that the overall weight of the public enterprise sector among OECD countries is currently less than half of the size it was at the beginning of the 1980s, with its share of GDP declining from about 10 per cent to below 5 per cent. The main factors behind this trend have been: a reassessment of the role of government in the enterprise sector; and the desire to enhance managerial incentives in divested enterprises and sever the link between managers and politicians, thereby lowering the dead-weight costs associated with managerial slack and influence-seeking activities. In the early phases, divestiture was also motivated by public finance considerations, *i.e.* raising government revenues by selling public assets.

During the 1980s, divestiture among OECD countries concerned mainly public enterprises operating in competitive industries such as manufacturing, banking and insurance. But since the early 1990s, divestiture has increasingly taken place in such industries as utilities, telecommunications and transportation. Technological advances and policy shifts have diminished the perception that state ownership is required in these infrastructure sectors. The divestiture of state-owned monopolies such as public utilities raises important regulatory issues. The experiences of OECD countries show that divestiture in these industries needs to be pursued in tandem with competition-enhancing policy and the design of post-divestiture regulatory frameworks. In particular, an adequate regulatory framework should be developed to promote competition and to protect the interests of consumers.

The method of divestiture chosen differed among countries: while competitive bidding was widely used, some countries opted for a managed approach (*e.g.* France in its recent two waves of divestiture – initially in 1986-88 and subsequently in 1993-95). In this approach, a substantial portion of equity (generally between 25 and 45 per cent) is sold to a selected group of investors with existing close ties to the companies. These selected investors constitute a closed inner core (*"noyau dur"*) of shareholders who are interconnected through loops of circular shareholdings and whose representatives make up a clear majority of the board of directors of the divested firm.

Empirical analyses of the effects of divestiture on firm performance show that divestiture has generally but not always led to improved company performance. The outcome has varied considerably according to such factors as the post-divestiture ownership and corporate governance structures as well as the legal, institutional and market environment. Evidence suggests that the impact of ownership transfer on efficiency and consumer welfare tends to be significantly positive only when corporate governance mechanisms work efficiently; hard budget constraints are imposed; preferential treatment is eliminated and previously sheltered markets are liberalised; contractual arrangements are designed and adequately enforced; and the private sector environment is relatively free from political influence. Evidence from Eastern European countries also suggests that the ownership change tends to have only marginal effects on performance in the case of firms controlled by insider owners (former SOE managers and/or employees). Also, in the cases where divestiture was primarily driven by the need for raising government revenues, the benefits from divestiture have proven disappointing due to insufficient attention paid to the market power of the firms being divested.

Sources: Gonenc, Maher and Nicoletti (2000); Morin (1998).

suggest that the contribution of SOE to overall economic performance is likely to be greatest when they are confined to natural monopolies or other industries where extensive public ownership is clearly needed on economic or compelling social grounds. Although China is still a developing economy, defining the strategic industries where SOE will dominate fairly narrowly is likely to be most conducive to economic growth and development. Moreover, international experience strongly suggests that corporatisation alone is insufficient to offset the adverse impact state ownership and control almost inevitably has on incentives to maintain good enterprise performance. External mechanisms to offset these adverse effects are thus essential to the ultimate success of the SOE core.

- In particular, the economic gains from SOE reorganisation could be greater if the current policies were directed at a more rapid and broader withdrawal of SOE from competitive industries and a wider and deeper participation of foreign and private capital in the restructuring of the SOE sector.
- Ensuing vigorous competition, particularly in strategic industries, and sustaining rigorous financial discipline is likely to be critical to establishing a SOE core that can compete in domestic and international markets on its own. High priority will need to be given to correcting serious weaknesses in these areas if the SOE core is to be established on a sound basis and make a successful adjustment to WTO entry. In this context, maintaining and, where necessary, strengthening regulatory regimes to buttress competition and financial prudential policies is also of high priority.

... the profitability of large EG...

Second, formation of large enterprise groups that are capable of sustained profitability is a major challenge under the best of circumstances. The aftermath of the M&A boom in the United States in the latter 1980s as well as the problems manifested by the Korean chaebols during the recent financial crisis illustrate that combinations that appear economically beneficial *ex ante* are often unsuccessful *ex post*. Successfully managing such enterprises is even more of a challenge. In China, the difficulties are greatly compounded by weaknesses in corporate governance mechanisms and the existing financial problems of SOE. Inevitably, some of these groups will prove unable to earn competitive returns, either under the increased competitive pressure of WTO entry or for other reasons. In such cases, further reorganisation and restructuring will be needed if the groups are not to become a burden on public finances.

... competition in strategic industries...

Third, the competitive implications of SOE dominance of strategic industries are somewhat unclear. An optimistic but not improbable prospect is that SOE reorganisation will help to break down regional barriers to trade while WTO entry ensures even the strategic industries have adequate competition. However, the amount of competition that will be allowed between SOE and non-state firms in these industries remains to be determined. Moreover, large enterprise groups pose risks of cartels or other non-competitive behaviour. Improvements in regulatory mechanisms to enforce adequate competition are very likely to be needed, particularly as adequate competition is essential to effective corporate governance of SOE.

... and performance of divested SOE

Fourth, experiences in European FCE underscore that simply removing SOE from state control does not guarantee that their performance will improve (Carlin and Landsmann, 1997; Commander *et al.*, 1996). Many of the

divested small and medium-sized SOE in China are unlikely to be able to survive and mechanisms to facilitate their exit will need to be improved. At the same time, further steps may be needed to ensure that fundamentally viable enterprises are not forced to exit because of inadequacies in financing outlets or other distortions.

V. ESTABLISHING EFFECTIVE CORPORATE GOVERNANCE MECHANISMS

Establishment of effective corporate governance mechanisms has become a key priority of reforms to ensure that SOE function effectively in a market environment. Two major objectives have guided the reforms in this area. The first is to establish mechanisms to exercise the state's ownership interest in SOE that are separate from the government's regulatory functions. The second objective is to set up internal governance mechanisms to provide incentives and accountability for managers to act in the interest of their owners.

Governance reform has involved a series of institutional and organisational transformations including: termination of the managerial functions exercised by government bureaux; establishment of a multi-tiered state asset management system; and the introduction of boards of directors and other modern governance mechanisms into corporatised firms. The success of the reforms in improving enterprise governance has been uneven: governance has improved most for SOE in competitive sectors and much less, if at all, for those in protected industries. Overall, the corporate governance mechanisms have not functioned nearly as effectively as was expected. This outcome is due largely to the fact that external discipline has remained weak; the state shareholder and regulatory functions have not been sufficiently separated in practice; and institutional and regulatory weaknesses prevent effective enforcement of the rights and obligations entailed in modern corporate governance mechanisms.

Like other transition economies, China faces the major challenge of establishing effective corporate governance systems in its SOE to ensure that they are competitive and can adapt to the changing demands of the market. Establishing effective governance of the SOE has become a key priority of China's current reform programme to set up a "modern enterprise system." Authorities are developing modern governance systems to push SOE to restructure and reorient managerial incentives to engage in profit-oriented, value-augmenting activities, in line with the owner's interest. Strengthening corporate governance is seen as an urgent task as Chinese policy makers have come to realise the increasingly adverse impact of the weak governance and ensuing inefficiency of the SOE sector on macroeconomic performance and the health of the banking sector. The imperative has also become urgent in view of China's prospective accession to the WTO. To deal with the increased competition from WTO membership, China's enterprises need to improve their decision-making mechanisms to compete successfully in domestic and international markets. Adoption of corporate governance mechanisms in line with international practice is also essential to the ability of China's enterprises to attract foreign capital in increasingly competitive global capital markets.

Establishing effective corporate governance has become a key priority

Ensuring that SOE are effectively managed is the ultimate challenge of corporate governance reforms. The key question is how owners – the state – can provide managers with incentives to use the firms' assets efficiently and act in the owners' best interests. Establishing effective governance systems in the context of SOE, however, has proven to be a difficult task throughout the world. International experience suggests that SOE usually suffer from the imposition of non-commercial objectives by the state, which hampers the ability of the enterprise managers to respond

Providing incentives for management of publicly owned assets...

efficiently to market forces. SOE also tend to lack incentives and sanctions needed for good management found in private firms. This is primarily because the ambiguity of property rights associated with state ownership creates a situation where there is usually no clearly accountable representative of the state to monitor the performance of managers (Pannier, 1996; Estrin, 1998). In transition economies, SOE reform is usually made all the more difficult by the lack of external disciplinary mechanisms to support internal governance practices, such as efficient financial markets, competitive product and factor markets, and developed legal and accounting frameworks and enforcement mechanisms (Brada, 1996; Richet and Huchet, 1999; Lin, 2000)

... is to be achieved by governance reforms in China

The governments in OECD countries as well as in other transition economies have used a range of measures to improve the governance of their SOE, with varying degrees of success. These measures include: corporatisation and restructuring; bankruptcy and other exit measures; and privatisation (Iskander, 1996). The approach taken in most other transition countries has been to transform SOE into non-state companies through massive privatisation. The different approach being taken by China is to force the SOE that will remain under state control to act more like private commercial firms through corporatisation and the creation of governance structures to provide the incentives and disciplines that operate in private firms. Under this approach, the government is withdrawing from the management of enterprises while exercising its functions as owner and shareholder through separate entities created for those purposes.

Reform measures to improve corporate governance of SOE

Earlier reforms focusing on increasing managerial incentives...

Since the launching of the economic reforms, the Chinese government has attempted to improve the governance of SOE by introducing market-oriented incentives and disciplines. The earlier reforms introduced in the 1980s centred on expanding managerial autonomy and incentives through contracts between managers and government supervisory agencies.⁷⁰ In particular, the Contract Responsibility System provided greater material incentives for managers and workers by tying management autonomy, pay, and retained profits to the performance of SOE.⁷¹ Control over SOE was decentralised, with all but 2 000-3 000 of the 118 000 SOE placed under the supervision of provincial and local governments instead of under the central government.

... made progress but created problems as well

These earlier experiments led to considerable success in increasing productivity, but they also produced new, and initially unanticipated, problems. These problems arose because the reforms significantly increased the autonomy and control rights of insiders without adequately strengthening the oversight functions of the state/owners. On the one hand, reform measures centred on the use of incentive contracts were successful in improving the efficiency of SOE by motivating managers and workers to make and keep profits (Groves *et al.*, 1994). However, they also hindered longer-term enterprise performance by creating conditions for moral hazard, where managers and workers could make small gains at a large cost to the firm or to the economy by passing losses and liabilities to the state (Broadman and Xiao, 1997).⁷² The rent-seeking behaviour of insiders led to such widely observed phenomena as speculative or uneconomic investments, asset stripping, diversion of

enterprise funds to the insiders/managers, and excessive wage increases. At the same time, the decentralisation of reforms led to the reduction in the ability of the central ministries to supervise the firms. The oversight ability of the government was substantially undermined because information necessary for monitoring could be distorted by insiders through a variety of means, such as false reporting of profits or soft loans to augment poor cash-flow. The decentralisation of reforms also aggravated the problem of government intervention in day-to-day enterprise operations by creating additional layers of local agencies. The interference by numerous, uncoordinated government agencies (dubbed “mother-in-law”) hindered the efficient decision-making of firms. The overall result of these conditions has often been characterised as “insider control under administrative intervention” (Zhang, 1998; Qian, 1999).

Since the early 1990s, policy makers and academics in China have increasingly adopted the view that poor SOE performance and weak governance is attributable to the “unclear property rights” and “lack of separation between government and enterprises”. In the subsequent SOE reform programme, a major focus has been given to clarify property rights through corporatisation; and to separate government ownership and regulatory functions by establishing the state as a shareholder with functions similar to those performed by private shareholders in other countries. A second major focus is to transform SOE into commercially oriented corporations with effective internal and external governance mechanisms. As discussed in Chapter IV, the shareholding of corporatised SOE is to be diversified through public listing in the stock exchanges, although the extent to which non-state shareholding in large SOE will be allowed is not yet clear. These reforms are intended to clarify property rights of SOE; delineate the roles of the state and the enterprises more clearly; and clarify and enforce the rights and responsibilities of the various actors participating in corporate governance.

Major reforms have been underway since the early 1990s

Separating state shareholder function from regulatory functions

One of the major objectives of China's state shareholding reform is to separate the state's ownership/shareholder function from its regulatory functions by creating distinct agencies to manage state assets according to commercial principles. Accordingly, line ministries or departments that were responsible for SOE in the past are to be phased out so as to terminate their managerial functions in the enterprises. The rationale is that the government must delegate its ownership responsibilities if SOE are to have effective management and the internal governance mechanisms are to function effectively.

One major objective: separate state ownership and regulatory functions

The reform of the state asset management system has created a multi-tiered network of institutions at the national, provincial, and municipal government levels to oversee and manage state assets. At the national level, the State Council acts as the ultimate owner of SOE assets on behalf of the Chinese people, with the National Administrative Bureau of State-Owned Property (NABSOP) acting as its administrative arm. At the provincial and municipal levels, State Asset Management Committees (SAMC) serve as similar upper-level bodies that are responsible for preserving and increasing the value of state assets.⁷³ Each SAMC oversees a number of state holding (sometimes called state asset management) companies (SHC) that manage the assets of SOE entrusted to their responsibility. In the case of large enterprise groups, their lead companies have been authorised to carry out the functions

A multi-tiered system will oversee SOE assets...

of SAMC and SHC for their constituent firms. Under the division of labour established by these reforms, SHC are responsible for the management of the state assets and exercise of the state's ownership rights, but are accountable to the SAMC.

... with newly created holding companies

In most cases, the SHC have been constituted by transforming the traditional industry line government bureaux,⁷⁴ although there are some exceptional cases such as Wuhan State Asset Management Company (Box V.1). The SHC have diverse ownership stakes in the companies under them, ranging from wholly owned to non-controlling interests in some joint-stock limited companies. Each individual SOE manages its own operations and is responsible for its own profits and losses. But they are subject to the ultimate control of the SHC, which have the legal claims to the returns on their shares in the SOE and bear limited responsibility for their enterprises' debts. SHC can also acquire shares of companies outside the group, including those affiliated with other SHC; in principle, this allows them to engage in restructuring through mergers and acquisitions with outside firms.

Government administration is being reorganised

A parallel restructuring of the central government administration has complemented the new state asset management system. A major step in this regard was the reduction of central government ministries from 40 to 29 during the latter half of 1998.⁷⁵ The primary rationale of this restructuring was to eliminate most remaining industrial branch ministries in order to terminate their managerial functions in SOE. Economic ministries have been ordered to sever administrative ties with SOE and to maintain an arms-length relationship with their former affiliates. The central government has announced that this transformation will be carried out at the provincial and local levels during 2000.

Introducing internal governance mechanisms

Modern governance mechanisms have been introduced

Another major objective of the current reform is to strengthen internal incentives and monitoring mechanisms in shareholding firms by introducing modern corporate governance mechanisms into corporatised firms.⁷⁶ The Company Law prescribes a system of corporate governance through three main bodies for joint stock limited companies (JSC):⁷⁷ the shareholders' general meeting; the board of directors; and the board of supervisors (see Box V.2). These internal governance mechanisms are intended to ensure effective corporate governance through the accountability of management to the board and shareholders; supervision and oversight of the board of directors and senior management by the supervisory board; and the accountability of the directors to the shareholders. The inspiration for the Company Law came largely from the civil law tradition of continental Europe, Germany in particular, and from Japan (Jordan, 1998; Lin, 2000). As in Germany, the shareholders' meeting in China in principle has much broader power than in Anglo-Saxon countries. Like the German corporate model, China's corporate governance system requires employee representation on the supervisory board. Mandatory employee representation on the supervisory board reflects China's stakeholder orientation toward corporate governance, which is consistent with the traditional role of SOE in China and the continued emphasis on an economy with "socialist characteristics".

Box V.1. **Wuhan State Asset Management Company¹**

Several models of the state asset management companies have emerged in China. In most cases including Shanghai and Beijing, asset management companies have been typically converted from old government line bureaux or large SOE. Wuhan State Asset Management Company (WAMC) is unique in that it is an integrated holding company encompassing a range of sectors and is more commercially oriented. Due to these unique features, the Wuhan model has received wide attention from other provinces and municipalities.

Formation and evolution of WAMC

In June 1994, Wuhan State Asset Administrative Committee was established to take the responsibility for preserving and increasing the value of state assets. In August, WAMC was formed to exercise the functions of management and operation of state assets. WAMC was initially given responsibility for 24 companies that were either producers of finished products or in the wholesale/retail trade area. Since November 1997, the authorities have added 22 more companies to WAMC, after finding that the 24 original companies were performing well. WAMC has also acquired three other companies using resources from assets under its control.

The Wuhan government has subsequently set up three other asset management companies, but they are sector-oriented derivatives of the old industrial bureaux (machinery and electronics; raw materials; light industry and textiles). The four companies, especially the WAMC, have been deemed successful in managing state assets and the municipal government is planning to transfer its holdings in other enterprises to the asset management companies.

Organisation and function of WAMC

WAMC has 8 departments and controls 49 enterprises encompassing a wide range of sectors including wholesale/retail trade, financial services, pharmaceuticals and chemicals, building materials, packing and printing as well as some heavy and light manufacturing. WAMC has diverse ownership stakes in the companies under it, ranging from wholly owned to non-controlling interests in some joint-stock companies. Thirty of the 49 companies are themselves holding companies, each controlling a number of individual enterprises.

There are two ways for WAMC to acquire assets of other companies: property transfer and market purchase. Property transfer means that all or a part of the state assets of some SOE are transferred to WAMC by the authorisation of Wuhan municipal government. Market purchase means that WAMC, by its own initiative, acquires interests in other enterprises through investment, share purchasing, or M&A.

Relationships between WAMC and constituent companies

WAMC manages its constituent companies in three ways including property management; participation in major decisions concerning large investments or bank loans and M&A among the companies under it; and monitoring of company performance, including selection of managers, performance evaluation and compensation, and financial supervision. WAMC carries out its functions and roles as a shareholder in the companies through its participation in shareholders' meetings, or by participation on the board of directors (as a member or secretary) of the companies where WAMC holds shares.

WAMC does not interfere directly in management of constituent companies. Each of the enterprises formulates its own business plans, although WAMC reviews those plans and provides advice. In principle, WAMC does not have the responsibility for approving lay-offs, nor does it interfere with other personnel decisions. WAMC does not provide direct loans to its member companies, nor does it provide guarantees against its own assets. Instead it works to "persuade" bank lenders to provide financing. To assist financially weakened companies under its control, WAMC may seek to: *a)* invite enterprises from outside the group or outside the province to merge or co-operate with the company; *b)* encourage companies with difficulties to adopt a share-holding form that leads to a change of management and other reforms; *c)* sign 3-year term management contracts with the managers, to be renewed according to performance; *d)* sell shares of the weak companies to employees or private companies; or *e)* encourage changes in product/business lines. In addition, WAMC has provided a number of incentives to the companies under its control, including the introduction of performance-based compensation packages to senior managers and the offer of stock options to managers in listed companies.

1. This box was prepared by Ms. Zhang Qi, Deputy Division Chief of the Foreign Economic Relations Department of the Development Research Centre of the State Council of China, with editorial revisions made by the authors of this study.

Box V.2. **System of corporate governance under China's Company Law**

Under the Company Law (1993), two types of companies are established, *i.e.* limited liability company (LLC) and joint stock limited company (JSC). The Company Law prescribes a system of corporate governance through an organisational structure comprising three main bodies: the shareholders' general meeting; the board of directors; and the board of supervisors. The LLC, with a small number of shareholders and a small scale of operation, may have a sole executive director (who may serve as the manager of the company) instead of the board of directors. A solely state-owned LLC does not have a shareholders' meeting but has the board of directors. This box describes the typical organisational structure of corporate governance in JSC.

Shareholders' general meeting is the highest authority within the company. It has the following rights and responsibilities: to decide on the company strategy and operational business and investment plans; to appoint and dismiss members of the board of directors and representatives of shareholders as members of the supervisory boards; to examine and approve reports by the board of directors and by the supervisory board; to examine and approve the company's proposed annual financial budget and final accounts, profit distribution plan and plan for recovery of losses; and to pass resolutions on the increase or decrease of registered capital, the issuing of bonds, and on merger, division, dissolution and liquidation. Shareholders' meetings are held once a year. Shareholders are entitled to one vote for each share held.

The board of directors comprises between five to nineteen members, with members elected by the shareholders' meeting. The board of directors is accountable to the shareholders' meeting and empowered with the following rights and responsibilities: to convene the shareholders' meeting and report work to the meeting; carry out the resolutions and decisions adopted by the shareholders' meeting; to draft proposed operational business and investment plans; to formulate plans for profit distribution, recovery of losses, merger, division or dissolution of the company; to decide on the company's internal organisation and management structure; to appoint, dismiss, and determine the remuneration of the company's general manager, the deputy manager (upon recommendation of the general manager), and the chief financial officer. The meeting of the board of directors is held at least twice a year. The general manager attends the meeting of the board of directors as a non-voting member.

The supervisory board comprises a minimum of three members, including representatives of the shareholders and at least one representative of the company's employees. The employees' representative(s) is (are) to be democratically elected by the employees. The tenure of a supervisory board member is three years, which is renewable upon re-election and re-appointment by the shareholders' meeting. Members of the board of directors, managers and the chief financial officer are not allowed to serve as members of the supervisory board. The supervisory board is empowered with the following rights and responsibilities: to oversee and examine the financial affairs of the company; to supervise acts of directors and managers; and to request remedies from directors or managers for their acts which have harmed the interests of the company. Supervisors attend the meeting of the board of directors as non-voting members.

Measures to strengthen managerial incentives are being introduced

Efforts are also being made to introduce measures to strengthen managerial incentives for effective performance in corporatised SOE, although most of them are still on an experimental basis. Market-oriented behaviour of managers in China has been hampered by the lack of market-based selection of managers and weak managerial incentives. The market-based selection of managers has been constrained by the political and bureaucratic influence in the selection process as well as by the underdeveloped labour market for managers in China. Managers of state-owned or state-controlled companies also generally have weak material incentives due in part to the limited scope of performance-related compensation schemes for individual managers.⁷⁸ To address these problems, the government has sought to encourage competition and other market-based procedures in the selection of managers.⁷⁹ The government has introduced, on an experimental basis, stock options as well as other remuneration packages more closely tied to company performance for managers and top executives of shareholding companies.⁸⁰ It has also sought to improve training of SOE managers and to promote adoption of mod-

ern business techniques used in private firms. New training programmes for SOE managers have been set up in various localities; sometimes managers have been sent overseas to learn modern business techniques.

Weaknesses in the corporate governance reforms in China

Overall, the reforms to improve corporate governance of large SOE in China have sought to establish the mechanisms that have been shown to be essential for efficient corporate governance of large firms in advanced market economies. In theory these reform measures were expected to improve the corporate governance practices of China's SOE. However, the general perception in China as well as available evidence seem to suggest that these reforms have not resulted in any appreciable improvement in the actual practices of corporate governance in either SOE or listed JSC. In fact, the process of corporatisation since the early 1990s has been correlated with a significant deterioration in the performance of China's corporate sector (Lin, 2000). There is anecdotal evidence at the firm level that corporatisation and public listing have tended to be viewed mainly as an inexpensive way to raise capital in the equity markets, involving at best limited obligations to improve corporate governance in the interests of shareholders (Steinfeld, 1998).

