1997

Reforming China’s state owned enterprises: what can be learned from the experiences of other economies in transition?

Charles Harvie

University of Wollongong, charvie@uow.edu.au

Recommended Citation
REFORMING CHINA’S STATE OWNED ENTERPRISES: WHAT CAN BE LEARNED FROM THE EXPERIENCES OF OTHER ECONOMIES IN TRANSITION?

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Charles Harvie

Department of Economics
University of Wollongong

Coordinated by Associate Professors C. Harvie & M.M. Metwally
Working Paper Production & Administration: Robert Hood
Department of Economics, University of Wollongong
Northfields Avenue, Wollongong NSW 2522 Australia
ABSTRACT

Many of China's large state owned enterprises (SOEs) are widely recognised as being inefficient, loss making and a major drain upon the country's resources. For the sustained progress of the country towards that of a market economy, further emphasis will need to be placed upon the reform of such enterprises. While steps have already been taken in this direction, such as the movement towards the corporatisation of such enterprises and the selling of shares in selected enterprises, a logical next step is to move in the direction of privatisation to further enhance their economic performance. The experiences of other transition economies could be relevant in identifying what are the major options and obstacles in this regard, and which, if any, possess most applicability in the context of China. The paper reviews the recent performance of China's SOEs, identifies the reforms which have already been implemented in this area, outlines the experiences of other transition economies in regard to the re-structuring of their SOEs, and places emphasis upon those options which are likely to be most applicable to the Chinese situation.
This paper was presented at the International Conference on *The Economies of Greater China, 7-8 July 1997*, The University of Western Australia, Perth, Australia.
1. INTRODUCTION

The legacy of central planning for China is the existence of unique economic problems in comparison to that of other rapidly developing economies in East Asia. In particular, two pressing and related problems have still to be overcome. Firstly a financial system which is not yet run on market lines, preventing the development of indirect policy instruments essential for macroeconomic control in the context of a market economy. Secondly, and the focus of this paper, the existence of a large number of state owned enterprises (SOEs), many of which being loss making. China has more than 100,000 state run companies, employing approximately two thirds of the urban workforce. It is widely believed that more than half of these state sector firms are currently making losses and that this proportion is rising. Government concerns about creating mass unemployment in the cities and major social unrest, has resulted in large SOEs being heavily subsidised as well as being able to gain access to soft credit. As a result the state banks, despite measures taken in 1994 to encourage them to lend on commercial lines and the creation of three development banks exclusively responsible for policy lending\(^1\) from 1995, were, in reality, under pressure to keep extending credit to large state firms and on favourable terms\(^2\). The result of this is an accumulation by the banks of unpaid debts which is undermining the financial system. Although the Chinese may save a great deal, a significant proportion of this is not being used in an optimum way. With few alternative ways of saving open to them, most Chinese save with the state banks. Approximately 70% of bank loans to industry still go to the state

\(^1\) The State Development Bank of China, the Export-Import Bank, and the Agricultural Development Bank of China.

\(^2\) At a negative real interest rate.
sector, which produces less than a third of industrial output, while the dynamic non state sector, producing the remaining two thirds of industrial output, finds access to such loans more difficult and the terms less favourable. The pressure on the government to continually provide more credit to state run firms also means that China remains vulnerable to bouts of inflation.

The inflationary pressure arising in 1992/93 led to a renewed phase of macroeconomic austerity, from July 1993, with the introduction of a 16 point austerity program announced by the Vice Premier Zhu Rongji, to restore order to the economy. This involved pursuing deflationary policies largely through controls on state investment via credit rationing and administered price controls, to lower economic growth and so reverse the rapid increase in prices. However this contributed to the SOEs facing tight credit, substantial losses and indebtedness, both to the banks and to each other (the triangular debt problem). By 1996, after almost three years of austerity, the SOEs were in a further weakened position, with unexpectedly large losses culminating in considerable state funding and extension of credit to the large SOEs by the state banks. During the first six months of 1996, for every dollar China’s industrial enterprises made in profit only one cent came from state enterprises. The lack of an apparent hard budget constraint has contributed to this relatively poor performance, with managers being unconcerned at rising losses and the cost of scarce credit. The further growth in the indebtedness of the state enterprise sector is proving to be of considerable concern. Estimates have been made that the accumulated loans made by the state bank sector to loss making state owned industrial enterprises, as at the end of 1995, could be as much as the equivalent of 10% of GDP or even more. Some state banks have poorly performing loans equivalent to 25% or more than the value of their assets. While the level of indebtedness seems now to be stabilising, the situation is forcing
the restructuring of the state enterprise sector. A major challenge facing China during the remainder of the 1990s will be the need to accelerate the movement towards restructuring of SOEs, while minimising its impact upon unemployment.

The optimism about SOE reform and restructuring from a new phase of reform begun in 1993 has now been questioned, given this recent expansion of subsidies and credit to the SOE sector. However a number of ad hoc measures are being implemented to tackle the problem of the poorly performing SOEs. These include corporatisation and commercialisation of the large scale enterprises, and the auctioning, leasing and merging of small and medium sized enterprises. In particular, through gradual corporatisation of the large SOEs the Chinese authorities plan to separate government administration from enterprise management. Based upon the recently enacted Company Law of 1994, the rights of enterprises were to be safeguarded while the responsibility of the state was to be limited. However the principle of state ownership is to be maintained. A key element of state enterprise reform will also involve divesting from them the provision of subsidised housing, social security, health care and other social benefits.