Corporate governance practices have not appreciably improved

The reasons underlying the continued weak corporate governance practices in China in spite of the reform measures are complex. But three main factors have been especially important.

Three main reasons for the weak governance practices

Weak external discipline

First, the reform measures so far have put a major emphasis on delegating control rights and autonomy to managers and local governments, but have failed to impose strict external discipline or constraints on the main players involved in the corporate governance of large SOE. International experience in SOE reform suggests that the success of corporate governance reforms, regardless of the particular approach being taken, is only ensured when effective external disciplinary mechanisms are available to reinforce the internal corporate governance mechanisms (Iskander, 1996). Even without changing ownership, SOE can be forced to significantly improve their performance when strict financial discipline is imposed, as shown by New Zealand's experience (World Bank, 1996b). In China also the effectiveness of corporate governance has been shown to vary greatly across sectors according to their degree of product market competition and exposure to financial discipline. In particular, growing competition from non-state enterprises has been most instrumental in inducing market-oriented behaviours and improving profitability of the SOE located in the competitive sectors (Naughton, 1994; Jefferson and Rawski, 1994a). Evidence suggests that managers and the boards of these firms tend to be most responsive to external market forces and most effective in meeting their demands (Richet and Huchet, 1999). In contrast, the economic behaviour of the large SOE or state-shareholding firms operating in the protected sectors – which largely comprise the “strategic” core – has been most resistant to the changes brought by various reform measures.

External discipline remains weak...

Large SOE in the core sectors have continued to enjoy state support in various forms, which partly results from the policy burdens imposed on them. China's SOE, as those of other transitional economies, have inherited a number

... due to policy burdens and policy lending by state banks

of policy burdens as legacies of pre-reform policies. These include: state mandates to operate in capital-intensive industries; distorted output prices; pension burdens and other social welfare costs; and the inability to reduce redundant workers for the sake of social stability (Lin, 2000). In theory, the state should be responsible only for the SOE losses that arise from the policy burdens, not for those arising from the SOE's own operational inefficiencies. However, in practice, it is very difficult for the state to distinguish between these two. As a result, the managers can always ascribe their losses to the state's policies, not to their incompetence or opportunistic behaviour. Consequently, the state ends up taking responsibility for all the SOE's losses through direct subsidies or policy lending through banks. The poorly-performing large SOE have been repeatedly bailed out by the state-owned banking system through policy lending and thus have not faced any real threat of bankruptcy or other exit measures. As a result, soft budget constraints, the absence of exit mechanisms and monopolistic rents have created especially large opportunities for rent-seeking by managers and government agencies. As long as these external disciplines remain weak, rent-seeking does not clearly affect the bottom line of firm.⁸¹

Continued state dominance in ownership, control and governance

Continued state dominance limits the effect of reform measures

Second, the creation of mechanisms to separate government ownership and regulatory functions and to reduce government interference in SOE has not fundamentally changed the essential nature of the ownership and control by the state. Rather it has largely involved a shift of formal control rights from a single controlling (state) authority to a small number of alternative government institutions such as the SHC (Lin, 2000). The resulting control structure does not represent a clear improvement in the governance of SOE, in that the fundamental problem of multiple principles with insufficient incentives or ability to act as true owners in SOE governance has not been resolved; moreover, the multiple state institutions which now control the Chinese corporations are ones that suffer from weak corporate governance themselves.

The efficacy of the holding companies has been limited

Anecdotal evidence suggests that the newly established SHC, which in principle should operate as commercial entities, continue to be more bureaucratically, rather than commercially, oriented. They tend to be heavily influenced by their upper-level agencies, state asset management committees (SAMC), which continue to function like government administrative departments. The predominant method of creating holding structures along industry lines further contributes to their bureaucratic orientation and tends to mix regulatory and commercial objectives. In particular, the SHC have been used to implement government-led restructuring of enterprises and workforce reductions in the industrial sectors for which they were previously responsible.

International experience of public holding companies is not always positive

Even if these problems could be overcome, the international experience in many OECD as well as non-OECD countries has shown that the intended benefits of the public sector holding companies tend to be outweighed by their drawbacks. A range of additional difficulties have been associated with public sector holding companies in these countries.⁸² As in China, such holding companies tend to impose an additional layer of bureaucracy when the upper-tier institution is not effectively separated from the regulatory function of the state. Non-economic objectives frequently govern the functioning of state-owned holding companies, to the detriment of the commercial principles

they are supposed to promote. Public sector holding companies formed along industry lines have often created obstacles to the development of competitive markets. In practice, public sector holding companies have proved effective only for: managing the largest natural monopolies and some strategic enterprises (Radygin, 2000); or in specialised services such as corporate restructuring, dealing with financial crisis and managing bailouts, and preparation for subsequent commercialisation and/or privatisation (Baumann, 1998).

At the same time, despite the reform objective of separating the government from enterprise management, the political/bureaucratic intervention by the state in the internal management of the SOE has continued. In particular, government involvement in the selection of senior management in large SOE is most problematic. The selection of managers continues to be heavily influenced by political and bureaucratic considerations, with various government authorities and their personnel departments influencing the appointment of senior managers (Mai and Perkins, 1997; Steinfeld, 1998; Zhang, 1998).⁸³ In the corporatised firms, the general manager tends to be pre-selected by the dominant or controlling shareholder, despite the statutory requirement that they should be appointed by the board of directors.

*Political/bureaucratic
intervention continues*

Ineffectual role of internal governance mechanisms

Third, the internal governance mechanisms introduced under the Company Law, such as the two-tier board structure, are potentially powerful mechanisms conducive to good corporate governance within the firm. However, in practice, the board structure does not appear to function as effectively as initially expected because it lacks several necessary checks and balances. First, the supervisory board in China tends to have very little power and independence to carry out its intended oversight functions. In the German model, the supervisory board appoints the board of directors, whereas under China's Company Law, they are appointed by the shareholders' meeting. Hence in China, the board of directors is directly accountable to the shareholders' meeting, rather than to the supervisory board as is the case in Germany. In addition, the supervisory boards in China are largely chosen by and subject to the controlling shareholder and do not effectively represent minority shareholders or other stakeholders. In fact, the members of the supervisory board have often come from retired company officials (Lin, 2000).

*Ineffective oversight functions
of the supervisory boards...*

The effective control of corporatised firms tends to be concentrated in the hands of the general manager acting on behalf of a single majority or controlling shareholder (the state). Despite the statutory requirements, there is in practice little effective accountability of senior management to directors that are genuinely independent. The roles of the chairman of the board and the general manager are often combined; and the board is dominated by executive directors who have managerial responsibilities. The appointment of the general manager and other members of the board are largely dominated by the controlling shareholder. As a result, the board of directors is neither independent from management nor accountable to minority shareholders. This limits its ability to provide effective, independent monitoring of management in the interests of all the shareholders and stakeholders.

*... as well as the domination
of insider control...*

... need to be addressed by upgrading the role of the boards

The lack of independence of the supervisory board as well as the board of directors from insiders, and hence their ineffectual roles in China's corporate governance, suggest that there is a large room for improvement by clarifying and reinforcing the functions and responsibilities of the boards and other statutory arrangements in the Company Law. Both international experience and the corporate governance literature suggest that the role of the boards can be substantially strengthened by appointing a sufficient number of independent, outside directors. For example, the Cadbury Codes of the UK recommend at least three non-executive directors in the board. The OECD Principles also recommend that boards assign a sufficient number of non-executive members capable of exercising independent judgement to tasks where there is a potential for conflict of interest (OECD, 1999b). Effective oversight by boards also requires improved transparency and timely disclosure of financial information of the companies.

Legal and regulatory frameworks and their enforcement need improvement

In developing and transition economies like China, the market and legal institutions and processes, which support good corporate governance practices in developed market economies, are relatively absent. China has made much progress in developing the legal and regulatory framework that supports its transition to the market economy. Critical legislation enacted recently includes: Company Law (1993), Central and Commercial Banking Laws (1995) and the Securities Law (1998).⁸⁴ The government has also been paying more attention to strengthening the regulations concerning accounting and disclosure standards. Nonetheless, the institutional and regulatory mechanisms that are necessary for ensuring good corporate governance practices are still relatively underdeveloped, which prevents effective enforcement of the rights and obligations entailed in modern corporate governance mechanisms. Thus, the challenge is not only to design and develop the legal and regulatory framework but also to ensure that the laws and regulations have the intended impact on the day-to-day decisions of economic actors. Establishing "rule of law" – rather than "rule by law" or "rule of man" – is another critical challenge facing China's enterprise reforms.

Corporate governance issues in the non-state sectors

Governance issues also concern non-state firms

Although less discussed, there are also issues concerning non-state enterprises that may require more policy attention in the future. These arise from the nature of governance in collectively owned enterprises and from the extensive insider influence that has accompanied the divestment of smaller SOE.

Collectives have complex governance structures...

While nominal ownership of collectives in China lies with the "community" of stakeholders, effective control is largely exercised by managers and local governments. In part because collectives have been important revenue sources for local governments, property rights seem to be better defined than for SOE and there has been a closer alignment of residual risk-bearing with control (Lin, 2000). However, control, property rights, and residual risk-bearing are not determined by law, regulations, or formal contracts but rather by implicit and somewhat imprecise arrangements (implicit contracts) that vary across firms and with circumstances. Although conversion of TVE into joint-stock co-operatives is reducing the direct role of local governments in their management, it does not necessarily alter the implicit and relatively complex nature of their governance mechanisms. Moreover, the importance of these arrangements in the economy is increasing as a large proportion of divested SOE is converted into joint-stock co-operatives.

The superior economic performance of TVE during most of the reform period has suggested that their governance structures have significant advantages. The equity stake of local governments in TVE and their broader role as stakeholders on behalf of their citizens has helped to shield the enterprises from interference and predatory actions by other government agencies.⁸⁵ Several scholars have argued that the implicit governance arrangements of the collectives have provided necessary flexibility in an environment in which the formal definition of and enforcement of property rights and contractual obligations has been quite limited (Weitzman and Xu, 1994; Li, 1996; Che and Qian, 1998). The implication of these arguments, however, is that the governance advantages of collectives are largely of a second best nature, that is, they have helped to overcome distortions and other limitations in the external environment in which the enterprises operate.

... that may have been advantageous earlier...

To the extent this is true, the governance features that were useful earlier may be less advantageous or even a liability in the future. Theory, and actual experiences with collective ownership in other countries point to several potential problems with their governance.

... but which now could lead to problems

- The “co-operative shareholding” form adopted by many smaller SOE gives each worker one voting share regardless of their equity stake. This impairs the alignment of control rights with ownership stakes and tends to weaken incentives for larger stakeholders to exercise effective oversight.
- Even where well defined for existing workers, property rights in collectives generally are not legally transferable. Workers who leave a collective must relinquish their equity claims. This tends to discourage labour mobility (Woo, 1997) and to encourage actions to increase short-term returns at the expense of the longer-term value of the enterprise.
- As has happened with workers’ co-operatives in several European FCE, collective ownership can be an obstacle to improving enterprises’ competitiveness through labour shedding.
- Uncertainties about ultimate control may deter joint ventures with outside investors. Collectives themselves are not eligible for stock market listing. In time, this could become a comparative disadvantage with private firms and make it difficult to adapt to changing market conditions.

Problems are also arising from the dominance by insiders in other forms of SOE divestiture. Managers have tended to control privatisation of their firms or their alliance with outside enterprises. Not infrequently, asset stripping through the transfer of the SOE to an enterprise controlled by its managers or by other means has occurred. Such abuses, apart from the harm to the SOE itself, tend to discourage outside investment in divested SOE generally.

Problems arising from insider abuses in SOE divestiture...

Insider abuses have been widespread in other transition economies and are difficult to avoid altogether. There have been signs in recent years that tighter budget constraints along with official crackdowns on corruption have somewhat reduced asset stripping and other insider abuses in China. However, the abuses are facilitated by weaknesses in governance mechanisms for divested SOE as well as the limited development of legal codes defining fiduciary responsibilities of managers and providing means for their enforcement. Until these mechanisms are improved substantially, problems arising from undue insider influence are likely to remain.

... are also widespread in other transition economies

Concluding observations

Much progress has been made...

The reforms aimed at establishing the “modern enterprise system” have tackled China’s corporate governance problems on various fronts. The corporatisation process has somewhat clarified property rights and has provided an institutional foundation for internal governance structures. In principle, government involvement in enterprise management has been curtailed. The exercise of ownership rights in SOE has been delegated to distinct agencies whose primary mandate is to preserve and increase the value of their state assets. The Company Law and subsequent reforms have made important progress toward establishing modern corporate governance structures for state-shareholding companies. The establishment of boards of directors and supervisory boards has provided mechanisms for monitoring management performance and establishing management accountability. Although still confined to a relatively narrow segment of firms, listing on the stock market has provided incentives for SOE to implement the Company Law and to improve the transparency of their operations.

... but the reforms need to be broadened and deepened

The newly established governance structures have not, however, functioned nearly as effectively as was expected. This outcome is due largely to the fact that financial discipline has not been established; the government continues to dominate ownership and control and to intervene in the internal governance of corporatised firms; and institutional and regulatory weaknesses prevent the effective implementation and enforcement of the rights and obligations entailed in modern corporate governance mechanisms. Despite the progress that has been made so far, greater efforts to broaden and deepen the current reforms will be needed to achieve the goal of setting up effective corporate governance system in China’s SOE sector. Intensifying reforms in this area is urgent and critical in the current stage of reform, as good governance practices are needed to avoid future problems that might arise even after initial gains have been made in solving SOE financial difficulties. Reforms in this area are also critical to reinforce those in other areas. As the various elements of corporate governance are interdependent and mutually reinforcing, China’s reformers will have to work on different fronts simultaneously. Three changes in the direction or emphasis of current policies are particularly important.

More effective internal governance mechanisms...

First, more efforts will be needed to ensure the effective functioning of the modern corporate governance mechanisms and, in particular, to address the governance problems associated with internal control. Reforms are also needed to ensure that shareholders’ rights are protected within a legal framework. These include further efforts to enforce statutory provisions providing for the accountability of managers to the boards and shareholders; to establish genuinely independent supervisory boards with more outside expertise; and to improve transparency and protection of the interests of non-controlling shareholders and stakeholders.

... further separation of the government from enterprises...

Second, more concrete efforts will be needed to fully curtail government interference in the decision-making of enterprises, in particular, selection of senior management. Further progress is needed to eliminate administrative intervention by local government agencies in the operation of SHC if this approach is to continue. Greater focus should be given to professional, commercially-oriented operations of SHC. To this end, the current efforts to establish and strengthen effective governance mechanisms in the SHC should

be given high priority over the next several years. Improving transparency and accountability should be an important part of this process. The effectiveness of SHC governance could also be improved by involving independent outside experts in their governance.

Finally, the effectiveness and sustainability of the current reform will ultimately depend on the strengthening of external disciplines in the near term as well as over the long term. Various areas of reforms, such as financial and competition policies, should be designed and implemented to impose hard budget constraints upon firms. In particular, further effort to strengthen financial discipline by eliminating remaining non-commercial considerations from bank lending is urgently needed. Efforts to eliminate policy burdens, improve product market competition and strengthen the financial discipline coming from the equity markets also need to be given high priority in this context.

*... and strengthening
of external disciplines*

VI. THE ROLE OF THE FINANCIAL SYSTEM IN ENTERPRISE REFORMS

Development of China's financial system is essential to the success of reforms to the enterprise sector. While a longer-term effort, substantial improvements are needed in several areas over the next several years if overall progress in enterprise reforms is to be sustained. A major challenge is to transform financial institutions that are now disproportionately focused on SOE to better serve the needs of the growing non-state sectors. Non-state enterprises as well as smaller SOE are now facing severe external financing difficulties. Efforts to improve their financing are focused on adapting existing facilities but have met with limited success so far.

A second challenge is to improve financial discipline of enterprise behaviour. Important progress has been made toward tightening bank lending standards and improving supervisory oversight. However, continued needs to provide credit to support aggregate real growth and sustain SOE until they can be restructured pose risks to the sustainability of improved lending practices. Unless this vicious circle is broken decisively, much of the progress that has been made in improving lending practices and strengthening corporate governance mechanisms could be set back. Development of money and capital markets is important to ensure that financial discipline becomes firmly rooted. These markets are also needed to provide mechanisms for market-based enterprise restructuring, which are still quite limited in China.

While given a lower priority for much of the reform period, financial reform in China has now become central to efforts to complete the transformation to a market-based economy. This increased emphasis partly reflects the fact that China's financial system has lagged behind the development of the enterprise sectors in terms of its responsiveness to market forces and adaptation to the increasing economic importance of non-state firms. Financial reform has also become essential to, and dependent on, progress on enterprise reforms. Additional impetus for financial reform in China has been given by the Asian crises, which have underscored the fact that major defects in financial systems have led, more often than not, to serious distortions and instability in the real economy (Lindgren *et al.*, 1996; Goldstein and Turner, 1996).

Financial reform is now central...

The basic objectives of China's financial reform are quite similar to those of other transition and developing countries, but the priorities and modalities are heavily influenced by the situation of its enterprises. Two objectives of financial reform are particularly important to improving enterprise performances.

... and critical to the success of enterprise reforms

- The first is to adapt the existing financial system, which has been heavily focused on providing financing to SOE, to accommodate the growing non-state sector.
- The second is to establish financial discipline over enterprises in order to reinforce and sustain the development of effective corporate governance mechanisms discussed in Chapter V.

A third important objective, discussed in Box VI.1, is to provide financial mechanisms to promote economic restructuring of enterprises.

Box VI.1. The role of the financial system in promoting industry re-organisation

Financial facilities to facilitate M&A and other re-organisation are still quite limited in China. As indicated in Chapters III and IV, mergers, acquisitions, and other forms of reorganisation are largely initiated and controlled by government agencies. Certain of the asset management and holding companies, such as the Wuhan Asset Management Company described in Chapter V, have begun to promote mergers and acquisitions with enterprises outside their own group, but their activities are still quite limited. The stock markets have served as a catalyst for mergers and acquisitions – nearly 200 occurred among companies listed on the Shanghai Exchange in 1998 alone – but the impact is limited by the narrow segment of institutions that are listed. Further development of the stock markets and increase in the number and range of listed companies should provide a foundation for market based reorganisations as well as help to break down the still considerable barriers to mobility of enterprise operations across provincial boundaries. However more will be needed, including: completion of the corporatisation process so that equity stakes can be transferred; clarification of enterprises' ability to dispose of their assets; and development of investment banking facilities to provide financing and technical advice for business reorganisations.

The recent establishment of the bank asset management (BAMC) companies¹ to work out the NPL of the commercial banks potentially represents an important development in the financial system's role in enterprise restructuring. The key mandate of the BAMC is to maximise recovery value of the assets acquired from the banks.² While the scope of their operations remains to be clarified, initial indications after the formation of the first BAMC, Cinda Asset Management Company for the China Construction Bank, suggested that the companies would have considerable flexibility and a range of instruments in dealing with non-performing loans. These include: reorganisation and management changes of indebted enterprises, facilitation of mergers and acquisitions, debt-equity swaps, and resort to bankruptcy in cases of economically unsalvageable operations. The legal and administrative claims derived from the holding of enterprise debt, combined with the backing of central government authorities, potentially give the BAMC considerable leverage to promote restructuring and overcome administrative barriers to its accomplishment.

The initial operations of the BAMC in the latter half of 1999 focused on debt-equity swaps with larger SOE (see Chapter III). The operations have been carried out by the BAMC holding the debt together with the original bank creditor(s) and the enterprise or enterprise group itself. The debt-equity swap agreements have been linked to reforms mandated by the Company Law (in particular establishment of boards of directors and boards of supervisors) as well as reorganisation of operations.³ However, major changes of enterprise senior management do not seem to have occurred, or at least have not been publicly announced. The agreements also do not seem to have imposed specific ongoing conditions on future performance or implementation of reforms. A provision in the agreements allows the BAMC to sell back the equity to the enterprise after several years if the BAMC would otherwise make a loss, but the degree to which this provision provides any effective conditionality remains to be seen. There is thus a concern that the program is seen as a "free lunch" by enterprises that does little to increase their incentives to improve their operations.

The broader effectiveness of debt-equity swaps in facilitating enterprise restructuring and in maximising the recovery value of BAMC assets remains to be seen. Economically successful reorganisations can involve concerted efforts over time. As holders of fixed income claims that need to be restructured, BAMC in principle have an ongoing influence on the restructuring process. By swapping the debt for equity, the BAMC gain a voice in selecting directors and senior management and in setting the strategic direction of enterprise operations. In practice, this influence is shared with other equity holders, with state asset management companies or government agencies retaining the controlling interest, at least in the case of larger SOE. The influence of the BAMC as equity holder is further limited given that formal claims and powers of minority equity holders in China are, if anything, weaker and less easily enforced than those of holders of fixed income claims. Continued holding of debt or other means may be most effective way for BAMC to promote successful restructuring in some circumstances, while debt-equity swaps are more effective in others. Thus BAMC are likely to need to retain flexibility in their instruments if they are to fulfil their mandate.

1. The four companies are: Cinda AMC (China Construction Bank), established in April 1999; Orient AMC (Bank of China); Huranga AMC (Industrial and Commercial Bank of China); and Great Wall AMC (Agricultural Bank of China). The latter three were established in November 1999. Together the four AMC are due to take on non-performing loans equal to 1.2 trillion yuan, or about 18 per cent of the total loans of these banks to the corporate sector.

2. According to an article published by the Xinhua News Agency (4 November 1999), business activities of the Cinda AMC will involve "... purchasing and performing trust management for non-performing loans accumulated by commercial banks; debt retrieval and restructuring; investment consulting; borrowing from financial institutions and applying to the central bank for re-lending funds; issuing bonds; direct investments; and various activities involving other sectors" The article also notes that BAMC are authorised in principle to sell debt to overseas investors.

3. A series of well-publicised debt-equity swaps were announced during the second half of 1999 involving large SOE in a range of industries. Indicative examples are agreements signed with Anshan Iron and Steel (Liaoning Province) and Baosteel Group (Shanghai) in November of 1999. These deals, in which all four BAMC were parties, involve substantial reductions in debt loads in return for restructuring arrangements whose details have not been fully revealed.

Efforts to accomplish these objectives have focused on the commercial banks. The key priority is to establish commercial principles – based on the ability of a borrower to repay and other objective risks – as the basis for lending decisions, in place of the government mandates and other non-commercial considerations that have shaped credit allocation in the past. This is essential if the soft budget constraints that have led to much of the current problems of enterprises are to be corrected. To accomplish this objective, major priority is being given to: relieving banks of their non-performing loans and bolstering their capital; improving the capabilities of financial institutions to make commercially sensible and prudent lending decisions; and bolstering financial supervisory capabilities to maintain prudential standards within the financial system as a whole. Another important longer-term priority is to broaden and diversify financial outlets by encouraging the growth of financial intermediaries apart from the major commercial banks, and by further developing money and capital markets.

Commercialisation of bank lending is the top priority

Providing adequate financing for enterprises

The structure of China's financial system is similar in many respects to those of other developing countries in early stages of their financial development (Table VI.1; see also Woo, 1998; Pei, 1998). Most credit is allocated through a bank-dominated system of financial intermediaries whose activities are still fairly segmented (Wu, X., 1995). Money and capital markets are relatively limited in scope and breadth. Although the portion of enterprise financing provided by these markets has been growing, it remains small (Table VI.2). As in other Asian crisis countries, the limited development of capital markets has fostered the growth of enterprise debt levels and has served to concentrate commercial risks on the banking system.

Banks dominate the financial system...

Table VI.1. Major financial institutions in China

Institution type	Number of entities	Main sources of funds	Main loan customers
I. People's Bank of China (central bank)	1	Government	Commercial banks
II. Policy banks	3	Government deposits	SOE
II. Commercial banks			
A. "Specialised" state commercial banks	4	Individual and enterprise deposits	SOE
B. Other nation-wide commercial banks	6	Individual and enterprise deposits	SOE; larger non-state enterprises
C. Regional commercial banks	8	Individual and enterprise deposits	SOE; larger non-state enterprises
III. Urban co-operative/commercial banks	n.a.	Individual and enterprise deposits	Urban collective enterprises; smaller SOE
IV. Urban and rural credit co-operatives	5 200 ¹ (urban) 50 000 ¹ (rural)	Individual deposits	Urban and rural collective enterprises (including TVE)
V. Trust and investment companies	240	Government entities and foreign borrowing	Local governments; SOE
VI. Securities companies	97	Enterprises	Enterprises
VII. Finance, leasing and insurance companies	n.a.	Enterprises and individuals	Local governments; enterprises
VIII. Foreign banks ²	162	Foreign depositors	Foreign-funded enterprises

1. Approximate figures.

2. Including branches and sub-branches of 13 foreign-funded and joint venture banks; and nearly 100 branches of foreign banks, mainly located in Beijing, Shanghai, Tianjin, and other cities in the coastal zone.

Sources: *China Financial Outlook*, 1999; *China Almanac of Banking and Finance*, 1999; Girardin and Ping, 1997; Kumar *et al.*, 1997.

Table VI.2. Sources of corporate funds

	1995		1998	
	Value (billion yuan)	Share (per cent)	Value (billion yuan)	Share (per cent)
Total external funds raised	1 152	100	1 395	100
Loans from financial institutions	1 014	88.0	1 152	82.6
Funds raised from markets	138	12.0	243	17.4
Bonds	22	1.9	15	1.1
Equity	15	1.3	84	6.0
Commercial bills	101	8.8	144	10.3

Source: *China Financial Outlook*, 1999, p. 57.

... and remain state owned

Three related features of China's financial system are distinctive and have important implications for the development of the enterprise sectors. First, virtually all domestic financial institutions are state-owned. Unlike European transition economies, which moved to privatise their banks and other financial institutions at a fairly early stage (OECD, 1997b), presently there are no plans in China to relinquish state ownership of existing financial institutions, although entry of new private institutions is encouraged in principal.

Concentration is exceptionally high

The second distinctive feature is the overwhelming dominance of the four major state-owned commercial banks in credit allocation. These institutions account for 90 per cent of loans provided by the banking system, and nearly three-quarters of total loans to business (Table VI.3). This concentration is very high compared to most other developing and transition economies and well above the concentration ratio normally considered to be compatible with adequate competition.⁸⁶

Table VI.3. Lending by major classes of financial institutions

As of end-1998

	Total loans (billion yuan)	Percentage of total	Loans to non-financial sectors (billion yuan)	
			Percentage of total	Percentage of total
Total	8 964.7	100	8 149.3	100
4 major state commercial banks	6 782.5	75.6	6 231.4	76.4
Other commercial banks	655.5	7.3	531.4	6.5
Rural credit co-operatives	953.4	10.6	881.4	10.8
Urban credit co-operatives	462.2	5.1	400.8	4.9
Trust and investment companies	111.1	1.4	104.3	1.3

Source: *The People's Bank of China Quarterly Statistical Bulletin*, various issues.

... as is the focus on lending to SOE

The third distinctive feature is the concentration of financing on SOE. Although the share has declined in recent years, at least 80 per cent of the loans of the major state banks, and nearly 75 per cent of all commercial bank loans, are directed to SOE, while less than 10 per cent go to non-state enterprises.⁸⁷ SOE also typically enjoy preferred access to equity and bond market financing. The gap between the SOE share of commercial bank lending (and overall credit raised externally) and their share of output has increased substantially

since the early 1980s.⁸⁸ In contrast, non-state enterprises including collectives receive only a small fraction of commercial bank lending. TVE receive only limited bank credit: their borrowing, mainly from the Agricultural Bank of China, represents less than 3 per cent of the total loans of the four major state commercial banks. Urban credit co-operatives are the main formal source of external finance for urban collectives and private enterprises, while rural credit co-operatives are the main source of loans to rural private enterprises. Not surprisingly, non-state enterprises, with the exception of foreign-funded businesses, rely noticeably more on internal funds to finance their investment than do the SOE (Table VI.4).

Development of the stock markets in China is intended in part to broaden and augment financing sources for enterprises (Box VI.2). China's enterprises raised nearly 6 per cent of their total external funding⁸⁹ in 1997 from equity issues, although a substantial portion of those issues were sold on the Hong Kong and several other foreign stock exchanges. In terms of the overall stock market capitalisation ratio (Table VI.5) and the portion of their external funds raised from the markets, the size of China's stock markets is approaching that of a number of OECD countries. However, nearly all the listed firms are large SOE. Access to the domestic bond markets, which are relatively underdeveloped, is also mainly confined to larger SOE.

The concentration on SOE has left the most rapidly growing enterprise sectors dependent on a narrow segment of the formal financial sector. This situation has imposed certain handicaps: in particular, non-state enterprises tend to be more vulnerable than SOE to cyclical downturns or (in the case of foreign-funded enterprises) to sudden reductions in foreign capital inflows.⁹⁰ However, several factors have partly offset the limited access to funding and allowed non-state enterprises to flourish. First, since non-state enterprises are on average smaller and more labour intensive than SOE, their demand for

Equity markets are another funding source

But financial outlets for the non-state sector remain narrow

Table VI.4. **Enterprise investment by financing sources, 1998**

	SOE	Collectives	<i>of which</i> TVE	Individually owned
Total investment (billion yuan)	1 536.9	419.2	323.3	374.4
Source (per cent of total funds raised) ²				
State appropriations	7.0	2.2	2.8	0.0
Domestic loans	23.3	15.3	13.7	6.4
Foreign sources	4.3	6.4	7.4	0.1
Own sources	49.9	57.0	58.4	84.9
	Jointly owned	Share-holding	Foreign-funded ¹	Hong Kong, China/Macao, China/Chinese Taipei funded
Total investment (billion yuan)	6.0	194.7	164.0	133.4
Source (per cent of total funds raised) ²				
State appropriations	0.5	0.9	0.1	0.2
Domestic loans	29.4	30.3	12.9	18.9
Foreign sources	1.3	9.0	56.1	43.4
Own sources	57.5	44.0	22.4	23.1

1. Excludes economic units funded by entrepreneurs from Hong Kong, China; Macao, China; and Chinese Taipei.

2. Excluding miscellaneous and unallocated funds. Hence the proportions do not add to 100 per cent.

Source: *China Statistical Yearbook*, 1999.

Box VI.2. Development of the stock markets in China

In the early 1990s, China became the first transition country to establish a formal stock exchange by opening two national stock exchanges. The Shanghai Securities Exchange and the Shenzhen Securities Exchange were formally opened in December 1990 and in July 1991, respectively. By the end of 1999, some 912 firms – mostly large SOE – were listed on the two national stock exchanges and the overall stock market capitalisation reached about one third of China's GDP. The development of China's stock markets has been hampered by excessive government control, segmented market structure (see below), insufficient liquidity, lack of transparency, and an under-developed legal and regulatory framework. More recently, however, the authorities have been accelerating efforts to develop and better regulate the stock markets. The major motivation behind these efforts is twofold: to broaden and augment financing sources for SOE; and to strengthen external financial discipline and the corporate governance of large SOE.

Listing procedures and share structure

Until very recently, the operation of China's stock markets had remained subject to extensive administrative control and intervention. The access to the stock markets was strictly controlled by the State Council, which decided the number of firms to be listed and the amount of capital to be raised. Each province was subsequently given a quota of new listings, and the selection of firms to be listed was influenced greatly by political considerations at the provincial level. This practice was ended in principle by the recent decision to give China Securities Regulatory Commission (CSRC) sole responsibility for decisions concerning initial public offerings (IPO), thereby taking away provincial authorities' ability to manipulate the listing procedures. Before their IPO, companies are required to implement the changes mandated by the Company Law and undertake the restructuring process required by CSRC. Private companies have largely been prohibited from either listing or assuming majority control of listed firms through market takeover. Firms in the non-state sectors represent only about 3 per cent of domestically listed companies and comprise less than 10 per cent of market capitalisation.

As in other countries, China's stock markets consist of the primary market where firms make their initial offering, and the secondary market where the stocks are traded. There are various types of shares issued in China, including: state shares (owned by the state); legal person shares (owned by corporate or other institutional units with legal person status, and which in practice are mainly state-owned); individual shares (owned by individual Chinese citizens, also known as A-shares); and domestically-listed foreign-held shares (available only to foreigners, known as B-shares). The government has attempted to maintain a rigidly segmented securities market (between A-share markets and B-share markets) because of concern about potential evasion of foreign exchange controls. State-owned shares include shares directly owned by state agencies and those owned by legal persons. The trading of directly state-owned shares on the secondary market is prohibited and that of legal person shares is mostly confined to other legal persons. Thus, state-owned shares constituting nearly two-thirds of all shares issued are effectively removed from active secondary trading, significantly limiting the liquidity of the secondary market in China.

The regulatory framework

The CSRC and State Council Securities Commission (SCSC) were established in October 1992, with the aim of strengthening regulation of the securities market. Since then, the CSRC had been strengthened and in 1998 it was granted sole power for securities market regulation and supervision, after being merged with the SCSC.

China's first Securities Law was adopted in December 1998 and took effect in July 1999. The passage of the Law represents a major step toward well-regulated, transparent securities markets in China. Among other provisions, the Law imposes greater discipline on and more clearly defines the obligations of market participants, including listed companies, their directors and officers, underwriters, brokers, dealers, and law and accounting firms. It also stipulates transparent procedures for examining and approving applications for stock issuance and listing, toughens penalties on false disclosure and improper trading activities, forbids brokerage firms from mixing their own and clients' money to trade shares, and bans banks and SOE from speculating on the secondary market.

There was also an important amendment to the 1985 Accounting Law, aimed at "restoring the independence of accounting activities and increasing the transparency of accounting information". Under the new law, company managers, rather than accountants, are held legally responsible for the truthfulness of accounting information, while the accountants are to be responsible in their own professional capacity rather than acting on behalf of the state and the enterprise. The law also stipulates higher standards for accounting information released by listed companies. The CSRC has also announced new rules strengthening disclosure requirements in other areas, such as board decisions relating to dividends, explanations of corporate decisions to not declare dividends, and more disclosure of large transactions. The CSRC has also required firms to publish annual reports on-line in addition to the newspaper announcements that were formerly required.

Table VI.5. **Comparative stock market statistics**

1997 data except as otherwise noted

	Stock market capitalisation/GDP (%)	Number of listed firms
China	24 (1998)	912 (1999)
Korea	29 (1996)	748 (1998)
Thailand	15	431
India	34	5 843
Indonesia	7	282
Mexico	39	198
Brazil	31	536
Japan	66	2 387
Germany	39	700
United States	144	8 851

Sources: World Bank, *World Development Indicators*, 1999; *China Financial Outlook*, 1999.

external funds is relatively less. Second, enterprises in a number of other developing countries, such as Russia and Mexico⁹¹ seem to have been able to grow substantially without having much access to bank credit or other formal established financial intermediaries. This success is partly attributable to the availability of informal financing facilities, such as inter-enterprise lending and the “curb” markets that became major sources of financing in Korea during the 1980s. Anecdotal evidence suggests that such informal financing channels, which are not officially sanctioned, are very active in China. Third, the relatively lax lending standards that have prevailed in the financial system, together with the substantial influence of local government officials over lending decisions, have partly offset the otherwise less favourable access of collectives to bank loans.

This situation has changed greatly in recent years as a result of financial reforms to commercialise bank lending and improve prudential standards (see next section). Bank lending standards have become noticeably more stringent. As a consequence, bank credit has become much more difficult to obtain for a substantial segment of the enterprise sector. Credit availability to larger SOE, particularly those designated to form the strategic core of the public sector, has been least affected by the change. Partly because they retain the implicit financial backing of the government, these enterprises continue to be accorded preferential status in bank lending and enjoy relatively greater access to other credit channels.

However, numerous reports indicate that collectives as well as smaller SOE are encountering great difficulty in obtaining new bank loans (see World Bank, 1999; Chen, 1999). Their difficulties stem not only from the reluctance of bank lending officers to extend loans to enterprises that do not, for most part, enjoy the access to government funds, implicit government guarantees or other preferences given to many large SOE. A large fraction of small and medium-sized SOE and collectives are either not creditworthy, or are only marginally creditworthy by virtue of their high debt loads and low, or negative profitability. Even in the case of creditworthy smaller SOE and non-state firms, lack of experience in credit assessment together with limited accounting systems and the poor transparency of enterprise accounts makes it difficult for loan officers to identify the good credit risks.

Lending standards have tightened...

... leading to a credit squeeze on non-state firms and SME-SOE

Bank lending growth has slowed sharply

While difficult to gauge in the aggregate, the “credit crunch” faced by China’s enterprises as a result of these conditions appears to be significant. One indication is the marked slowdown in total bank lending that became evident in the latter half of 1997, following the formal suspension of credit quotas at the beginning of that year. The slowdown seems too abrupt and pronounced to be fully explained by the more gradual decline in nominal GDP growth since 1996, and suggests restrictions on credit supply have played a role. Other evidence (Chen, 1999) indicates that credit limitations have impeded growth of TVE in recent years.⁹²

Steps are being taken to improve credit availability...

Authorities have been taking a number of steps to improve credit availability in the near term and to broaden financial outlets for non-state enterprises over the longer term. Beginning in 1998, the commercial banks were given a mandate to develop special facilities for lending to creditworthy SME. However, these facilities do not seem to have greatly eased the funding squeeze faced by these enterprises. More recently, authorities have sought to increase liquidity of smaller commercial banks and other lending institutions that are generally better ending positioned to evaluate creditworthiness of smaller enterprises. Some of the lending authority taken away from local bank offices during earlier reforms has also been reinstated in order to alleviate bottlenecks arising from the concentration of decisions in higher offices. Regulations are also being relaxed to allow SME to issue corporate bonds, although larger enterprises still have the preferred access to what is still a fairly small market.

... including credit guarantees

Beyond the near term, credit guarantee mechanisms are seen as a major instrument for improving the access of SME to credit. A number of provinces and cities are experimenting with a “mutual” guarantee system funded by the enterprises and supplemented in some cases by contributions from local governments.⁹³ Several of the organisational forms envisaged in the divestiture of smaller SOE, notably leasing and contract forms, should help to encourage further development of inter-enterprise funding mechanisms. Some academic experts have also advocated development of an over-the-counter market to provide access to equity financing for small- and medium-sized SOE as well as non-state enterprises.

Longer-term priorities: increase bank lending to non-state enterprises...

Nevertheless, these steps are unlikely to be sufficient to provide the funding facilities that will be needed as more enterprises shift to the non-state sector and state control shrinks to the strategic core. The longer-term strategy to provide these facilities has three elements. The first is to continue to facilitate and encourage expansion of lending by the larger state commercial banks to non-state firms. The large banks probably have adequate incentives to lend to creditworthy non-state enterprises; however given their bureaucratic structure and traditional orientation toward SOE, these banks are not especially well placed to identify good credit risks among such firms.

... foster growth of other financial institutions...

The second element is to foster the growth of the commercial banks and financial institutions with the greatest comparative advantage in lending to SME and non-state enterprises. The recent permission granted to two regional banks (Pudong Development Bank and Shenzhen Development Bank) to list on the stock market is seen as an initial move by authorities to provide additional capital that will be needed for expansion of these institutions.

However, the institutions will also need to be able to increase their funding base, which in turn will depend upon further development of interbank and other markets for wholesale deposits.

The third element is to expand participation by foreign banks and other foreign financial institutions. These institutions, either through wholly owned operations or through joint-ventures with existing domestic institutions, may ultimately come to play an important role in financing the enterprise sector once the financial opening provisions mandated by China's recent agreement with the United States government on WTO entry come into effect. However, as the experiences in several OECD countries such as Japan and Korea have shown, the capacity of foreign banks to engage in lending to enterprises depends on their access to local currency funding. Given the difficulty and expense of setting up retail deposit networks, this access will depend critically on their ability to attract enterprise deposits and to tap the domestic money markets.

... and increase foreign participation

Establishing financial discipline

The incentives provided by the financial system, together with competition in product and factor markets, are critical to the external environment that determines whether ownership structures, boards of directors, and other mechanisms of corporate governance result in economically efficient enterprise behaviour. A number of serious financial and macroeconomic problems experienced by OECD countries during the 1980s and 1990s can be traced to breakdowns in financial discipline. Examples include: the savings and loan crises in the United States; the real estate bubbles and excessive debt accumulations during the late 1980s in the United Kingdom and several Nordic countries, which subsequently led to severe recessions in the early 1990s (Edey and Hviding, 1995); and the property market bubbles in Japan during the latter 1980s. Similar distortions in the financial system, aggravated by deficiencies in accounting and credit assessment systems and poor transparency of enterprise operations, were also major contributors to the 1997 crises in several Asian countries (World Bank, 1998). Together with improved corporate governance, financial discipline will be critical in determining whether the near-term gains from economic restructuring in China are translated into sustained improvement in enterprise efficiency and profitability.

Financial discipline is essential to effective corporate governance

While product market competition is reasonably well established in the majority of industries (World Bank, 1994), China's financial system has retained vestiges of the central planning regime that have largely prevented it from providing the oversight and financial market discipline necessary for efficient enterprise behaviour. The most serious defect has been the use, until recently, of banks as quasi-fiscal agents to provide "soft" credit based on central or local government plans (Lardy, 1998; Steinfeld, 1998; Gao and Schaffer, 1998). The provision of soft credit was a key factor in the excessive and inefficient investment and excessive debt accumulation that occurred during the investment boom of 1993-1995 (Wu, J., 1995). As indicated in Chapter II, increased management autonomy appears if anything to have aggravated these problems by affording enterprises greater freedom to respond to the perverse incentives in the financial environment. That the financial environment is essential is further supported by evidence, cited in

"Soft" credit from banks has caused major problems

Chapter V, that enterprises that have gone furthest in governance reforms often perform more poorly than those less far along in those reforms.

Financial intermediaries and markets are both necessary...

Debate continues in the literature as to the elements of the financial system that are most necessary to sustain good corporate governance. Financial markets, particularly the equity market, play a major role in Anglo-Saxon countries while banks play the key role in continental Europe and Japan. In China as well as other developing countries, the question is not whether to develop one or the other. Both are ultimately necessary, but there remains a question of the priority to be given to their development.

... but financial markets in China are limited...

However, financial markets that can exercise effective oversight take some time to develop. Admittedly, the stock markets have provided, through their listing requirements, incentives for companies to improve disclosure and implement corporate governance reforms.⁹⁴ However these incentives are blunted by the relatively small number of firms admitted to the market each year as well as by the predominance of small investors with limited experience and resources for evaluating the performance of the listed companies.⁹⁵

... and banks are the key to effective discipline in the medium term

Two further considerations suggest that reforms to improve the effectiveness of the banking system, and to a lesser extent other financial intermediaries, are likely to be most critical to improving enterprise performance in the circumstances that China is likely to face for much of the next decade. First, limited information and lack of transparency concerning enterprise operations hamper effective oversight by open financial markets and increase the comparative advantage of "insider" financial stakeholders, notably banks. A second and more practical consideration is that the process of working out large non-performing loans of the enterprise sector unavoidably affects the relations between banks and their business customers and requires special attention to restore the incentives for banks to provide financial discipline. These considerations are supported by historical experience; in particular, financial reform efforts in Eastern European transition countries have given greatest emphasis to establishment of effective market-based banks and other financial intermediaries in the initial stages (OECD, 1997a and 1997b; Blommestein and Spencer, 1994).

Financial discipline rests on a credit culture

Development of an internal "credit culture" is the fundamental requirement if financial intermediaries are to exercise effective discipline over enterprise behaviour (see Group of Ten, 1997). A credit culture means that ability to repay is the overriding consideration in extending loans and risk is the primary factor shaping the terms on which loans are made. Creation of a credit culture requires good corporate governance of the financial institutions including: management accountability; effective internal controls and incentives to accurately assess risk; and effectively functioning boards of directors and other mechanisms to ensure that managers act in the interest of owners. In addition to these requirements, an effective system of prudential supervision and oversight is essential if the financial system is to remain stable and provide the proper incentives to enterprises. Identifiable failures in the regulatory process, ranging from severe moral hazard to lax oversight of financial institution practices to excessive forbearance in addressing known problems, have figured prominently in nearly all the major financial crises cited earlier.

In China, the establishment of a credit culture has been greatly impaired by three factors. First, the *capability* of financial institutions to maintain prudent lending standards has been constrained until recently by the use of the four major banks to extend loans on the basis of non-commercial criteria (Cheng and Cheng, 1998; Bouin, 1997). Officially designated “policy loans” include government directed credit to designated sectors or projects regardless of the objective creditworthiness of the borrower or the commercial viability of the project. However, a substantial further portion of bank loans are effectively policy loans. Local officials, who have had considerable influence over the local offices of the commercial banks,⁹⁶ have been able to divert lending to speculative or other commercially questionable projects. Banks typically have been required to supply credit to allow loss-making SOE to maintain their operations and pay their workers.

Financial discipline is impaired by limited capability...

Second, *incentives* to maintain a credit culture have been severely blunted by the dominance of formal and informal policy lending and by the fact that the banks are themselves state-owned institutions in which profit and avoidance of losses have traditionally been viewed as (at best) secondary priorities. Incentives to hold enterprises accountable for their obligations have been further limited by the lack of effective legal and administrative mechanisms, in particular foreclosure and bankruptcy, for enforcing loan contracts. Third, lack of *information* further impairs the credit culture of financial institutions. Information necessary for effective credit assessment and monitoring of loan performance is, as in many developed countries, severely limited by inadequate accounting systems and generally poor information available about enterprise performance. Particularly for the largest commercial banks, the large number of branches spread over a wide and diverse geographic area makes it difficult for senior management to maintain adequate internal controls; and also complicates the task of central bank supervisors in maintaining effective oversight.

... and poor incentives and information

These deficiencies have been greatly increased by the high level of non-performing loans (NPL) of the major commercial banks. According to official figures, NPL are around 15-20 per cent of the total loans of the four major commercial banks; but outside estimates suggest they could be more than twice as large (*e.g.* Lardy, 1998). Maintenance of sound lending standards is exceedingly difficult under such circumstances: international experiences indicate high NPL levels reduce incentives for banks to rigorously assess credit worthiness, monitor loan performance, or enforce loan contracts (Lindgren *et al.*, 1996).

High NPL levels greatly aggravate the problems

Since 1995, extensive reforms have been underway to establish sound lending standards and improve prudential standards. In that year, three new specialised (“policy”) banks were established to take on the policy loans of the commercial banks. A new banking law that came into effect in 1996 made bank management accountable for loan performance. In 1997, the central credit plan (the system of credit quotas for the major commercial banks and their branches used for credit allocation) was formally abolished. These steps have been accompanied by measures within the commercial banks to implement sound lending practices. These include: the use of internal credit rating standards based on enterprise credit history and financial conditions; and the establishment of strict accountability of individual loan officers and their senior managers for containing non-performing loans.⁹⁷ To reduce the undue

Extensive efforts are being made to address the weaknesses

influence of local government officials, authority for granting loans was shifted from local offices to provincial head offices; although, as noted earlier, this policy has since been partially reversed.

NPL are being addressed

A major further step was taken in 1999 with the establishment of four bank asset management companies (BAMC) to take on the non-performing loans of the four major commercial banks that were incurred before 1996.⁹⁸ The BAMC are authorised to acquire 1.2 trillion yuan of NPL, amounting to nearly 18 per cent of the total loans of the four major commercial banks. Establishment of separate entities to deal with NPL allows more flexible means to work out the loans,⁹⁹ and is consistent with “best practices” as they have emerged from international experiences.¹⁰⁰ However, the portion of NPL being transferred is significantly below outside estimates of their level, and does not provide any explicit accommodation for loans that become classified after 1995.

Accounting and loan classification systems are being upgraded

Considerable effort is also being made to address deficiencies in information needed to assess credit worthiness and monitor loan performance. These include programmes to upgrade accounting skills and standards. To further improve bank lending standards and practices, a new loan classification system was introduced on an experimental basis by the People's Bank of China (PBOC) in 1996. This system is based on international standards and, in principle, is more “forward looking” in identifying potential problem loans than the essentially backward-looking system that has been used traditionally.¹⁰¹ Commercial banks have also been given somewhat greater flexibility to vary interest rates from official benchmark levels in order to better incorporate risk in loan pricing.¹⁰² An important further step is the development of a national “credit registry” system under the auspices of the People's Bank of China together the commercial banks similar to those used in Germany, Italy, and several other European countries. The purpose of the credit registry is to provide information to potential lenders about the outstanding loans, credit history, and financial performance of loan applicants.¹⁰³

Financial supervision is being strengthened

Finally, steps have also been taken to upgrade financial supervisory capabilities and improve prudential standards of non-bank financial intermediaries. Under the 1999 reorganisation of the PBOC, supervisory oversight of local commercial bank operations was shifted from the central bank's local and provincial offices to nine newly created regional (“mega”) branches. The intent is to further reduce the undue influence of local governments on credit expansion. PBOC supervisory authorities have also moved forcefully to strengthen supervision and curb financial abuses. They have moved to curtail unsanctioned activities of trust and investment companies (and closed several) and forced banks to divest their trust and investment company subsidiaries. They have also converted urban credit co-operatives into commercial banks subject to banking sector regulations; and are moving to tighten supervision of the operations of rural credit co-operatives, which are reported to be in serious financial difficulties.¹⁰⁴

Overall, important progress has been made

Taken as a whole, these financial reform measures taken so far represent important and necessary progress toward establishing financial discipline. There is widespread agreement that loan standards and credit quality have improved significantly since 1996. The information needed to sustain these

standards should improve further as accounting, loan classification, and other financial control systems mature. Efforts to improve supervision and curb financial abuses should also help to bolster financial discipline, as well as reduce threats to financial stability.

However, important as they are, the present measures are unlikely to be sufficient by themselves to ensure that the improvement in financial discipline goes far enough, or even that existing gains will be preserved. Establishment of governance structures for the commercial banks is only beginning. As indicated in Chapter V, further liberalisation and development of capital markets will be needed before they can serve as a major force for good corporate governance or financial discipline. In addition to these necessarily longer-term processes, there is a pressing need to relieve two key and closely related bottlenecks that threaten to halt or even set back current reforms.

But further measures are needed to sustain progress...

First, despite official intentions, there are several reasons to believe that state commercial banks continue to make substantial amounts of policy loans – that is credits that do not satisfy rigorous commercial standards but are extended for other reasons – even if they are not explicitly designated as such. Given the large fraction of SOE that are making losses, aggregate loan growth is stronger than would be expected if sound commercial loan standards were being rigorously applied across the board. In 1998, commercial banks were required to provide matching loans to supplement the government's infrastructure spending programme.¹⁰⁵ Periodic statements by government officials urging banks to increase lending for technical purposes, or to support restructuring in particular sectors, also suggest that the transition to commercial lending standards remains incomplete.¹⁰⁶ This situation reflects the fact that the fundamental conditions underlying policy lending and the use of bank loans for fiscal purposes, namely scarce government financial resources and the financial weakness of a large segment of enterprises, persist. However, continued policy lending undermines and limits the effort to instil rigorous lending standards by sending mixed messages to loan officers and senior bank management. If continued, it is also likely to erode lending standards and circumscribe any gains in financial discipline.

Bottlenecks need to be relieved soon in two areas: ending policy lending...

Second, despite its substantial scale, the current programme to work out bank NPL is unlikely to prove sufficient. The experience of OECD as well as many non-OECD countries indicates that the existing stock of bank NPL needs to be dealt with fully and decisively, and the fundamental factors that led to the NPL ("flow problem") corrected, if banking sector financial problems and their repercussions are to be resolved in a lasting fashion (Lindgren *et al.*, 1996; Goldstein and Turner, 1996). Neither condition has yet been met in China. If outside estimates of NPL are at all accurate, substantial amounts of loans remain with commercial banks that are likely to prove non-performing in the future. Moreover, continued policy lending indicates that the underlying factors behind the growth of NPL have not been fully eliminated. While it is too early to assess whether NPL on bank books will again grow to critical levels, experiences of other countries indicate that banking sector problems are very likely to recur in such circumstances. For example, banks in Hungary had to be recapitalised on four successive occasions during the first half of the 1990s (OECD, 1997b). Moreover, current measures will at best only partially restore the financial soundness of the major banks. Evidence suggests that such partial restorations tend to do little to raise bank incentives to

... and completing the resolution of bank NPL

maintain sound lending standards or effective loan monitoring (Aghion, Blanchard and Carlin, 1994).

Government control of the largest banks poses special problems

Finally, although perhaps not as critical in the near term, the close government control of the four major commercial banks, although it may have helped in improving lending standards in the near-term, is also likely to complicate the task of sustaining financial discipline by banks over the longer-term. Until recently, the banks had not participated in the corporate governance reforms described in Chapter V. Authorities did announce in early 2000 that supervisory boards would be established for the four major banks and are considering means to diversify their ownership somewhat. However, even if the current weaknesses of these mechanisms discussed in Chapter V were to be addressed, the dominance of the four banks in credit flows and their central place in the economy will make it difficult to fully eliminate non-commercial considerations from bank lending.

Concluding observations

Overall, significant progress is being made

As has often happened in rapidly growing economies, development of China's financial system has lagged behind that of its enterprise sector. As the measures cited here indicate, authorities have been moving vigorously and on a broad front in recent years to redress this gap. The steps that are being taken to achieve these goals are already showing some positive benefits. Provided they can be sustained, these efforts should help significantly in correcting the distortions that have adversely affected enterprise behaviour in the past, and in reinforcing the reforms to corporate governance mechanisms discussed earlier.

But several weaknesses need to be addressed...

Nevertheless, there are important gaps in current reforms as well as tensions among some of their objectives that remain to be resolved. Although ultimately intended to reduce disparities in financial treatment among enterprises, the effect so far has been to increase them. Financial discipline for non-state enterprises and smaller SOE has increased significantly, but (partly for that reason) their access to credit has worsened. Debt-equity swaps and the development of the stock market have effectively increased the preferential credit access of larger SOE (particularly those destined to remain under government control) and tend to blunt the effects of improved financial discipline from the banks. Banks in any case face greater difficulties in applying stringent lending standards to large SOE than to smaller SOE or non-state enterprises. As with corporate governance, substantial further progress on financial reforms will be needed to sustain the progress that has been made and to ensure that the near-term gains from economic restructuring are translated into long-term improvements in enterprise performances.

... and rapid progress needs to be made in two key areas

The prior discussion suggests that substantial progress within the medium term is particularly needed in two key areas to maintain progress in the overall reform process. First, it is not yet clear whether the efforts to adapt existing financing mechanisms will be sufficient to alleviate the credit crunch non-state enterprises and smaller SOE are now facing, or to allow these segments to realise their growth potential over the longer term. Entry of foreign and new domestic institutions should improve financing facilities for the non-state sector, but the improvement is likely to be gradual and will depend on

the development of the inter-bank and other facilities needed to provide the funding base for the new entrants. In the meantime, a more active and comprehensive approach to improving financing for smaller SOE and non-state enterprises will be needed if present restraints on credit supplies do not ease, or worsen. As suggested in Chapter III, acceleration and expansion of existing experimental programmes to provide credit guarantees or loans to creditworthy smaller SOE and non-state enterprises would help in this respect and need not involve substantial direct budgetary costs in the near-term.

Second, it is essential that the vicious circle underlying the continuing need to provide policy loans be decisively broken and soon. Otherwise, the current tightening of bank lending standards is unlikely to be sustained, banks' financial health is unlikely to continue to improve and could worsen again, financial discipline is likely to remain highly uneven and weak overall, and the effectiveness of corporate governance reforms will be seriously compromised. The key requirement is to end remaining commercial bank lending to enterprises that are not creditworthy, with alternative forms of support to the enterprises provided where necessary. Some expansion of the current programme to deal with bank NPL may also be necessary if, as is quite possible, substantial amounts of such loans remain in commercial bank portfolios.

Ending non-commercial bank lending is essential

- The most effective approach would be to end remaining policy lending by the commercial banks and to apply strict lending standards across the board to all enterprises regardless of their status or condition. Under this approach all loans failing to meet strict commercial standards but deemed necessary for other reasons would be transferred to the policy banks, whose operations would then have to expand. If this cannot be done in present circumstances, a second best approach would be for bank management and supervisors to explicitly identify and acknowledge loans made for non-commercial purposes (*i.e.* those not meeting strict commercial lending standards), in order to effectively segregate such policy lending from the normal commercial lending process.
- Given the significant risk that the NPL problem could re-emerge, authorities may also need to consider expanding the present programme to allow loans classified as NPL in the initial stages of the 1996 banking reform (say 1996 and 1997) to be transferred to the BAMC. However, it is very important that any such modification be done on a "one time only" basis so that banks' responsibility for sound lending is not impaired.

Over the longer term, the government ownership and exceptional dominance of the major state commercial banks presents particular challenges to financial reforms in China. The problems other countries have encountered in maintaining effective governance of state-owned banks raise questions about whether the major commercial banks in China will be able to maintain prudential standards and exercise effective financial discipline over enterprises, while at the same time serving as the "lead banks" for the strategic core of SOE and developing their facilities for financing non-state enterprises. The present policy is to promote development of existing and new financial institutions to increase competition while relying on supervisory authorities to prevent any backsliding in prudential standards. However, more comprehensive restructuring of the banking system, including the four major commercial banks, will deserve consideration for the next phase of reforms.

Longer term challenges: the governance of state banks...

*... and accelerating the
development of financial
markets*

Finally, the development of domestic capital markets is important to allow enterprises to improve their capital structures and to reinforce the financial discipline provided by banks and other financial intermediaries. Better developed financial markets are also needed to reinforce financial discipline on enterprises, particularly given the risks to the banks' effectiveness in this regard posed by dominant state ownership. While the stock market has been growing rapidly, the overall approach to developing the capital markets has been one of gradualism. Their impact on the enterprise sector as a whole is limited by the narrow range of participants permitted on both the supply and demand sides of the markets. A more rapid approach to development could help to encourage efforts by enterprises to reform their governance structures and improve transparency, as well as to develop market mechanisms for facilitating industry restructuring.

VII. DEVELOPING SOCIAL SECURITY PROGRAMMES

In addition to meeting the needs of China's ageing population, social security reforms are necessary to reduce financial burdens on enterprises and to provide a social safety net to deal with the human consequences of economic restructuring and reorganisation. Labour redeployment centres are the key instrument being used in the near term to support workers laid off from SOE and to assist them in finding new jobs. However, their scope has been limited by the scarcity of government revenues needed for their support; and their success in finding jobs for workers has been mixed.

Key priorities over the longer term are to extend unemployment insurance to improve labour market performance; to improve the distribution of medical care costs among workers, government, and enterprises; and to reform pension programmes. Current reforms are confined mainly to urban areas but extension of some programmes to rural areas is planned to begin in the next five-year plan. Over the longer term, the reforms will ultimately involve substantial further burdens on public finances and are likely to require changes in tax policies.

The traditional social welfare system prevailing in China since the early 1950s has guaranteed SOE workers a full range of social benefits including: lifetime employment; pensions; and health care. Many SOE have provided social services, such as education and housing, that in other countries are provided by local governments or the workers themselves. During the pre-reform period, these benefits were partly borne by employees in the form of low nominal wages (*i.e.* below their marginal product) while the rest were paid for by fiscal appropriations from the government.

SOE provide extensive social benefits and...

Under the enterprise management reforms instituted at the beginning of the 1980s, SOE became responsible for these social welfare programmes but their scope remained largely as before. Direct contributions by employees to the programmes were minimal. The programmes continued to be administered by each individual enterprise, subject to government mandated standards, rather than incorporated into provincial or nation-wide schemes. Non-state enterprises, including township and village enterprises, were not required to provide comparable benefits and there has been no formal social welfare or safety net programme for the rural population. Benefits provided by SOE typically are not portable; nor has there been any unemployment insurance until very recently.

... are responsible for their financing

This antiquated social welfare system has become an increasing impediment to modernisation of China's enterprise sectors in several ways. The system imposes benefit expenses on SOE that are relatively high on average and unevenly distributed (Table VII.1). Total outlays by SOE for social benefits (excluding the new unemployment insurance programme) have averaged around 30 per cent of their payrolls, but are 50 per cent or higher in the most heavily burdened cases.¹⁰⁷ These burdens have increased over time as the ratio of retired to active employees has risen with the ageing of the population.

The antiquated system impedes modernisation...

Table VII.1. **Average social benefit expenses of SOE**

Proportion of total payroll (per cent)	
Medical care	5.5
Pensions	20.0 ¹
Worker's compensation	0.5
Housing	5.0
Unemployment insurance	3.0
Total	34.0

1. The statutory responsibility of enterprises. In practice, the proportion is often higher.

Source: Figures are based on estimates given in interviews with Chinese officials. The data are approximate averages and vary significantly among enterprises.

... and causes broader problems

Apart from the direct effects on SOE, the system has also led to some broader problems. As indicated in Chapter II, limits on social safety net facilities have not infrequently blocked efforts to reduce excess SOE workers and impeded M&A and other re-organisations as well as bankruptcy. The lack of unemployment insurance and portability in benefits limit labour mobility. As in other countries, the provision of medical benefits at no cost to beneficiaries encourages their over-use and inefficiency in their provision.

Reforms began in the early 1990s

Reforms of social benefit programmes have been actively underway in China since the early 1990s. The reforms have focused on unemployment insurance, health, and pension systems and are directed nearly entirely at urban workers and residents. A major reform to reduce SOE burdens for worker housing was scheduled to begin in 1998 but was postponed and no new date has been set.¹⁰⁸ Current policies are focused on urban areas but creation of a nation-wide social benefit system that would include rural areas is a longer-term goal. As discussed in the remainder of this chapter, the overall objectives of these reforms are as follows:

- Socialisation of the benefits through the creation of community-wide programmes to replace those individually administered at the SOE level;
- Extension of benefits to workers in non-state sectors and, eventually, to rural areas;
- Spreading of the expenses of the programmes among SOE, workers, and local governments, in part to reduce the burdens on SOE;
- Improvement of incentives for efficient provision and use of the programmes;
- Improvement of labour market functioning.

Reforms to deal with displaced workers

Unemployment has been increasing...

The official rate of urban registered unemployment in China has been increasing since 1992 and reached 3.1 per cent during 1997-1998. However, this figure is acknowledged to seriously understate the true level of urban unemployment since laid-off ("xiagang") workers resulting from SOE downsizing typically are not registered as unemployed. Estimates suggest that including these laid-off workers would raise China's urban unemployment to more than ten per cent, and quite possibly as high as fifteen per cent.¹⁰⁹

The number of unemployed workers is expected to swell further in the year 2000 as Chinese companies shed staff to increase efficiency in preparation for the stiffer competition that WTO membership is expected to bring. Eleven million new workers will enter the urban work force in 2000. At least 4 to 5 million additional workers are likely to be laid off from SOE, urban collectives, military industries, and the civil service.¹¹⁰ Prospects for finding jobs for these workers are not good. Given their financial difficulties, urban collectives and SOE – even those without surplus labour – are unlikely to have much capacity to increase their employment. Increases in productivity have reduced the demand for the number of workers needed in many professions.¹¹¹ At recent trends, only about 6 million new urban jobs are likely to be created – less than half the total needed.

... and is expected to get worse

Mechanisms to provide laid-off workers with basic living expenses for a transition period and to assist in finding new jobs are thus vital if SOE restructuring is to proceed. The existing strategy for accomplishing these objectives relies heavily on the “reemployment centres” (REC) discussed below. However, these centres are essentially a transitional arrangement. Under current plans, the centres will be phased out by the end of 2002 and replaced by the unemployment insurance arrangements that are now in the process of being developed.

Laid-off workers need assistance for restructuring to proceed

Re-employment centres

REC were established to facilitate the large-scale exit of surplus workers from SOE and to better allocate the burden for their support among enterprises and local governments.¹¹² Before their emergence, local governments were solely responsible for providing living support to displaced workers and for assisting them in finding new jobs. This assistance was provided through re-employment agencies jointly managed by local government labour and finance bureaux and by trade unions. Funding for these re-employment agencies came mainly from local budgets, unemployment insurance funds, and social donations. However since funding was quite limited, permitted lay-offs were few and the cost of most surplus workers continued to be borne by the enterprises themselves.

REC facilitate shedding of surplus labour

The first REC was established by Shanghai Textile Holding Company (the former Shanghai Textile Bureau) as a pilot project in July 1996. The arrangements were subsequently expanded to other cities and regions and their use throughout the nation was mandated in the summer of 1998. REC typically are created and administered by local governments. Their functions are threefold: provision of a basic living allowance,¹¹³ re-training,¹¹⁴ and assistance in locating new jobs. Workers are allowed to stay with the REC for a maximum of three years; those who fail to find new jobs within this period are transferred into the unemployment insurance network. Access to REC has so far been limited to workers laid-off from SOE (workers transferred to subsidiaries or auxiliary units of SOE are not eligible). Financing for the centres is supposed to be shared on an equal basis by the SOE, local governments, and local social insurance funds.

REC have been extended nation-wide

According to figures compiled by the Ministry of Labour and Social Security, 11.9 million workers were in reemployment centres for at least part of 1999. In Hubei province alone, 7 492 RECs had been set up and were supporting about 350 000 former SOE workers (80 per cent of them from industrial

11.9 million workers were in REC in 1999

SOE); a further 300 000 newly laid-off workers are expected to enter the centres in 2000.

Success has been mixed

The overall record of the REC has been somewhat mixed. Nearly half of laid off workers have come from enterprises or localities that have insufficient financial resources to fully support the centres. In the worst cases, laid-off workers have received virtually none of the basic income support to which they are theoretically entitled. Profitable SOE have often borne considerably more than one-third of the expenses of REC. Local governments have often required these firms to finance all or most of the expenses of their workers in the REC.¹¹⁵ Abuses have also occurred, with many workers reported to have taken unreported jobs while remaining on the centres' rolls.

But more than half of laid-off workers have found new jobs

On the key criterion, the location of new jobs, the performance has been better. More than half of the workers that have entered the centres are reported to have since found new jobs; official figures indicate that 4.5 million laid-off SOE workers found new positions in 1999 alone.¹¹⁶ In Shanghai, 92 per cent of 1 million laid-off have found new jobs in the past three years. Not surprisingly, progress has been less in slower growing regions: in Hubei province only 30 per cent of the workers in REC managed to find new jobs in 1998. However, the overall record seems good considering the rising unemployment rate and falling employment growth in urban areas over the past several years. The majority of the new jobs have been in service industries, and a large fraction have come from private firms. The role of the REC in these placements, as well as their effectiveness in retraining workers, has been questioned, since a large proportion, and perhaps most, of the jobs seem to have been found through friends or relatives. Nevertheless, the ability of local labour markets to absorb a relatively high fraction of the laid-off workers has been critical to allowing SOE to continue to shed substantial amounts of their surplus workers.

Unemployment insurance

Unemployment insurance is being expanded

The unemployment insurance system was first established in China in the mid-1980s to ensure that urban unemployed workers had a basic living allowance. The system is now being expanded and reformed with the ultimate goals of providing interim support for all unemployed workers, relaxing constraints on enterprises' ability to adjust their labour forces, and improving labour market integration and labour mobility. While now confined to urban areas, extension of unemployment insurance coverage to rural areas is envisaged to begin in the next five-year plan beginning in 2001.

More than half of urban workers are registered...

Nearly half of China's urban workers were registered with the system by the end of September 1999. Registered workers who become unemployed are eligible to receive basic living subsidies for up to two years; in the first year, the subsidy level equals that given to workers in the REC, but the subsidy is reduced by 50 per cent in the second year.

... and coverage is being extended

Under the new unemployment insurance regulation that came into effect on 1 November 1999, coverage has been extended to all urban workers including those in private enterprises, self-employed workers and contract rural workers. Required contributions are 3 per cent of wage payments, of

which two-thirds is paid by the enterprise and the remainder is paid by the worker through a payroll deduction.¹¹⁷

Unemployed workers who have received subsidies for two years, and workers who have been in REC for three years, are transferred into the more general welfare programme providing a minimum allowance for living expenses that is available in principle to all urban residents. In 1999 this programme, which is funded from local government budgets, was functional in 668 cities and 1 689 counties. The amount of the allowance varies by region, according to their cost-of-living.

General welfare follows after unemployment benefits are exhausted

Health and pension system reforms

Reform of health and pension programmes is essential not only to reduce current burdens on enterprises but also to meet the needs of China's rapidly ageing society. As with unemployment insurance, health and pension programmes are now largely confined to urban workers and residents.

Pension and health care reforms are essential

Health care

For most of the reform period, SOE have been fully responsible for the medical costs of their employees. Initially, SOE were compensated for these expenses by government appropriations. However under the management reforms instituted in the mid-1980s, SOE became responsible for their own expenses and profitability. Government reimbursement for medical care was withdrawn in principle, although in practice the government continued to provide funding for SOE unable to meet the expenses on their own. Medical care responsibilities have led to steadily rising costs in relation to payrolls in a manner quite familiar in many OECD countries. As in the OECD, the costs have been aggravated by the limited incentives to economise on health care services that are largely provided to workers without explicit charge to themselves. The heavy burden of health care costs has become one of the constraining factors on the economic performance of SOE. As with pensions, health care burdens vary considerably among SOE, and even more between SOE and non-state enterprises, as well as across regions. Disparities in health care coverage as well as the lack of portability of benefits has discouraged labour mobility.

SOE health care burdens have been rising

Pilot programmes to unify the management of medical funds under local governments were carried out in certain cities in the beginning of 1990s. The unification diminished to a certain extent disparities in health care burdens among SOE. But it did not drastically reduce the overall burden on SOE, nor did it address the gap in burdens between SOE and other enterprises.

Experimental reforms began in the early 1990s

In November 1993, a new health reform plan was instituted, with the objective of reducing financial burdens on SOE and increasing the responsibility of workers for the cost of their health care. The plan creates a two-tier system of benefits comprising individual medical accounts and a community-wide pool ("unified" account). Workers contribute 2 per cent of their salaries through payroll deductions to the individual accounts. Enterprises contribute a further 6 per cent of salaries, 30 per cent of which goes into the individual accounts and the remainder into the unified account. Medical expenses are

The goals: reduce SOE burdens; increase workers' responsibility

paid in the first instance from the individual medical accounts. Once the account is exhausted, a worker is normally responsible for paying any additional medical expenses.¹¹⁸

Implementation is still at an early stage

Implementation of the reforms is still at an early stage: by 1999, 24 of China's 41 provinces had established reformed medical insurance programmes. Partly because of the early stage of the reforms but also because of rapidly rising medical care costs, there has as yet been little if any reduction in SOE burdens for medical care. The reforms represent a very initial and limited step toward improving incentives to economise on health care provision. Although workers now contribute a modest amount out of their own payroll, choices among plans, co-payments for specific treatments, and other provisions that have been needed to improve incentives elsewhere do not yet exist.

Pension reforms

The major challenge to pensions: demographics

China's demographics alone pose a formidable problem for its pension programmes. The proportion of the population above the age of sixty is expected to increase by nearly fifty per cent over the next 10 years, to reach 10 per cent by 2010 (OECD, 1998a, 1998b). Public pension plans, which presently cover SOE workers together with government employees and the military, are virtually entirely pay-as-you-go. Pension burdens vary markedly: the average ratio of retirees to current workers is nearly 2 to 1 for SOE established during the 1950s versus half that ratio for enterprises established in the 1970s or later. The divergence in pension obligations is the major source of the discrepancies in overall SOE social welfare expenses. A large and growing number of SOE are financially unable to meet their pension obligations.

Major reforms are underway

Since 1993, authorities have been instituting major pension reforms in order to achieve three basic objectives. The first is to provide more sustainable funding mechanisms to meet current needs and especially to deal with the rapid projected rise in outlays in the future. The second objective is to reduce overall SOE pension burdens as well as the divergences in these burdens among enterprises. The third objective is to extend the coverage of pension programmes to the non-state sector, in part to level the competitive playing field among various types of enterprises and to improve labour mobility.

Reformed pensions plans rest on three pillars

Policies to address these problems began in 1993 with the establishment of individual pension accounts. The system that has since emerged is based on three "pillars". The first is a basic defined-benefit plan financed by contributions proportional to a worker's salary. The second is an individual pension account financed by (compulsory) contributions from workers; while the third is a voluntary supplementary plan financed by individual firms or insurance policies purchased by workers. In 1997, the three elements were integrated and the separate funds were unified and placed under the management of agencies of the provincial and local governments. Contributions were standardised at 13 per cent of salary for the basic benefit (currently being paid by enterprises); with a further employee contribution of 11 per cent of salary paid into the individual pension accounts. In principle, total contributions paid by the enterprise itself are supposed to be limited to 20 per cent of workers' salaries.

By the end of June 1999, the new pension network had been expanded to cover 110 million retirees, 26 million more than in 1998. Beginning in 1999, the coverage of pensions is being gradually extended to include the non-state sector.

Coverage has expanded rapidly

As yet, the pension reforms have not appreciably reduced financial burdens on SOE as a whole. This is partly because the social pooling in the new arrangements applies mainly to new workers and so does not address the pensions due to current retirees. Burdens have been shifted somewhat, but mainly from loss-making and low profit SOE that are unable to meet their obligations to more profitable SOE, which in some cases are required to pay more than the theoretical maximum of 20 per cent of salaries.

But burdens on SOE have not yet been reduced

Beyond the near term, the success of the pension reforms is limited by the poor financial conditions of the two main pillars, SOE and local governments. With the deterioration of the financial situation of SOE, the collection rate of the social security fund has been decreasing. Moreover, local governments, particularly those in the less developed central and western areas, are often too financially strained to fully meet their obligations. The fall in payments from these sources has been only partly made up by additional contributions coming from non-state enterprises as coverage is expanded. Largely as a result, the deficit of the pension pools has been rising rapidly, and reached an estimated total of 100 billion yuan in 1999.

Financial problems limit progress

The gap between pension obligations and the present and prospective resources available to meet them is growing. Expanded coverage, while it has alleviated the near-term squeeze on the funds, increases pension obligations over the longer term. Financing of the unfunded pension obligations solely through existing mechanisms would likely increase burdens on enterprises to untenable levels.

The gap between obligations and revenue resources is growing

Concluding observations

Reforms to China's social security programmes are still at a very early stage. Two important accomplishments have come from the measures taken so far. First, the arrangements for the REC have permitted substantial downsizing in SOE workforces. The REC together with the developing unemployment insurance system should make it easier for workers to change jobs, and for state and well as non-state enterprises to adjust their employment levels, than has been the case in the past. Second, the reforms have established infrastructure and policy frameworks as a foundation for the development over time of a comprehensive system of social benefits.

There are two important accomplishments

More clearly remains to be done and there are several near-term and longer-term obstacles to the accomplishment of the objectives of the programmes that will need to be overcome. First, most of the programmes have yet to be fully implemented and the pace with which implementation can be completed is limited by the present financial weakness of SOE and many local governments. These financial problems also limit success in spreading the financial burdens of providing social welfare benefits.

Weak financial positions of SOE and governments are an obstacle

Also needed: more attention to incentives will be needed...

Second, as the programmes develop and coverage is expanded, more attention is likely to be needed to providing necessary incentives for the efficient use and provision of social benefits. For example, it has been suggested that medical insurance be focused on prevention and basic care, leaving individuals at least partly responsible for “elective” and other treatments (Ge, 1998b). As OECD countries have found, without sufficient incentives, social benefit costs can rise to untenable levels.

... and additional revenues to pay for past pension obligations

Finally, probably the most difficult problem facing the successful development of social benefit programmes in China is the financing of the accumulated burden of past obligations, mainly pensions. While some progress has been made in broadening the funding base for the programmes, it has been quite limited so far. The especially heavy pension burdens of long-established SOE were largely incurred when the enterprises were administrative units of the government and are rather arbitrary in an economic sense now. However, it is unlikely that pension burdens on SOE can be contained or more equally distributed without substantial additional general revenues to help meet the past obligations. The added burden need not be excessive: Zhao and Xu (1999) have estimated that additional pension debts can be amortised over 50 years with a general tax equal to about 1 per cent of GDP. This proportion is not large in absolute terms, although it represents a more substantial increase from the present level of government revenues.

VIII. CONCLUSIONS

Both in terms of the individual objectives discussed in previous chapters and from the broader perspective of its overall sustainability and macroeconomic performance, the enterprise reform process is at a critical juncture. Much progress is being made on the broad range of areas needed to complete the transition to a market economy and to secure the competitiveness of China's enterprises. Measures that have been taken should help boost enterprise financial performances over the medium term and provide a modest impetus to real growth in the economy as a whole.

Considerably more needs to be done, however, if the reform process is to be sustained and ultimately succeed. In many areas, reforms undertaken so far provide necessary structures and mechanisms for improving enterprise performances, but the conditions required for their effective functioning are often lacking. Lack of adequate progress in some areas, such as ending policy lending by commercial banks, is limiting or preventing progress in other areas. Much of what remains to be done is included, in principle, in official reform plans; but some of the steps are proving to be particularly difficult to implement.

The reforms also need to make substantial progress in several key areas over the next several years. This urgency partly reflects the fact that reforms have become increasingly interdependent, as well as the need for rapid and effective adjustments by enterprises to the changes that will come with growing international competition. Rapid progress in several areas is also required to limit the deflationary forces current enterprise reforms have engendered and so maintain the aggregate real growth needed to sustain the reform process. Moreover, faltering or undue delay in reform efforts can only aggravate the already apparent tensions between the financial demands imposed by reforms and the scarcity of government revenues.

The prior chapters document that much progress is being made in China's economic reforms but that there are gaps as well as significant obstacles. This final chapter briefly considers the overall progress of the reforms in terms of its implications for macroeconomic performance and the sustainability of the reform process. This is followed by an assessment of areas where further measures or changes in the orientation of policies now being undertaken appear to have the greatest potential payoff in terms of strengthening the effectiveness of economic reform efforts and improving their longer-term prospects of success.

Two broader questions remain

Macroeconomic performance and reform sustainability

As indicated in the first chapter, the enterprise reform process in China depends on the dynamic among three main elements: enterprise profitability in the near term; improvements in enterprise operational efficiency over a longer period; and macroeconomic performance. A "virtuous circle" in this dynamic is one in which: reforms increase enterprise profits and thereby raise funds for investment to upgrade operational efficiency. The increased investment also contributes to real growth; which in turn further bolsters profitability, helps to reduce excess capacity, and generates new jobs to absorb workers displaced by reforms. A faltering in this dynamic can turn the virtuous circle into a vicious circle, whereby enterprise structural problems depress real growth, which in turn makes it more difficult for reforms to proceed. Improvements in enterprise behaviour are

Sustained progress rests on a virtuous circle

essential if a virtuous circle in reform is to be maintained. Adequate real growth in the overall economy is also very important. While the growth slow-down since 1996 is not directly responsible for most of the financial problems of enterprises, sufficient real growth in the future will be necessary to ensure that reforms result in improved enterprise profits; displaced workers are able to find new jobs; and government revenues needed to support future reform efforts are available.

Reforms underway represent significant progress...

From this perspective, the measures discussed in the prior chapters represent important progress. This progress reflects not only the advances made on particular measures, but also the breadth of the reforms, and the fact that they are generally, although not always, mutually supporting. The resulting improvements in enterprise cash-flow and profitability should provide a modest boost to aggregate real growth over the next several years. As the process of labour shedding is completed, the job and income insecurity that have been depressing consumption spending should begin to decline. These impacts should reduce the fiscal stimulus needed to support aggregate growth and leave more government revenues available to directly support economic restructuring and other necessary reforms. Improved enterprise financial conditions and measures to deal with bank non-performing loans may also lead to an easing of credit availability and allow monetary policy to play more of a role in supporting growth. While there can be no guarantee of continued progress – that depends also on external demand and other developments that are difficult to predict – overall the prospects appear better now than they did several years ago.

... but prospects beyond the medium term are less certain

It is too early to tell, however, whether current reform efforts will achieve as much beyond the next several years. Prospects depend particularly on developments in three areas. The first is the extent to which problems in the non-state sector prove to be largely self-correcting or whether they persist or even get worse. The second is the degree to which enterprise operational inefficiencies will be alleviated through increased investment by enterprise and industry reorganisation. The third is the sustainability of efforts to restore banks' financial viability and to base lending on sound commercial principles. The fact that the full extent of the problems in these areas is not well known further adds to the uncertainties surrounding the longer-term effectiveness of the current reform strategy.

Much more remains to be done...

To make further progress, and even to preserve the gains that have been achieved so far, will require not only continued effort on existing reforms but also additional measures to address the gaps and bottlenecks identified in prior chapters. Reforms so far have been most successful in alleviating the effects of past problems and distortions. There has been noticeably less progress in improving enterprise governance and external discipline, but these areas have now become central to the success of the overall reform process. Improvements in enterprise behaviour are essential to ensure that enterprises make effective use of the existing resources and take the strategic investment and other decisions necessary for their long-term competitive viability. Reforms in these areas have established an important foundation of structures and mechanisms for improvements in performance, but in many cases key conditions needed for their effective functioning have not been put in place. For the most part, the major reforms that need to be undertaken have been endorsed in principle, or are at least consistent with, existing

official plans. However, as the difficulties that have impeded progress in these areas illustrate, some of the remaining steps are particularly difficult because they pose potential conflicts with other social goals or traditional practices. This is illustrated by the severe constraints that continue to limit progress in industry reorganisation through M&A, elimination of government interference in enterprise management, and the curtailment of policy lending by commercial banks.

Sustaining the reform process is also likely to require rapid progress on a broad range of fronts over the next several years. While gradualism has worked well for much of the reform period in China, there also have been occasions when excessive gradualism in circumstances requiring more decisive action has led to serious problems. In retrospect, the gradual approach taken until 1999 in dealing with bank NPL allowed the loans to continue to accumulate and delayed progress in reforming lending standards. At least three considerations strongly suggest that the reform process needs another major leap to be sustained. First, to successfully meet the increased competition from WTO entry, much of the economic restructuring, reorganisation, and supporting reforms will need to be well established by the middle of this decade. Second, unless rapid progress is made in completing reforms to boost enterprise profitability and improve enterprise behaviour, the important gains that have been made in reducing overhead burdens are likely to be substantially dissipated. Financial discipline will be essential to both these efforts but is unlikely to be effective unless policy lending is curtailed and bank NPL problems and the conditions leading to them are more completely addressed. And third, with strains on public finances already evident, the scope for prolonged fiscal stimulus to offset the deflationary effects of enterprise problems is limited; over-reliance on such stimulus could jeopardise future resources needed to directly support reforms. Together these considerations suggest that the reform process will become more constrained and difficult to sustain unless rapid and broad progress is made in the key areas.

... and progress needs to be rapid and broad

Areas where the process could be improved

The economic reform process in China has several important strengths that account for much of its success. First, although not always the case, the process is now reasonably *comprehensive* in addressing the major areas essential to establishing a market-based and competitive economy. Second, *pragmatism* in the reform process has provided essential flexibility to allow changes in the content and implementation of policies to improve their effectiveness. And third, the *decentralisation* of policy implementation to provinces and local governments, although it has caused problems at times, has on balance been beneficial to reform. This decentralisation has allowed for local experimentation and has sometimes led to more rapid implementation of reforms than probably would have been the case in a more centrally driven process.

The reform process has several key strengths...

These strengths have also been accompanied by several important weaknesses that have limited the progress that reforms might otherwise have been achieved.

... as well as weaknesses

- There has been an overemphasis on SOE, particularly larger SOE, in certain areas of reform; while problems of other enterprise sectors have

received less attention than their problems or importance to overall economic performance would seem to warrant.

- Government direction and interference in economic decisions has limited the effectiveness of otherwise sound reform plans in several areas, most notably in M&A and in preventing the separation of government from SOE management from being fully implemented.
- Regional barriers to investment as well as trade continue to be an important impediment to enterprise restructuring and reorganisation.
- Scarcity of revenues along with uneven tax burdens continues to be a key constraint on the pace as well as content of reforms.

Addressing these weaknesses is already part of the longer-term reform agenda. But stronger efforts in the medium term could help to improve the implementation of current policies and their economic benefits.

Several changes could have high pay-offs...

The prior chapters also have pointed to more specific areas where additional policies are likely to be needed to redress gaps or other problems in current efforts. In this context, there are a number of policies that could have particularly great benefits for the effectiveness and sustainability of reforms and for overall macroeconomic performance. Substantial progress could be made on some of these over the next several years. Others steps are likely to take longer.

... measures to help non-state enterprises...

Greater efforts in the medium term to address problems of non-state enterprises could have substantial payoffs and may be necessary to sustain adequate real growth. Market forces alone may not be sufficient to overcome the heavy debt burdens and other problems of collectives. There is a risk that difficulties in obtaining external financing will seriously restrain growth of collectives and small and medium-sized SOE. Government resources to directly assist non-state enterprises are necessarily quite limited. However, acceleration and broadening of credit guarantee and other programmes to improve financing for non-state enterprises could help in the medium term. Alleviation of the "credit crunch" now facing non-state enterprises could also help to improve the effectiveness of monetary policy and reduce the burden on fiscal policy in sustaining real growth.

... remedy weaknesses in corporate governance reforms...

Expedited measures to strengthen SOE corporate governance mechanisms would accelerate the improvement of SOE management, especially in sectors that are now relatively protected. Most important are measures to reduce the dominance of insiders in SOE governance and curtail interference of government agencies. These include: vesting responsibility for appointing top management exclusively with the board of directors rather than government and political officials; requiring that the boards include genuine outsiders who can be held accountable; and establishing genuinely independent supervisory boards. Failure to make substantial improvements in these areas fairly soon could substantially increase the difficulties and costs incurred by SOE in adjusting to WTO entry.

... complete reforms to improve banks soundness and lending standards...

Timely measures to complete the restoration of financial soundness to the major banks and to establish rigorous lending standards are equally crucial. Current measures represent important steps toward these goals; but experience strongly suggests that partial steps provide only limited and insecure payoffs in terms of better financial discipline. The most important need

is to curtail remaining policy lending through means such as those suggested in Chapter VI. Further efforts by authorities to deal with bank NPL may also be needed if loans classified after 1995 turn out to be higher than is now apparent. As emphasised earlier, these areas are crucial to any sustained improvement in enterprise behaviour.

Liberalisation of the current M&A process, especially for SOE, would help considerably in the effort to improve economies of scale and scope in industry. Much could be accomplished in this area in the next several years through central government efforts to overcome barriers to inter-regional investment and business acquisitions; by allowing SOE greater flexibility to dispose of assets acquired in M&A; and by giving state holding companies greater scope and autonomy in carrying out M&A. Rapid improvement in these areas could significantly reduce the transition costs from WTO entry as well as greatly enhance the benefits.

... liberalise the M&A process...

Although they will take longer to be completed, extensive reforms to increase government revenues and to reform the tax system are essential. The reform agenda acknowledges the importance of increasing revenue but present efforts are mainly directed at improving enforcement and collection. Moderate increases in existing tax rates or introduction of new taxes (provided they were applied in areas able to bear the additional burdens) that were used to accelerate and broaden economic restructuring could have a high payoff in the medium term. Over the longer term, the tax base is likely to have to be broadened further to support reforms to social benefit programmes. Major tax reform to eliminate disparities in effective tax rates among SOE and other ownership types will also be needed.

Essential over the longer term: fiscal reforms...

Adoption of a narrower, rather than broad, definition of the strategic core where SOE will dominate or at least have a major presence would help to reduce risks that SOE will burden public finances and absorb resources that could be used more productively elsewhere. Experiences of OECD countries strongly suggest that, except for natural monopolies, SOE are rarely as efficient as private enterprises and often become chronic loss-makers that absorb excessive government attention and resources. Theoretical considerations suggest that the economically justifiable scope for state ownership may be wider in developing economies than in more advanced economies. But the privatisations now underway in many such countries suggest that, in practice, the scope is narrower than was previously believed.

... limiting SOE to industries where they are essential...

Finally, financial reforms will continue to be critical to sustaining progress on reform but there may need to be some changes in emphasis as they proceed. While stock market growth has been impressive, development of bond markets is likely to be at least as important to diversifying enterprise funding sources and to reducing their dependence on banks over the next ten years. It is also not at all certain that development of smaller banks and even entry of foreign banks will be sufficient to deal with the potential problems posed by the dominance of the four largest state commercial banks. Further and more radical measures, such as the division of one or more of the banks along regional lines, may need to be considered.

... and broadening of financial reforms

Notes

1. Under international definitions as reported by the World Bank, the poverty rate was 22 per cent in 1997, about one-third of the rate at the beginning of reforms.
2. The apparently extended slowdown is somewhat misleading as 1992 was a cyclical peak in which growth was well above potential. This was followed by an abortive credit tightening that was relaxed in 1994 and resumed in 1995 and which resulted in an apparent soft-landing in 1996, when inflation fell sharply with only a mild further reduction in real growth. However, the continued slowdown after 1996 represents a departure from earlier macroeconomic cycles, when growth typically re-accelerated within two to three years following the prior trough (Oppers, 1997).
3. World Bank (1994). A number of energy and agricultural prices remain subject to controls, although these are being relaxed. Labour markets are quite rigid and labour mobility is still quite low, as is the mobility of products and factors among regions.
4. Presently, the scope of state ownership in China is roughly comparable to that prevailing in France and several other European countries in the early 1970s. That non-state ownership will continue to grow has been most recently acknowledged officially by the statement from the Fourth Plenary Session of the 15th Chinese Communist Party in September 1999: "With public ownership dominant, diverse forms of ownership will be developed side-by-side."
5. China's gradual reform was more rapid and broader in its earlier phases than the early stages of reform in Russia and Eastern Europe under their Communist regimes, and went much further. During the 1990s, however, reforms in the European countries have proceeded very rapidly and in some respects have gone beyond those in China.
6. This belief has been strongly reinforced by the problematic experience of Russia's rapid ("big bang") transition following the fall of its Communist regime.
7. Indeed, reforms have overtly favoured economic development of coastal regions relative to the interior and have been accompanied by a steadily rising gap in living standards between urban and rural populations. Moreover, several million workers have been displaced from state enterprise payrolls as the direct result of reforms taken over the past five years.
8. Total government revenues in China, including taxes, fees and other sources, are about 18 per cent of GDP, well below the 25-30 per cent level maintained in other large developing countries, such as Brazil, India, and Indonesia.
9. The regionalism in economic policy is reinforced by the limited degree of economic integration among China's provinces (World Bank, 1994) and by marked discrimination in central government economic policies among regions, such as the preferential treatment of foreign investment in the coastal provinces. There are also marked differences in net fiscal revenue flows across regions, although coastal provinces are not uniformly better off in this respect than interior provinces.
10. For extensive analysis of the regional dimensions of China's economic reform processes, see *China's provinces in reform* (1997) edited by David Goodman. The chapter on Hubei (second volume of the study) particularly illustrates the forces shaping regional development strategies.
11. Under official definitions, private enterprises with less than eight employees are classified as individually owned while those with more employees are denoted as "private".
12. This figure refers to the universe of all industrial enterprises, which includes a substantial number of subsidiary entities (most outside the SOE sector) that do not keep independent accounts but whose conditions are not consolidated with those of their parents in official statistics. Detailed data on enterprises, such as that on financial conditions discussed later, is typically derived from the subset of enterprises that maintain independent accounts, which account for about 60 per cent of total industrial output. SOE accounted for 41 per cent of the output of this subset in 1997.
13. The SOE share of the fixed assets of industrial enterprises with independent accounting units was 64 per cent in 1997; their share of all industrial assets is less, but probably at least 50 per cent. The latter figure assumes that non-state enterprises without independent accounting units are somewhat less capital intensive (lower ratio of assets to output) than non-state enterprises with independent accounting units.
14. Growth of TVE has also benefited from business relations with SOE, which have lent TVE funds and other resources (in part as a means of avoiding limitations imposed by government planning). TVE have grown most rapidly in coastal provinces, especially Guangdong, where openness to foreign investment and other preferential government policies

- have created a particularly favourable environment. They have grown noticeably less rapidly in the central regions, and least rapidly in the West.
15. For a recent review of studies of factor productivity in China's enterprises, see Jefferson, Singh, Xing, and Zhang (1999). Their conclusion that SOE productivity growth has been moderately positive contrasts with other analyses suggesting virtual stagnation in SOE productivity growth during the 1980s (Woo *et al.*, 1994). Jefferson *et al.* also argued that firms that have shifted from the state to the non-state sector tend to be among the more successful; and their shifts thus tend to magnify the apparent gap between SOE and non-state enterprise productivity.
 16. The slower productivity growth of SOE has led to a steadily widening cost disadvantage *vis-à-vis* non-state enterprises; while the greater competition and variety in the market produced by the entry of non-state firms have sharply circumscribed the ability of SOE to make up for higher costs by charging higher prices (Jefferson *et al.*, 1999).
 17. The text estimate for 1998 is based on preliminary figures derived from interviews with Chinese officials and on the results of the OECD statistical analysis (OECD, forthcoming). Profit figures reported in the *China Statistical Yearbook* for 1999 suggest a milder drop of about half the amount indicated in the text. However, the *Yearbook* figures for 1998 appear based on a somewhat different classification of SOE than used in earlier yearbooks and may not be comparable with earlier years. Unless otherwise noted, profit figures given in the text are based on the definitions of the published series in the *China Statistical Yearbook* and the *China Industrial Yearbook*. Under these definitions, after-tax profits refer to profits after deduction of sales, value-added, and most other taxes but before deduction of corporate income tax. Before tax profits are after-tax profits plus sales and value-added taxes paid. These definitions are compatible with the data reported in other published analyses, including those by the World Bank and IMF. However, the definitions differ from those used in the OECD study of the CNBS data (See Annex), where after-tax profits are net of corporate income taxes as well as the other taxes.
 18. The ratio of before-tax profits to sales in 1997 was 10.4 per cent for SOE and 7.2 per cent for collectives. The average ratio for all non-financial enterprises in OECD countries was about 10.5 per cent in the early 1990s (OECD, 1995), but was probably higher in manufacturing. Expressed on a comparable basis with OECD countries, a rough estimate gives the profit rate of all industrial SOE after deduction of all taxes, including income taxes, at around 1.3 per cent of equity; this compares to an OECD average of 4 per cent during 1990-1993. The OECD ratios also differ considerably among countries, with several, including Japan, reporting lower ratios than for China.
 19. Explicit government subsidies to make up for these losses are even lower and also have been declining in recent years. However, these figures represent only a small portion of overall public sector support to SOE, the bulk of which has been provided through "policy" loans provided by banks.
 20. See World Bank (1999). The incidence of losses for SOE in earlier years is not available but the trend in loss ratios for industry as a whole is probably indicative.
 21. On average, nearly 20 per cent of Fortune 500 companies in the US incur losses in a given year.
 22. About 60 per cent of these firms are SOE. The remainder include collectives (the majority), foreign funded, and "mixed" ownership forms. The sample is an updated version of that used in a study by the World Bank and CNBS (World Bank/CNBS, 1998; see World Bank, 1999) using a sample for 1995-1997.
 23. The debt-equity swap programme introduced in 1999 also potentially creates incentives for large SOE to underreport profits. See Chapter III.
 24. Indeed, the sharp decline in export growth during 1997-1998 probably explains much of the precipitous drop in the profit rate of foreign-funded enterprises (before-tax profits dropped from 15 per cent of assets in 1995 to 4 per cent in 1997; World Bank, 1999, p. 23).
 25. Excess supplies in those industries, such as petroleum, that are still heavily protected from foreign competition have been further aggravated by widespread smuggling of foreign produced goods that continued well into 1998. (Since mid-1998, authorities have instituted a major counter-smuggling effort that has substantially curtailed this smuggling).
 26. In such a situation, the incentive is for enterprises to expand production as far as feasible, even in the face of excess capacity in the industry at large. Since capital is virtually free, losses can be covered by new bank loans, and production, even if unprofitable, still serves to cover part of the wages of a workforce that is effectively a fixed cost.
 27. Since the debt ratios, as well as interest rates, have fallen, they do not explain the fall in profit rates since 1996.
 28. The 1999 figure is from published data reported by the China Economic Information Network, March 9, 2000. Reported financial charges for collective enterprises are only 2.4 per cent, which is somewhat surprising given that their asset-liability ratios are comparable to those of SOE. This SOE figure is also high relative to the average of OECD countries. Interest rates paid by OECD corporations averaged about 3.5 per cent in the early 1990s (OECD, 1995).
 29. This figure is derived from the OECD analysis (OECD, forthcoming). The figures from that sample put financial charges of large and medium-sized enterprises at 4.9 per cent of sales, somewhat higher than the text figure for all SOE for 1999.
 30. Taxes paid by SOE are more than twice as large in relation to their gross output as those paid by other firms. This situation reflects a long-standing policy to use SOE as the major revenue source for central and local authorities, while promoting

- development of non-state enterprises through preferential tax treatment. Foreign joint ventures have been particularly favoured in this regard with tax exemptions and other preferences applied within the special economic zones.
31. Certain policies have long favoured the development of non-state enterprises, notably their exemption from central planning restrictions and their relatively favourable tax treatment. In addition, policies to encourage foreign direct investment can be regarded as part a broader Chinese "industrial policy" to improve efficiency throughout the business sector as a whole.
 32. Local governments are allowed to set their own targets within the context of the overall national goals. In Hubei, the provincial government plans to transform 60 per cent of its loss-making SOE into profitable operations by the end of 2000. The extent to which the substantial increase in the incidence of SOE losses in 1998 has altered these plans is not yet clear, however.
 33. Authorities have indicated they eventually intend to end differences in tax treatment among various types of enterprises. The implication is that tax preferences favouring foreign-funded enterprises will be phased out. However, although the creation of a level playing field for all investors remained as official policy, the authorities have announced a number of measures to boost FDI flows in 1999, including increased tax concessions and extended preferential policies.
 34. These figures are based on estimates from the IMF and World Bank and figures provided in interviews by government officials. There are probably substantial surplus workers in collective enterprises as well. A recent World Bank study has estimated that as much as 35 per cent of the workers in SOE and collectives combined could be surplus to requirements (*Financial Times*, 10 December 1999). Estimates of surplus workers in agriculture run as high as 100 million. In practice, estimates of redundant workers are typically derived from surveys and are based on the judgement of enterprise management about the minimal number of workers that would be needed to produce profitability at capacity. These judgements can be misleading and may overestimate the number of redundant workers when production lines are badly organised.
 35. The text estimate is based partly on discussions with experts at the International Monetary Fund and other international agencies. Official data are not entirely clear as to the precise figures but a literal reading suggests a somewhat higher figure of about 16.5 million. According to official figures, roughly 11.5 million SOE workers had entered the re-employment centres by the end of 1999, with most having left their SOE since 1996. The pace of layoffs slowed below initial plans during the first half of 1999, due to concerns over slowing real GDP growth, and, in July 1999, the Minister of Labour and Social Security estimated that lay-offs would total about 3 million for the year, compared to nearly 5 million in 1998. However separations apparently accelerated during the latter half, and reportedly had reached 4 million by the end of September 1999 (*Economist Intelligence Unit Country Report on China*, 1999, Q4) and may have reached 5 million by year-end.
 36. According to a survey by the State Economic and Trade Commission taken in 1998, about half of all workers separated from core SOE companies had been transferred to ancillary activities or taken early retirement. This mechanism is particularly heavily used by large SOE under central government control, since they are not eligible to use the reemployment centres established by local governments. For example, Wuhan Iron and Steel Group has transferred more than half of its original employees to such activities since 1993 (Interview with Wuhan Iron and Steel Company officials, June 1999).
 37. The transfer of production workers to ancillary activities also helps to lower overall payroll expenses of the SOE, since the transferred workers generally do not earn the bonuses paid to production workers.
 38. According to an interview with officials of the Economic Commission of the Shanghai Municipal Government (June 1999), nearly 90 per cent of the workers separated from SOE during 1997-1998 had found alternative jobs.
 39. This estimate is based on the OECD statistical analysis of enterprise conditions (OECD, forthcoming).
 40. According to figures derived from the OECD statistical analysis, nearly 20 per cent of all large and medium sized enterprises have interest/sales ratios above 10 per cent; the ratio is 18 per cent or higher for nearly 10 per cent of all firms. The proportions for SOE and collectives are higher (OECD, forthcoming).
 41. Debt-equity swaps are effectively unavailable to commercial banks themselves as a device for dealing with bank loans since they are forbidden by law from holding equity in companies. The bank asset management companies, as legally distinct non-bank entities, are not subject to this restriction.
 42. Reported by AFX-Asia, 30 March 2000. Indicative examples are agreements signed with Anshan Iron and Steel (Liaoning Province) and Baosteel Group (Shanghai) in November. Most of these deals were signed before January 2000, and the pace of new deals seems to have slowed over the next several months. The slowing is reportedly attributable to resistance from enterprises to making organisational changes demanded by asset management companies and from local governments concerned about impacts of the reorganisations on local employment. These obstacles may well prove a temporary impediment but illustrate the multiple parties and often conflicting interests involved in enterprise reforms.
 43. Roughly 2 000-2 400 large industrial SOE were loss-making in 1998. Assuming these loss-makers account for around half of the total liabilities of industrial SOE, their debt levels could be reduced by nearly one-third if all of the 350-400 billion available under the programme were devoted to these enterprises.

44. *China Statistical Yearbook*, 1998, Table 13.21. Figures are for 1997. The table indicates that for most categories, less than 50 per cent, and often less than one-third, of the equipment was installed during the 1990s. Although estimates of the age of industry capital stocks are difficult to compare, it is worth noting that in the early 1990s, less than 30 per cent of the capital stock in the former Federal Republic of Germany was more than 11 years (OECD, 1990-1991, p. 86).
45. In August 1999, the government announced the issuance of an additional 60 billion yuan of treasury bonds, 9 billion of which has been earmarked for low interest loans for technical upgrading of SOE. The 9 billion represents less than 0.4 per cent of total sales of all large and medium-sized SOE, but a much larger fraction of the sales of the target enterprises that will receive the loans.
46. Local authorities derive a major portion of their revenue from SOE under their control. They thus tend to be quite reluctant to have their well-performing SOE acquired by outside enterprises since this would erode their tax base.
47. These benefits include: support for workforce reductions; reductions in debt or interest owed to banks; tax forgiveness; and permission to list on the stock market. Only the first involves immediate direct outlays. Banks, or more recently bank asset management companies, typically bear the expense of debt reductions or the foregoing of interest payments.
48. In 1999, 435 large and medium-sized loss-making SOE went bankrupt or closed.
49. Figures of CNBS as reported by the China Economic Information Network, 9 March 2000. The total losses of loss-making firms dropped by 16 per cent over 1998. The improvement in profitability appears to have been widespread, with a majority (26) of provinces, independently administered municipalities, and autonomous regions reporting increases over the same period of 1998.
50. "Chinese Companies Fight for Profit amid Dubious Recovery," *Wall Street Journal*, 4 May 2000. Listed companies are, however, more export-oriented than SOE as a whole and hence may have been more affected by the downturn in the Asian region. While government efforts to show efforts from reforms may have created incentives to overstate profits, the debt-equity program and longer-standing efforts by managers to hide profits also create incentives for underreporting. Hence the bias in the reported data is difficult to assess.
51. Although less clear, SOE will probably remain an important presence in parts of the automobile, chemical, electronic, and machinery industries.
52. Analogous transformations are also needed for small and medium-sized SOE, but are effectively accomplished as part of the "letting go" process.
53. Among the 2 562 large SOE that were selected for the original pilot programme, more than half became JSC while another 28 per cent became wholly state-owned LLC.
54. Through mid-1993, the state maintained strict controls over the majority ownership in listed companies, mandating that a minimum of 51 per cent of all shares issued should be held by the state. In August 1993, an official circular issued by the National Administration of State Property (NASP) made a distinction between "absolute state-holding companies" and "relative state-holding companies," and mandated that the state's share in the former should exceed 51 per cent, while it could range between 35 per cent and 51 per cent in the latter category of companies. This distinction disappeared in the 1994 Company Law, which simply mandated a minimum of 35 per cent for the state share in listed companies.
55. Exception is given only with the explicit approval of the state authorised investing institution or department, such as the National Administrative Bureau of State-Owned Property (NABSOP) at the central government level and the state asset management bureaux of local governments.
56. Statement of the Fourth Plenum of the 15th Central Committee of the Chinese Communist Party, held in September 1999.
57. In December 1999, the China Securities Regulatory Commission (CSRC) announced plans to cut the state shares in the listed firms from 62 per cent to 51 per cent.
58. Elkem, a Norwegian light metals group, agreed to acquire full ownership of Ningxia Shizuishan No. 1 Carbon Plant (*Financial Times*, 7 June 2000).
59. Horizontal associations among enterprises were initially sanctioned by the issuance by the State Council in July 1980 of *Interim provisions for the promotion of enterprise associations*. The regulations governing these associations were further enumerated several years later in the *Regulations of the State Council on some issues of further promoting horizontal integration*, in which the term "Enterprise Group" was used for the first time.
60. Most foreign direct investment (FDI) during the 1980s came from Hong Kong, China and other economies with predominately ethnic Chinese populations. This pattern shifted in the early 1990s, when FDI became dominated by foreign multinationals (MNC). Nearly 300 of the 500 largest multinationals have investments in China. By the early 1990s, firms financed by MNC were supplying nearly half the total domestic output in industries such as mobile communication equipment, machine tools, and pharmaceuticals.
61. Compared with the world top 500 companies (whose sales revenues on average are about US\$ 10 billion), however, the total assets and net assets of these Chinese EG are still much smaller.
62. While often compared to Korea's *chaebols*, EG in China, especially the ones under provincial and local government control, are different in several respects. The most important differences stem from the degree of domestic market

- competition. Whereas the domestic markets in Korea have been oligopolistic and protected from imports, Chinese domestic markets have been characterised by a high degree of competition in many sectors, due in part to the heavy presence of foreign-invested companies. Given their more protected market situation, Korean chaebols were able to enjoy monopolistic rents and thereby pursued diversification into a wide range of unrelated businesses. In contrast, Chinese enterprise groups have not been able to earn large rents and largely for that reason became horizontally diversified to a much lesser degree.
63. The characteristic of such co-operatives is that the shares can typically be held only by existing employees. Employees who quit the firm are in principle required to sell their shares back to the other workers.
 64. *China Statistical Yearbook* figures show a fall in industrial SOE from about 87.9 thousand in 1995 to 53.3 thousand in 1999, a drop of about 40 per cent. However, much of the drop probably reflects consolidations or reclassifications rather than divestiture. Broadman (1999) estimates that only 10 to 15 per cent of SOE have actually been transferred into the non-state sector, although he may be regarding collectives as still part of the state sector for this purpose.
 65. Out of these transformed enterprises, 48.9 per cent became share-holding co-operative companies, 25 per cent were registered as limited corporations, 12.4 per cent reorganised as leasing companies, 3.3 per cent as joint-ventures, 5.25 per cent were merged or combined with other companies, and 3.4 per cent were sold.
 66. These abuses included forced sales of minority share interests to workers or forced loans by workers to management to finance management buyouts" and unauthorised closure of money-losing operations and abandonment of their workers.
 67. *Zhonghua Gongshang Shibao* (China Business Times, 16 June 1999).
 68. *Zhongguo Xinwen She* (China News Service, 8 July 1999).
 69. For example, *Legend Group Holdings* is undergoing an ownership restructuring using share options. Under the current plan, the company's parent – the Chinese Academy of Science – is to transfer 35 per cent of its shares to more than 200 employees by the end of 2000 (*South China Morning Post*, 29 June 2000).
 70. The promulgation of "14 autonomous managerial rights" in 1992 further strengthened managerial rights.
 71. The Contract Responsibility System, which was introduced in 1988, employed five types of contracts. The two most common contract forms were: *a*) "management responsibility contracts" for large and medium-sized SOE, which ties management teams' autonomy, pay, and excess profit retention to the meeting of profit and tax remittance targets; and *b*) "enterprise management responsibility contracts" for large and medium-sized SOE, which are similar to *a*) but also cover enterprise directors (and sometimes workers). Other types of contract forms included: "general quota responsibility contracts" for all types of enterprises; "leasing contracts" for collectives and small SOE; and "asset management responsibility contracts" for small and medium-sized SOE (Broadman and Xiao, 1997).
 72. These abuses have often been described as the "privatisation of profits and socialisation of losses.
 73. The SOE Property Regulations of 1994 stipulates that the State Council shall exercise the property rights over SOE assets on behalf of the state (ultimately on behalf of the Chinese people) (World Bank, 1997b).
 74. In Shanghai, the State Asset Management Committee (SAMC), organised as a government department, exercises the state's ownership interests in the state's municipal assets. The SAMC has established an executive body – the State Asset management Office (SAMO) – to perform the administrative functions. At the intermediate tier, holding companies in Shanghai have been mostly converted from old government sector line bureaux. For example, Shanghai Textile Holding Group Company has been transformed from the previous Shanghai Textile Industry Bureau and as such continues to be responsible for the supervision of the textile SOE under the Shanghai municipal government. The Shanghai model has been the basis for many other cities. In some other cases, including Wuhan and Shenzhen, some SHC are completely newly created entities.
 75. This reform plan was announced at the March 1998 session of the Ninth National People's Congress. Of the remaining 29 ministries, 22 ministries remained unchanged, three ministries and commissions were renamed and four new ministries were created. This restructuring created two new economic super-ministries that took over the functions of old ministries, *i.e.* the Ministry of Information Industry (MII) and the State Economic Trade Commission (SETC).
 76. It can, among other things, decide on the business policy and investment plan of the company; elect and recall directors and decide on their remuneration; elect and recall supervisors representing shareholders on the supervisory board; examine and approve the budget; adopt resolutions on the issuance of company bonds; and exercise many more direct powers of management.
 77. Joint stock limited companies are supposed to establish all these three bodies. Limited liability companies may have a sole executive director instead of the board of directors.
 78. One of the factors underlying the weak performance-related compensation is the regulation that prohibits senior officials of SOE from receiving monetary incomes more than three times the average incomes of employees (Lin, 2000).
 79. For example, the Beijing municipal government plans to set up a working group and an examining committee to select SOE's managerial staff according to market mechanisms. The Beijing municipal government has chosen several SOE to be the trial units for the new managerial system, including two subsidiaries of the Beijing Coal Corporation (the Mentougou Coal Company and Beijing Coal Machinery Plant). The selection process will involve advertising, public

- competition, and examination by officials and experts. Different standards have been adopted for different positions, and the duration of the contracts is usually three to five years.
80. Beijing selected in 1999 ten SOE to experiment with stock option contracts. Ten more high-tech companies, key enterprises and listed companies in Beijing will be selected in 2000 for the stock option contract experiment. Under the contract, SOE managers will obtain a certain amount of shares in instalments at an agreed price during their tenure and can earn returns two years after they leave their posts.
 81. From the perspective of agency theory, the fundamental problem of information asymmetries between managers (and local agencies) and owners/investors has actually been exacerbated by the reform measures. In the developed market economies, firm performance signals managerial performance and, therefore, poorly performing managers can be identified and replaced. This situation, however, does not apply to the Chinese transitional system where the continued policy burdens and soft budget constraints make it difficult to evaluate the true performance of SOE managers as firm profitability is not a good indicator. Even without policy burdens, continued bank lending that is not based on commercial standards will confuse market signalling, making it difficult for the state or other investors to make economic decisions. Under this situation, only the imposition of hard budget constraints on firms, localities, and banks alike will lead to better corporate governance and push the restructuring or exit of inefficient firms. Without imposing strict financial discipline and ending the policy burdens on the SOE, other reform efforts such as corporatisation, public listing of firms and the creation of oversight board structure are unlikely to lead to any significant improvement in actual corporate governance practices.
 82. In fact, most transition economies have avoided using the holding company scheme. The major exception is Kazakhstan, which has established holding companies on a large scale (Pannier, 1996).
 83. Some Chinese scholars have argued that the corporate governance of SOE cannot be made effective as long as managers are selected by bureaucrats or Party officials. It is argued that the management selection problem is the built-in problem of state ownership, which cannot be solved by state-dominated corporatisation. They argue that there is no mechanism to ensure that only qualified people will be selected for management, because bureaucrats rather than capitalists select managers of SOE. Since bureaucrats have the authority to select managers but do not need to bear the consequences of their selection, they have no proper incentives to find and appoint high ability people. Since good performance does not guarantee continued tenure, the manager does not have adequate incentives to improve longer-term performance (Zhang, 1998).
 84. Earlier important enactments include the Economic Contract Law (1981 and revised in 1993), the Foreign Economic Contract Law (1985), the Trademark Law (1982) and the Patent Law (1984).
 85. However, collectives have also been subject to political intervention, corruption, and other abuses by local government officials.
 86. As noted in Stiblar (1997), a market concentration above 70 per cent for the five largest commercial banks is generally recognised internationally to be excessive for adequate competition. Concentration ratios are below this level in at least the larger OECD countries (see Hawkins and Turner, 1999, Table 1).
 87. Figures reported by Pei (1998, Table 4) indicate that 84 per cent of the loans of the four major state banks went to SOE in 1995. Although exact figures for later years are not available, the current ratio is probably slightly lower.
 88. This increase is largely due to the policy shift away from direct financing of SOE investment by government agencies toward bank financing. However, as indicated in Table VI.3, government agencies still provide a significant share of SOE financing.
 89. This share is rather high by OECD standards. Even in the United States market, new equity issues typically amount to less than 5 per cent of total external funds raised by corporations. The high Chinese ratio can be regarded as at least partly transitional in that it reflects the large amount of newly listed companies that have entered the market over the past several years.
 90. Cyclical downturns in China have typically been preceded and accompanied by substantial credit tightening. Such tightening directly hits less favoured borrowers directly as well as reduces surplus funds of enterprises and funds available through informal credit channels. This pattern is illustrated by the downturn during 1989-1990, when investment in fixed assets by collectives dropped by nearly 27 per cent cumulatively, compared to less than one per cent for SOE (*China Statistical Yearbook*, 1998, Table 6.2). Interestingly, the slowdown in collective investment growth was much less pronounced, both in absolute terms and relative to SOE, during the much milder ("soft-landing") credit restraint during 1995-1996.
 91. See OECD *Economic Surveys: Russian Federation* (2000). The ability of Russian enterprises to function without obvious access to formal credit channels has been highlighted by the much milder expected downturn following the crisis in early 1999.
 92. At the same time, growth in bank lending remains well above nominal GDP growth and has picked up slightly in the first half of 1999. This suggests that while certain enterprise segments have been seriously affected by the credit limits, the overall impact on real GDP growth has been modest.
 93. In principle, BAMC should be able to provide funds or guarantees on borrowing for enterprises that are competitively viable but which, because of their size or lack of transparency, are unable to obtain bank loans. Provision of such

- guarantees would be consistent with the BAMC mandate to maximise the recovery value of their assets. However, in practice, BAMC may well be very reluctant to take on the unavoidable risk involved, particularly given the difficulties of identifying SME whose operations are fundamentally sound.
94. Listed companies need to implement the changes mandated by the company law and have their accounts examined by licensed accounting firms. The market rule suspending trading of stocks of firms that have incurred more than two consecutive years of losses also provides some financial discipline, although in practice the rule has been only partially applied.
 95. Permission to list on the market has been subject to fairly restrictive quotas on new entrants, so that a firm that satisfies the requirements for listing may still have to wait considerable time before it can issue stock on the exchanges.
 96. Local offices of the People's Bank of China have also been vulnerable to pressure from local governments. During past cyclical expansions, local governments were often able to increase credit advanced by the central bank offices above the amount specified in the credit plan. The ability of monetary authorities to control aggregate credit expansion was seriously weakened as a result. See Zhu, 1997.
 97. Indeed, Vice-Premier Zhu Rongji is reported to have threatened to remove senior bank managers who preside over significant further growth in problem loans.
 98. Since the commercial banks became legally responsible for their loan performances in 1996, NPL incurred from that year onward are ineligible for transfer to the BAMC.
 99. In particular, the BAMC, as legally distinct entities, are able to undertake debt-equity swaps. The commercial banks themselves are unable to engage in such transactions since they are legally forbidden to hold equity.
 100. Generally, establishing separate entities to deal with NPL is appropriate when the problems are very large, since large NPL tend to distort banks incentives and weaken their ability to monitor lending or to enforce existing obligations. Poland's bank restructuring during the early 1990s is something of an exception to this rule, since it left the workout of NPL with the banks and yet is acknowledged to have been relatively successful compared to the programs of other FCE countries during this period (Sota, 1997; Kawalec, Sikora, and Rymaszewski, 1993). However Poland's programme provided incentives for bank-enterprise restructuring agreements, as well as strict conditions governing those agreements, and occurred in other circumstances that are not easily replicated in other countries.
 101. Under the new system, loans are regarded as non-performing if overdue for more than 3 months – the standard international practice. Non-performing loans are classified into four categories, also in accordance with standard international practice (special mention, substandard, doubtful, and loss). The new system is supposed to incorporate more forward looking criteria based on a borrower's performance in making these classifications. Under the traditional system, loans have typically been classified as non-performing only when they actually become overdue. Particularly given the prevalence of "balloon" loans in which most payment occurs at maturity, this often means that loans are recognised as non-performing well after it becomes apparent they cannot be serviced. As noted by Mo, Y. (1999), banks have carried loans from enterprises that have gone bankrupt on their books as non-performing. The new system is currently being used on an experimental basis in Guangdong province but the intent is to extend it nation wide once improvements to bank accounting and control systems are further along.
 102. The allowable margin, thirty per cent of the base lending rate, is still rather modest compared to loan spreads typically seen in OECD countries, particularly at the currently low level of nominal interest rates. Furthermore, the extent to which the allowable margins are actually being used is unclear, given the difficulties banks face in making accurate risk assessments.
 103. Under current plans, the system will be operational in 300 cities by the end of 2000 although it will initially provide information only on outstanding loans. Ultimately, the intent is to cover all borrowers regardless of size, which would make the Chinese system more comprehensive than those in Europe, which typically do not maintain information on small enterprises.
 104. Authorities in 1999 also curtailed activities of informal markets for trading equity stakes that had developed in a number of regions. Activities deemed legitimate in these markets have been folded into the officially sanctioned regional centres linked to the major exchanges of Shanghai and Shenzhen.
 105. This requirement amounts to a partial step backward from the abolition of formal credit quotas in 1997. The banks were subject only to aggregate quotas on their total infrastructure lending and in principle the banks were free to accept or reject individual loan applications based on their credit worthiness. In practice mixed signals to loan officers would have been difficult to avoid.
 106. Banks reportedly have been slow in approving applications for funds under the government infrastructure programme. This suggests that banks are able to resist pressures to lend for non-commercial purposes to some degree, and that the upgrading of lending standards has been taken seriously. It does not, however, indicate that non-commercial considerations have disappeared as influences on bank lending.
 107. For example, social benefit payments by Shanghai Textile Holding Company to its workers have averaged 42 per cent of its payroll for social benefits (nearly 15 per cent of total revenue) since 1993. This includes expenses for housing of 6 per cent of payroll and pension payments equal to 25.5 per cent of payroll. Social benefits paid by Baosteel Group amounted to nearly 55 per cent of payroll in 1998 (These figures were provided by company officials in interviews with

- the authors). Admittedly the nominal burden on enterprise profits may differ from the effective burden (incidence) to the extent the charges are shifted back onto wages or forward onto output prices.
108. The plan was to encourage workers to purchase their own housing. To facilitate this process, banks have been developing their facilities for extending housing loans. Rents on units that were not purchased were also to be raised, eventually to market levels. The postponement of the reform partly reflected concerns that sufficient credit would not be available to support the purchases.
109. The United Nations Development Programme estimated that China's real urban unemployment rate had reached 13-15 per cent in 1998 after taking into account of the magnitude of laid off from SOE. The number of laid-off workers, including those from collective enterprises, had mounted to 16 million by the end of 1998 (Ge, 1999).
110. Nearly 1 million civil servants were laid-off during 1999 as part of the continuing downsizing efforts of government agencies; and a further 170 000 workers were laid-off from military industries.
111. Mo, R. (1999).
112. There are numerous unemployment agencies in China supported by the government or run by the private sector. They also serve the needs of laid off workers for job searching.
113. The living allowance varies from 140 yuan to 380 yuan per month, depending on local wage scales (*China Daily*, 3 December 1999); this represents about two-thirds of the average base wage for an industrial worker. One third of this payment is deducted for medical insurance and pension contributions. For example, in Hubei province, members of the REC receive 260 yuan each month, out of which 90 yuan is deducted for payments of medical insurance and pensions.
114. Each member has two training opportunities within the three-year time span at the REC.
115. Central government regulations prohibit SOE from establishing REC. In practice, local governments often have forced profitable SOE under their jurisdiction to set up their own centres rather than allowing their laid off workers to enter the locally administered REC. Unofficial estimates indicate that nearly one-third of profitable large and medium-sized SOE under local control maintain their own REC.
116. *Xinhua Daily News*, 26 January 2000.
117. *Xinhua Daily News*, 4 November 1999.
118. See Ge (1998*b*). Exceptional medical expenses, defined as expenses above 10 per cent of a worker's salary, are covered by the unified fund, up to an amount equal to 4 times a worker's salary.

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Annex

Summary of selected results from analysis of enterprise panel data

The data and design¹

The empirical analysis in this annex is based on an annual panel data sample of enterprises from 1995 to 1998 collected by China National Bureau of Statistics (CNBS). The sample is drawn from large and medium-sized industrial enterprises with different types of ownership across industries and provinces in China. The original sample includes more than 22 000 enterprises, comprising nearly 85 per cent of all large and medium-sized industrial SOE, and a comparably large fraction of large and medium-sized collectives and foreign invested enterprises. However, values for one or more of the variables were often missing, clearly incorrectly entered (*i.e.* negative employment), or implausible. Elimination of these values reduces the original sample by 10 to 15 per cent, depending on the variable. Largely because of these exclusions (as well as other differences in the sample and statistical approach from those used by the CNBS), the figures in the sample are not exactly equal to comparable data from published sources.

The analysis summarised below was carried out by staff at the China National Statistics Bureau, Division of Industrial and Transportation Statistics, according to specifications supplied by the OECD authors. For the exercises described in the first two sections below, “after-tax” profits refer to profits after all taxes, including the corporate income tax, have been deducted. This definition differs from the “total profits” reported in the *China Statistical Yearbook*, which are net of value added and sales tax but gross of the corporate income tax. Corporate income taxes average about 1 per cent of assets. The composition of the loss-making sub-sample is virtually the same under either definition, since all but 0.5 to 1 per cent of sample firms making losses on an after-tax basis according to the definition used here are also making losses according to the definition in the *Yearbook*.

To facilitate portions of the analysis, firms were divided according to their estimated average total factor productivity into quartiles. In the following figures and tables, “low” productivity firms are those in the lowest quartile; “medium” productivity firms are those in the second and third quartiles; and “high” productivity firms are those in the highest quartile. The productivity estimates were based on a panel regression on the full sample (after exclusions) of deflated value added on employment and fixed assets, assuming a Cobb-Douglas production function (allowing non-constant returns to scale) and allowing the average level of total factor productivity to vary with each sample year. Partitions were also made of the data based on the profit measures and the liability-asset ratio as indicated in the tables.

Main features of enterprise financial conditions

Several important observations emerge from examination of the profit and other key financial indicators for all industrial firms in each ownership class.

First, there has been a significant decline in both the before and after tax profit rates for all categories of firms between 1995 and 1998 (Figures A1 and A2). The decline has been greatest for foreign funded enterprises, and reflects their relatively high concentration in export industries hit hard by the Asian crisis. The profit decline has been only slightly less pronounced for SOE but comparatively mild for collective enterprises.² With declining profitability, there has been a corresponding increase in the proportion of firms making after-tax losses: the fraction for SOE rose from slightly more than 33 per cent in 1995 to just over 45 per cent in 1998 (see Figures A3 and A4). While some of these shifts reflect the movements from marginal profitability to small losses, the biggest changes between were in the high and low ends of the distribution, with the portion of large loss makers rising substantially while the portion of solid profit makers fell nearly as markedly.

Second, current profit rates are quite low generally, even for firms that are in the black. Only 28 per cent of enterprises making positive profits in 1998 had returns on assets of 2.5 per cent or above (Figure A3); nearly three-quarters of all firms were making returns below 1 per cent of assets (see Figure II.4 in the main report). Moreover, a large majority of the firms in the red are incurring large losses in the sense that before tax profits (before value-added, sales, and income taxes are deducted) also are negative. The situation for SOE is considerably worse: more than 30 per cent were making large losses in 1998, while most of the remainder were only marginally profitable. Collectives were doing only modestly better. In contrast, the profit situation of foreign-invested enterprises is more sharply bifurcated, with nearly one-third making large losses and nearly one-third making solid profits.

Figure A1. After-tax return on assets

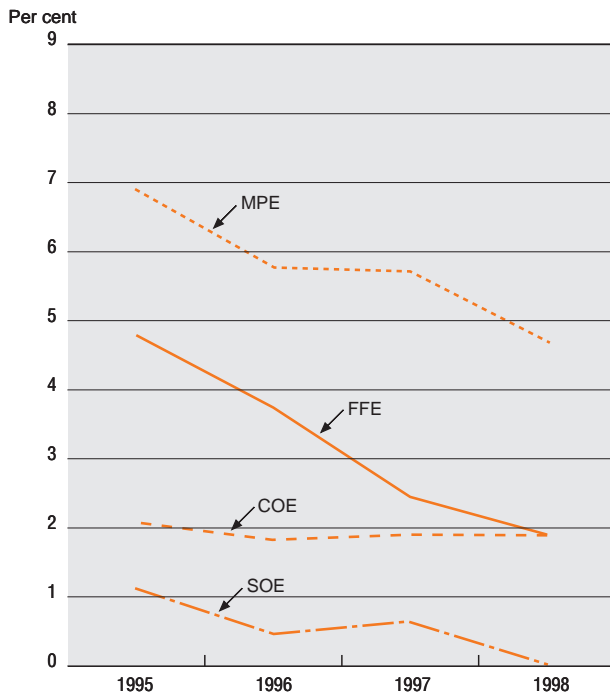


Figure A2. Before-tax return on assets

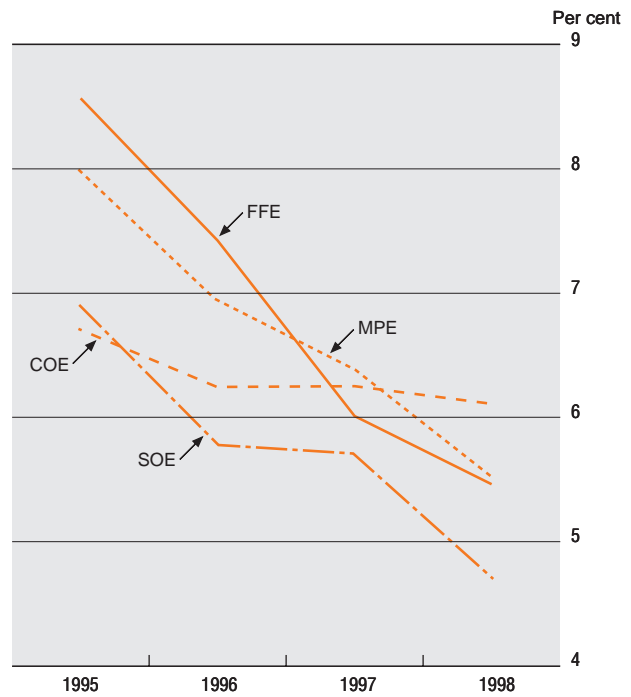


Figure A3. Firms by profit category, 1998

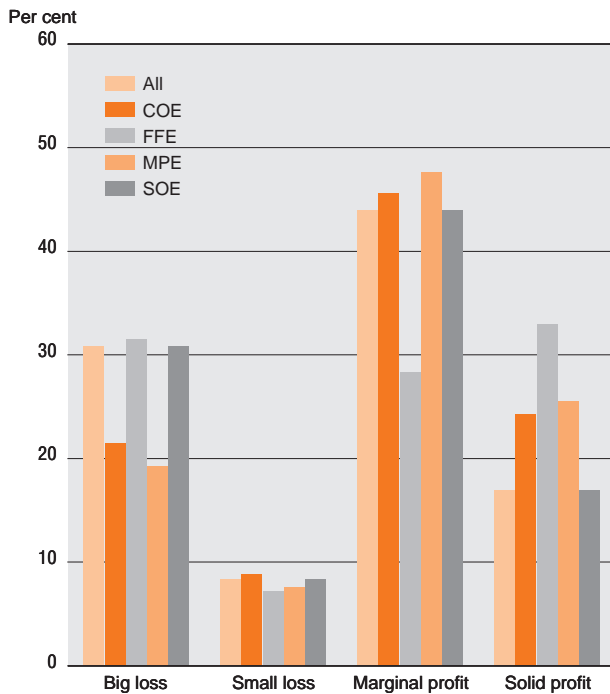
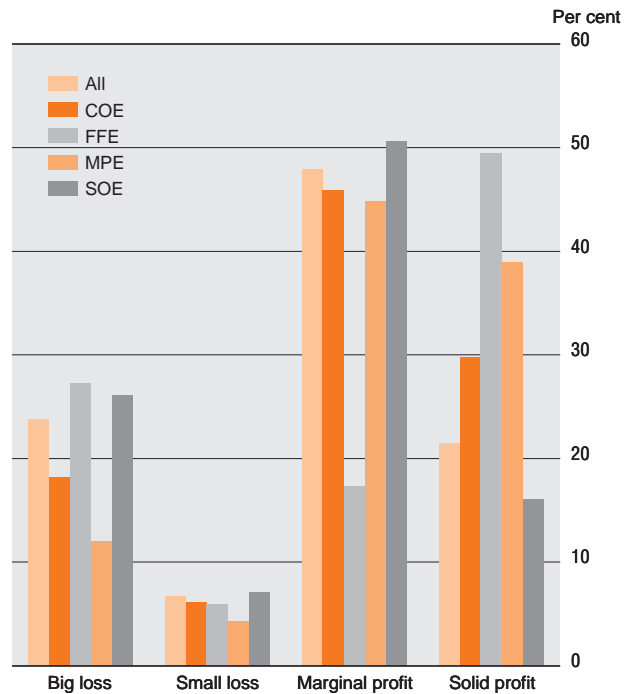


Figure A4. Firms by profit category, 1995



Note: COE = collectively owned enterprises; FFE = foreign-funded enterprises; MPE = enterprises with mixed or private ownership; SOE = state-owned enterprises. Figures refer to large and medium-sized enterprises and are OECD estimates based on the panel data set compiled by the National Bureau of Statistics of China. Due to sample differences, some of the figures differ somewhat from those published in the *China Statistical Yearbook* and other official sources. "Big loss" = negative before tax profits; "Small loss" = positive before tax profits but negative after tax profits; "Marginal profit" = positive after tax profits less than or equal to 2.5 per cent of total assets; "Solid profit" = after tax profits greater than 2.5 per cent of assets.

Source: China National Bureau of Statistics and OECD calculations.

The high debt loads and debt-service costs of enterprises are a further indication of the financial difficulties of SOE and collectives. As noted in Chapter II, both groups have comparably high average debt loads. However, nearly 38 per cent of SOE compared to about 30 per cent of collectives have debt-asset ratios that are very high (above 83 per cent, corresponding to a debt-equity ratio of nearly 5) (Figure A5). Moreover, a higher proportion of collectives (although still only about one-third) than SOE have debt burdens more in line (although still typically higher) than those found in other OECD countries. Debt-service burdens in relation to sales are also somewhat higher for SOE (Figure A6).

Third and not surprisingly, firms with relatively low overall productivity tend to have the worst financial conditions. After-tax profit rates are strongly negative for all groups of firms with estimated productivity in the lower quartile, but positive for those in the upper quartile (Figure A7). Debt loads are also highest for lower productivity firms, averaging nearly 80 per cent for those in the lower quartile (Figure A8).

Finally, much of the apparent difference between SOE and the other firms reflects the substantially heavier tax burdens of the former (see Figure A9). This is illustrated by the fact that before tax returns for the major ownership groups shown in Figure A2 are much closer than the after tax returns shown in Figure A1. Indeed, the large gap in after-tax profit rates between SOE and other classes with relatively high productivity (upper quartile) is reversed into a mild advantage for SOE on a before-tax basis (Figure A10). This pattern reflects the tendency for relatively productive (and profitable) SOE to bear a disproportionate share of the overall SOE tax burden. This is indicated in Figure A10, where the gap in tax rates between SOE and other firms is much greater in the upper productivity quartile than in the lower quartiles.

Regional and industry variations in financial conditions

Examination of performances across regions and industries reinforces the impression of serious problems in the financial conditions of SOE. The data also indicate that although there are significant regional and industry variations, the problems are pervasive. As in most countries, smaller SOE have a higher incidence of loss-making than larger SOE. Smaller SOE also account for a disproportionate share of the total losses of SOE compared to their share of total output; but the bulk of losses are being incurred by medium and large firms. Looking across regions, profit ratios are generally lower and the proportion of loss-making firms higher in the north eastern, central and western provinces compared to the coast (Table A1) (The relation between financial performance and regional growth is weak, however: SOE financial conditions are not appreciably better in central provinces than in western provinces, even though growth in the central provinces has been significantly higher). The overall picture is again one of serious problems, with SOE in fourteen of the thirty-one provinces reporting net (after-tax) losses in 1997. There is some tendency for profit rates and loss ratios to be higher in provinces with relatively high liability-asset ratios, suggesting that debt-servicing burdens may be one factor in the regional variation in profit and loss ratios. However, low profitability itself can contribute to high liability-asset ratios, as firms with poor financial performances resort to bank loans to offset declining cash-flow.

Financial conditions of SOE and collectives also vary noticeably across industries (Tables A2 and A3). Among the larger industries, profit rates are especially low for SOE in the food processing, textile, leather, furniture, paper, and mineral and metal products industries; and in most of these cases the proportion of firms incurring losses is also above the overall average. The overall impression is, again, one of low profits and high loss incidence in most individual SOE industry groups. Apart from a few smaller or protected sectors, such as tobacco and power generation, no industry can be said to be doing well. Financial performances of industries in the collective sector are noticeably better than their SOE counterparts in terms of profitability and loss incidence, despite their higher liability-asset ratios. However, the industries that are having the most serious problems in the SOE segment are also generally performing below average in the collective sector.

Patterns of profit/loss-making

Two sub-samples of the data have been used for the analysis of the patterns of profit/loss-making of Chinese enterprises. The first is a pooled sample that comprises all the enterprises that appear in any year with valid observations. The second is a panel sample that includes only the subset of enterprises with valid observations in all four years.³ The panel sample thus allows us to follow the same enterprises over the four-year period.

In Table A4, the profit status of enterprises has been divided into four categories: 1) "big loss-making" enterprises whose before-tax profit is negative; 2) "small loss-making" enterprises whose before-tax profit is positive but total profit (profit obtained after paying taxes except for income tax) is negative; 3) "marginal profit-making" enterprises whose total profit is positive but after-tax returns on total assets is less than or equal to 2.5 per cent; and 4) "solid profit-making" enterprises where total profit is positive and after-tax returns on total assets is greater than 2.5 per cent.⁴

As can be seen from Table A4, SOE have a higher probability of being in the loss-making category than other types of enterprises. Foreign-funded enterprises (FFE) have the highest proportion of firms falling in the "solid profit" category, followed by mixed/private ("other") enterprises, collectives, and SOE. Overall, the performance of FFE is bifurcated: most firms are in one of the two extreme categories, *i.e.* "big loss-making" and "solid profit". Between 1995 and 1998, the profit situation has deteriorated for all types of enterprises in both pooled and panel samples. In particular, the proportion of the SOE falling into the "big loss-making" category increased from 23 per cent to 35 per cent over the period for the pooled sample; and from 18 per cent to 34 per cent for the panel sample.

Figure A5. Distribution of liability/asset ratios

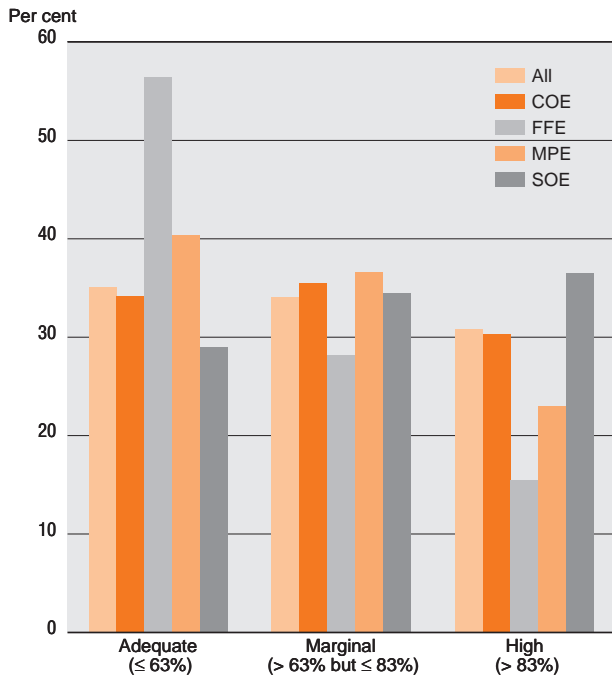


Figure A6. Interest payments as ratio of sales revenue, 1998

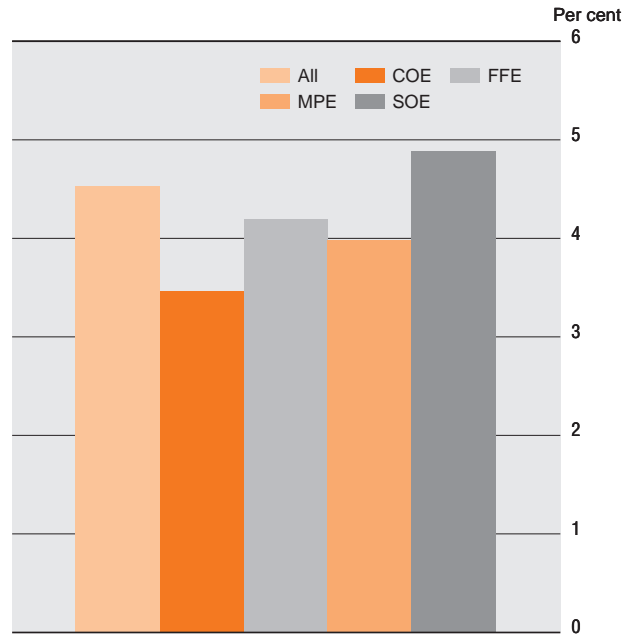


Fig A7. After-tax profits/assets by productivity category, 1998

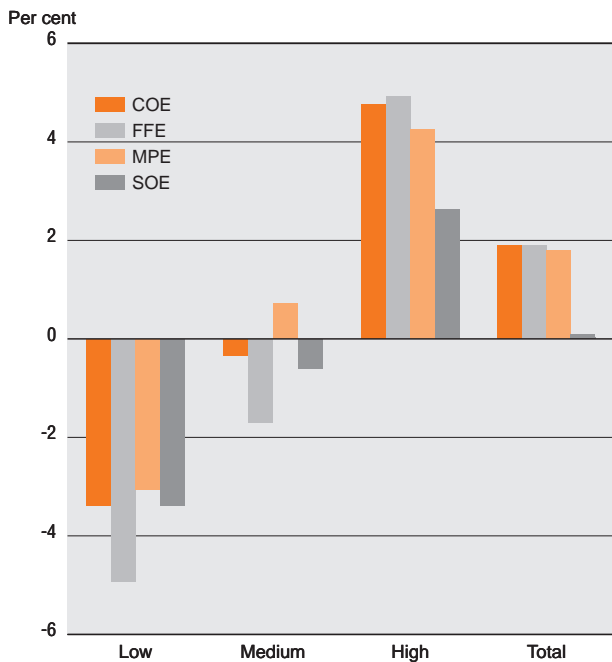
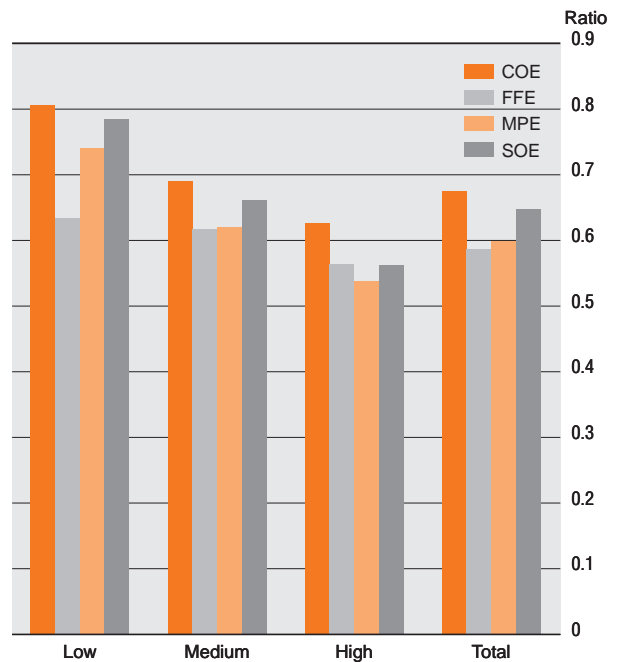


Figure A8. Liability/asset ratios by productivity category, 1998



Note: COE = collectively owned enterprises; FFE = foreign-funded enterprises; MPE = enterprises with mixed or private ownership; SOE = state-owned enterprises. Figures refer to large and medium-sized enterprises and are OECD estimates based on the panel data set compiled by the National Bureau of Statistics of China. Due to sample differences, some of the figures differ somewhat from those published in the *China Statistical Yearbook* and other official sources.

Source: China National Bureau of Statistics and OECD calculations.

Figure A9. Taxes/sales by productivity category, 1998

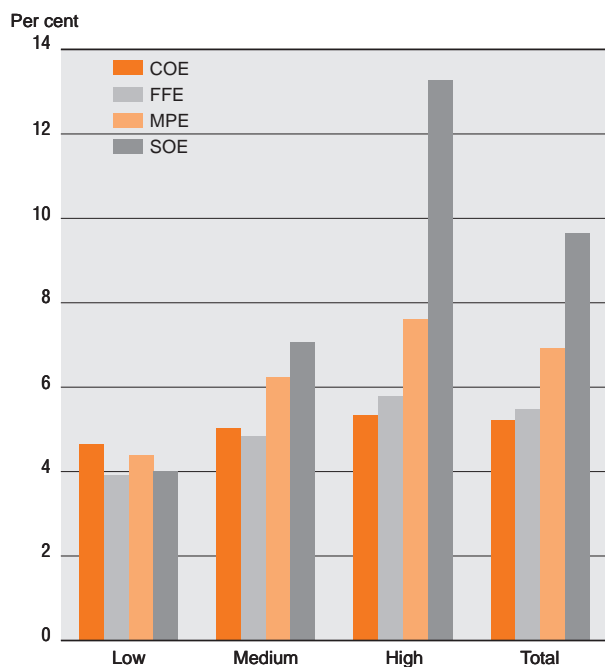
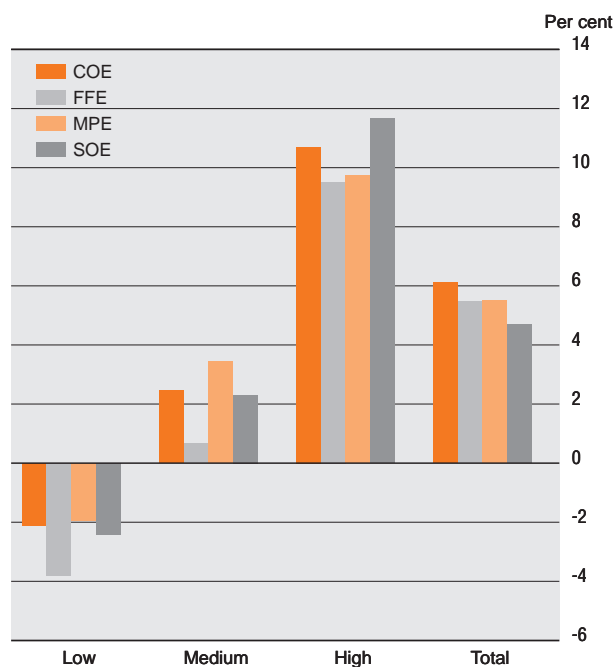


Figure A10. Before-tax profits/assets by productivity category, 1998



Note: COE = collectively owned enterprises; FFE = foreign-funded enterprises; MPE = enterprises with mixed or private ownership; SOE = state-owned enterprises. Figures refer to large and medium-sized enterprises and are OECD estimates based on the panel data set compiled by the National Bureau of Statistics of China. Due to sample differences, some of the figures differ somewhat from those published in the *China Statistical Yearbook* and other official sources.

Source: China National Bureau of Statistics and OECD calculations.

For enterprises in the panel sample, the number of the years spent in the loss-making status (including both “big” and “small” loss-making) was calculated by ownership and by region. Table A5 shows that enterprises on average spent 1.24 years as a loss-maker. Among the most profitable enterprises are collectives and mixed/private enterprises and enterprises located in the Coastal region, which tend to have the lowest number of average years spent as loss-maker. In contrast, SOE, followed by FFE, have the highest incidence of chronically loss-making firms, *i.e.* firms that made losses during the entire four-year period. The chronic loss-makers are more concentrated in the northeastern and western regions than in coastal or central regions of China.

Do enterprises tend to stay in the same profit categories across years? Or are they more likely to change their profit status over time? The transition matrices shown in Table A6 suggest that loss-making enterprises tend to stay in the same profit status in the subsequent years. For example, among loss-making SOE in 1995, 77.4 per cent remained loss-makers in 1996, 70.7 per cent in 1997, and 71.7 per cent in 1998. Less than 3 per cent of the loss-making SOE moved into the satisfactory profit status in the subsequent years.

Table A1. SOE financial conditions by region and province, 1997¹

Per cent

Region	Province	After-tax ² profits as ratio of sales	Liabilities as ratio of total assets	Proportion of firms making losses ³
	National total	1.5	65.2	38.2
Coastal	Beijing	2.4	58.6	20.0
	Fujian	7.3	57.6	33.1
	Guangdong	2.3	64.1	42.1
	Guangxi	-3.0	68.4	50.5
	Hainan	-6.2	76.0	45.0
	Hebei	2.7	63.6	27.3
	Jiangsu	1.3	63.8	38.1
	Shandong	2.5	65.2	27.7
	Shanghai	2.3	57.6	33.8
	Tianjin	-0.4	69.1	36.2
	Zhejiang	2.0	60.4	43.0
Central	Anhui	0.5	62.2	53.2
	Guizhou	-0.2	70.4	39.2
	Henan	1.0	67.3	34.2
	Hubei	0.3	64.1	40.2
	Hunan	-1.4	68.6	50.7
	Inner Mongolia	2.0	63.2	25.8
	Jiangxi	-1.1	73.4	34.3
	Shaanxi	-3.8	72.0	47.1
	Shanxi	2.3	62.9	25.3
Northeastern	Heilongjiang	8.6	67.4	35.9
	Jilin	-1.9	71.6	43.9
	Liaoning	-0.4	64.8	37.9
Western	Chongqing	-4.1	71.4	57.8
	Gansu	-1.9	66.5	40.6
	Ningxia	-0.7	67.9	54.2
	Qinghai	-7.6	76.6	48.1
	Sichuan	2.4	67.4	50.5
	Tibet	20.5	32.9	28.2
	Xinjiang	-0.4	70.5	43.4
	Yunnan	10.9	56.6	41.8

1. Figures refer to industrial enterprises at the township level or above.

2. Profits net of value-added, sales and other business taxes but before deduction of corporate income taxes.

3. On an after-tax basis as defined in note 2.

Sources: *China Statistical Yearbook*, 1998, Table 13.14; and *China Industrial Yearbook*, 1998, p. 106

Table A2. Enterprise financial conditions by industry, 1997

	Per cent					
	SOE			Collectives		
	After-tax profitsAnnex 2 as ratio of sales	Proportion of firms making lossesAnnex 3	Liabilities as ratio of total assets	After-tax profitsAnnex 2 as ratio of sales	Proportion of firms making lossesAnnex 3	Liabilities as ratio of total assets
National total	1.5	38.2	64.8	2.8	18.9	70.8
Light industry	0.6	40.6	71.4	2.7	19.4	71.9
Heavy industry	1.9	35.9	62.7	2.9	18.5	69.9
Coal mining and dressing	3.3	29.3	60.1	4.8	16.1	42.4
Petroleum and natural gas extraction	10.6	7.7	56.3	4.1	11.1	73.6
Ferrous metals mining and dressing	-0.5	31.3	43.7	4.7	13.9	72.9
Non-ferrous metals mining and dressing	4.8	32.9	63.1	9.1	8.8	54.9
Non-metal minerals mining and dressing	-1.9	34.9	63.7	5.4	10.0	60.5
Other minerals mining and dressing	-1.6	-	71.3	-	-	-
Logging and transport of timber and bamboo	0.4	37.1	66.5	4.9	12.9	61.7
Food processing	-4.1	46.8	83.3	3.9	10.5	68.0
Food production	-0.9	40.1	75.2	3.8	18.0	66.9
Beverage production	5.5	39.5	69.4	2.7	16.1	76.8
Tobacco processing	9.9	19.4	57.6	2.9	21.2	76.9
Textiles	-4.7	48.2	83.7	1.4	26.8	78.6
Garments and other fibre products	-1.6	32.0	70.0	2.5	22.3	68.2
Leather, furs, down and related products	-6.3	44.0	84.3	3.4	21.1	70.3
Timber processing, bamboo, cane, palm fibre and straw products	-5.8	39.9	76.8	3.6	11.5	67.0
Furniture manufacturing	-2.9	34.0	63.5	3.3	16.7	69.1
Papermaking and paper products	-2.4	37.1	77.8	3.1	21.4	74.2
Printing and record medium reproduction	3.1	33.8	59.3	3.4	20.3	67.6
Cultural, educational and sports goods	-0.7	30.4	76.6	3.8	20.1	57.5
Petroleum processing and coking products	2.2	26.9	61.0	4.0	14.5	66.6
Raw chemical materials and chemical products	-0.3	36.1	70.4	3.7	20.2	70.1
Medical and pharmaceutical products	2.5	37.6	70.5	4.1	24.4	66.8
Chemical fibre	-1.7	40.7	75.0	2.9	22.8	73.4
Rubber products	-0.2	35.1	76.8	3.3	21.3	70.5
Plastic products	-1.6	36.5	74.9	2.1	22.9	71.5
Non-metal mineral products	-4.8	39.7	68.7	1.5	16.7	74.5
Smelting and pressing of ferrous metals	0.6	46.5	57.5	1.0	23.4	71.1
Smelting and pressing of non-ferrous metals	-0.6	38.2	71.7	1.7	24.7	72.4
Metal products	-3.4	39.4	76.9	2.1	20.3	72.1
Ordinary machinery	-2.0	39.0	70.0	2.7	21.9	70.5
Special purposes equipment	-2.0	39.3	70.7	3.0	21.0	69.1
Transport equipment	0.6	38.7	67.7	2.4	22.9	67.6
Electric equipment and machinery	-1.0	37.9	72.3	2.9	24.7	68.9
Electronic and telecommunications equipment	3.9	41.0	72.0	4.7	27.7	68.3
Instruments, meters, cultural and office machinery	-2.0	39.0	70.0	1.7	21.9	70.5
Other manufacturing	-7.2	-	77.1	-	-	-
Electric power, steam and hot water production and supply	4.8	22.0	54.7	3.3	11.2	64.1
Gas production and supply	-5.2	53.5	45.0	0.6	25.0	66.7
Tap Water Production and Supply	5.2	34.6	34.7	4.2	11.3	52.4
<i>Memorandum:</i>						
<i>By size:</i>						
Large	-	33.8	-	-	20.1	-
Medium	-	42.2	-	-	31.7	-
Small	-	36.7	-	-	18.8	-

1. Figures refer to industrial enterprises with independent accounting system.

2. Profits net of value-added, sales and other business taxes but before deduction of corporate income taxes.

3. On an after-tax basis as defined in note 2.

Sources: China Statistical Yearbook, 1998; China Industrial Yearbook, 1998.

Table A3. SOE losses by industry for selected provinces, 1997

	Hubei			Shandong		
	Proportion of firms making losses	Losses of loss-making firms	Losses as ratio of value-added	Proportion of firms making losses	Losses of loss-making firms	Losses as ratio of value-added
	(%)	(million Y/firm)	(%)	(%)	(million Y/firm)	(%)
National total	40	2.4	9	28	2.7	3
Light industry	41	2.1	13	29	2.2	6
Heavy industry	39	2.8	7	26	3.5	3
Coal mining and dressing	29	4.0	25	16	15.4	2
Petroleum and natural gas extraction	100	59.0	4	–	–	–
Ferrous metals mining and dressing	25	–	–	17	8.8	5
Non-ferrous metals mining and dressing	42	0.8	3	7	3.4	1
Non-metal minerals mining and dressing	38	1.6	12	23	3.4	9
Logging and transport of timber and bamboo	29	–	–	–	–	–
Food processing	44	1.3	13	31	1.8	9
Food production	39	0.5	11	24	1.5	10
Beverage production	35	0.6	6	18	3.3	3
Tobacco processing	20	6.3	1	–	–	–
Textiles	50	5.1	19	32	4.5	9
Garments and other fibre products	33	0.8	6	38	0.8	15
Leather, furs, down and related products	12	5.0	18	38	1.9	15
Timber processing, bamboo, cane, palm fibre and straw products	40	0.8	33	25	1.5	11
Furniture manufacturing	40	0.3	14	15	0.2	3
Papermaking and paper products	41	4.7	56	23	2.1	3
Printing and record medium reproduction	32	–	5	25	1.3	12
Cultural, educational and sports goods	30	0.7	20	20	0.2	1
Petroleum processing and coking products	56	2.2	0	33	4.7	1
Raw chemical materials and chemical product	37	2.3	8	25	2.5	4
Medical and pharmaceutical products	46	3.1	22	28	2.1	7
Chemical fibre	50	4.5	9	21	1.5	1
Rubber products	59	2.6	15	20	1.6	1
Plastic products	39	0.8	9	25	0.4	4
Non-metal mineral products	37	1.9	21	38	4.6	23
Smelting and pressing of ferrous metals	68	5.5	3	31	6.3	1
Smelting and pressing of non-ferrous metals	56	5.0	9	24	9.0	5
Metal products	42	1.7	28	36	1.2	20
Ordinary machinery manufacturing	41	2.8	29	26	3.8	11
Special purposes equipment	38	1.9	12	30	2.4	6
Transport equipment	40	3.3	6	32	3.2	8
Electric equipment and machinery	45	2.0	10	27	2.3	7
Electronic and telecommunications equipment	50	2.3	18	19	1.2	1
Instruments, meters, cultural and office machinery	49	3.4	36	46	2.1	18
Other manufacturing	41	1.5	18	34	1.9	37
Electric power, steam and hot water production and supply	32	6.8	5	11	4.8	1
Gas production and supply	60	2.0	-7	55	2.8	–
Tap water production and supply	39	1.6	13	41	0.8	9

1. Figures refer to SOE with independent accounting systems; the definition of losses corresponds to the one in Tables A1 and A2.
Sources: *Statistical Yearbook of Hubei Province, 1998*; *Statistical Yearbook of Shandong Province, 1998*.

Table A4. **Profit status of enterprises by ownership type, 1995-1998**
Per cent

	Full sample				Panel sample			
	Big loss	Small loss	Marginal profit	Solid profit	Big loss	Small loss	Marginal profit	Solid profit
1995								
SOE	22.9	7.0	53.9	16.2	17.7	7.2	57.9	17.2
Collectives	16.1	5.5	50.1	28.3	10.4	5.2	54.4	30.1
Foreign-funded	23.6	6.3	20.5	49.6	21.1	9.9	23.7	45.4
Others	10.8	4.4	17.8	37.1	9.3	5.1	48.3	37.3
1996								
SOE	29.0	7.2	51.8	12.1	23.9	8.0	55.8	12.3
Collectives	18.9	6.3	48.8	25.9	12.8	5.8	55.6	25.8
Foreign-funded	23.2	6.1	32.5	38.2	20.4	5.9	35.5	38.2
Others	13.5	3.9	48.5	34.0	13.7	5.6	47.3	33.4
1997								
SOE	30.9	8.3	50.1	10.6	26.8	8.7	54.8	9.7
Collectives	19.2	8.3	50.0	24.6	16.3	9.1	51.8	22.8
Foreign-funded	27.1	4.9	32.2	35.9	21.7	3.3	36.8	38.2
Others	16.3	5.8	48.4	29.5	15.1	7.1	48.0	29.8
1998								
SOE	35.4	8.5	47.4	8.7	34.3	9.1	48.6	7.9
Collectives	22.0	9.1	47.3	21.6	23.4	9.7	48.5	18.5
Foreign-funded	29.1	7.2	31.1	32.7	27.0	3.9	36.2	32.9
Others	20.5	6.2	45.5	27.8	22.4	5.4	45.1	27.1

Source: China National Bureau of Statistics and OECD calculations.

Table A5. **Total time over a four-year period that enterprises spent in loss-making 1995-1998**

	Proportion of enterprises making losses for the given number of years (per cent)					Average years of loss-making
	0 year	1 year	2 years	3 years	4 years	
By enterprise type						
SOE	44.0	16.9	13.8	11.7	13.6	1.3
Collectives	56.9	17.8	10.3	7.3	7.8	0.9
Foreign-funded	55.3	11.8	11.2	8.6	13.2	1.1
Others	62.9	13.7	8.8	7.6	7.1	0.8
By region¹						
Coastal	53.7	16.6	11.4	8.5	9.8	1.0
Central	41.2	16.8	15.2	13.1	13.7	1.4
North Eastern	37.8	16.9	13.9	15.3	16.2	1.6
Western	38.6	17.6	14.6	11.6	17.7	1.5
All enterprises	47.4	16.7	12.9	10.6	12.3	1.2

1. For definition, see Table A1.

Source: China National Bureau of Statistics and OECD calculations.

Table A6. **Transition of enterprises among profit status**¹

		Per cent					
		All enterprises			SOE		
		Profit status in the end-year					
Profit status in the beginning year		Loss-making	Marginal profit	Solid profit	Loss-making	Marginal profit	Solid profit
		From 1995 to 1996					
Loss-making		76.3	21.2	2.5	77.4	20.3	2.2
Marginal profit		18.5	76.2	5.3	19.8	75.9	4.3
Solid profit		5.7	34.0	60.2	7.5	39.0	53.5
		From 1996 to 1997					
Loss-making		75.9	22.2	1.9	75.9	22.4	1.6
Marginal profit		18.5	76.4	5.2	19.0	76.5	4.5
Solid profit		5.9	31.3	62.8	7.2	38.5	54.4
		From 1997 to 1998					
Loss-making		83.9	14.8	1.3	84.9	13.9	1.2
Marginal profit		23.0	72.7	4.3	23.0	73.2	3.7
Solid profit		5.0	32.2	62.8	6.9	36.9	56.2
		From 1995 to 1997					
Loss-making		69.7	27.0	3.3	70.7	26.6	2.7
Marginal profit		26.6	67.1	6.3	27.8	66.9	5.4
Solid profit		11.1	44.7	44.1	12.9	52.8	34.2
		From 1995 to 1998					
Loss-making		70.9	25.7	3.4	71.7	25.6	2.7
Marginal profit		37.0	57.4	5.6	38.3	57.0	4.8
Solid profit		18.7	46.6	34.7	22.0	52.2	25.9

1. The share of firms belonging to the profit status in the end-year. For example, the first row in each panel shows, among the firms making losses in the beginning year, the share of firms staying in or moving to each profit status in the end-year specified.

Source: China National Bureau of Statistics and OECD calculations.

Notes

1. For further details and additional results, see OECD (forthcoming).
2. A greater concentration of SOE in industries with the worst excess capacity problems probably explains much of this pattern, although precise figures to verify this hypothesis are not available.
3. The size of the sample is substantially reduced when only the enterprises that appear in all four years are selected, which indicates that a substantial number of firms leave or enter the survey. The size of the pooled sample, which ranges from 16 128 cases in 1996 to 11 923 in 1998, is reduced to 7 039 in the panel sample.
4. The definition of “total profit” has been used in the analysis because it is a definition most commonly used by Chinese publications, including *China Statistical Yearbook*.

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