Complicating the SOE dilemma for the Chinese authorities are two other mounting pressures, one from inside China and the other from outside. Inside pressure in the form of growing income disparities between social strata and geographical regions threatens to fuel social unrest. Many of the loss making government enterprises are in the poor provincial areas, where there closure would only exacerbate the existing income disparity. At the same time, China is experiencing outside pressure as its trading partners demand greater access to its markets as the price for its long delayed entry into the WTO. The increased competition generated could prove to be fatal for many
inefficient, capital and technology short SOEs, and even some of
the profitable ones.

On the positive side the non state sector is growing very
rapidly, resulting in the SOEs share of industrial production and
employment having fallen steadily. Some forecasters suggest that
the number employed by state industries fell by 10 million in the
last year alone.\textsuperscript{3} The growth of private firms along with the quasi
private township and village enterprises (TVEs) may mean that
the withering of the state sector can be managed smoothly. This in
turn should allow more resources to be gradually shifted to the
non state sector, thereby increasing China’s further potential for
growth.

The remainder of this paper proceeds as follows. In section 2 a
review of developments in the industrial sector and the recent
performance of the SOEs is conducted. Section 3 identifies the
major reform measures which have been advanced to improve the
performance of the SOEs. Section 4 briefly identifies other SOE
reform related measures in the areas of employment, social
security and housing. Section 5 conducts a review of the
privatisation experience and measures taken in other transition
economies in regard to their SOEs, and identifies their potential
applicability to China. Finally section 6 presents a summary of
the major conclusions to be derived from this paper.

2. INDUSTRIAL SECTOR AND SOE PERFORMANCE

The economic progress of the Chinese economy has been truly
remarkable. Since reform began in 1978 the economy had
quadrupled in size by 1995, and is expected to increase by a
further 50% by the end of the decade. The major engine for this
growth is to be found from the extensive investment in the
industrial sector, and the opening up of the economy to
international trade and investment. However despite this
stunning and sustained economic success for China as a whole, a number of unresolved legacies remain to be overcome from the country’s “growing out of the plan”\(^3\). Two crucial and interrelated problems have arisen from this process and are in urgent need of attention by the authorities. Firstly there is the need to put the financial sector on a commercial footing and to develop indirect policy instruments, such as that of the interest rate, as a means of conducting macroeconomic control within the context of a market oriented economy. Secondly, as with other reforming socialist economies such as India and Vietnam, there is a pressing need to restructure the country’s SOEs. Although the relative size of the SOE sector in the Chinese economy has declined sharply since the onset of reforms in the late 1980s, it still remains important in the economy. In 1978, about 78% of the gross value of industrial output was accounted for by SOEs, declining significantly to around 31% by 1995 (see Table 1). Despite this the SOE sector’s contribution to total output remains large, and it employs about two-thirds of China’s 170 million strong urban workforce (Figure 1). In addition, the SOE sector is closely linked to the banking system through the credit plan, pre-empting over two thirds of total domestic credit\(^4\). It also remains important in budgetary operations, contributing directly to about one fourth of total revenue and receiving operating subsidies amounting to two thirds of the overall budget deficit.

The overall financial performance of the SOE sector, however, remains weak. Although the gross profits of SOEs rebounded markedly in 1992-93 with the strong performance of the economy, the losses of some SOEs have continued at a very high level. A

\(^3\) This description of China’s development has been taken from Naughton (1996)

\(^4\) This figure has been put as high as 80-90% by other sources.
Table 1
Industrial Production by Ownership of Enterprises (%)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>State</td>
<td>78.0</td>
<td>56.1</td>
<td>30.7</td>
</tr>
<tr>
<td>Collective</td>
<td>22.0</td>
<td>35.7</td>
<td>43.2</td>
</tr>
<tr>
<td>Private/Individual</td>
<td>0</td>
<td>4.8</td>
<td>12.5</td>
</tr>
<tr>
<td>Joint Venture/Foreign</td>
<td>0</td>
<td>3.4</td>
<td>13.6</td>
</tr>
</tbody>
</table>

Source: China Statistical Publishing House

Figure 1
Composition of China's Employment

Source: China Statistical Publishing House 1995
sectoral disaggregation of losses during the early 1990s suggests that they were about equally distributed among the industrial, foreign trade and commerce, and grain sectors. In the industrial sector, about one half of the losses were concentrated in the coal and oil industries alone. Following the adoption of new accounting standards in early 1994, it was estimated that about one half of all SOEs were incurring losses. Even on official figures, the percentage of enterprises which lose money rose from 27% in 1990 to 43% in 1995, and, for the first time ever, the state sector as a whole swung into a small loss during the first three months of 1996 and this did not include the subsidies provided by government. In the past SOE losses have been covered about equally through budgetary subsidies and bank loans, with the latter having a consequentially detrimental effect upon the portfolio quality and capital structure of the state banking system.

The loss making SOEs therefore represent a sizeable drain upon government revenue and domestic saving, and present a significant obstacle to the future reform and health of the economy. For example the World Bank estimated that China subsidised its SOEs to the tune of US$14.4 billion in 1993, against a US$7-8 billion budget deficit that year. The more recent performance of the SOEs indicates that this deterioration is continuing, suggesting an urgent need for attention by the authorities, and that China’s state sector is in worse shape now than at any time in its 18 years of economic reform. The weakness of the state sector has been further compounded by the austerity program in effect since July 1993 arising from the break neck growth of output in 1992 and 1993, initiated by Deng Xiaoping’s famous visit to the coastal provinces in early 1992, and the consequential build up of inflation within the economy (see Table 2). The austerity measures involved controls on state investment
Table 2
GDP Growth and Inflation 1990-97

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP Growth (%)</th>
<th>RPI (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>3.8</td>
<td>2.1</td>
</tr>
<tr>
<td>1991</td>
<td>9.3</td>
<td>2.9</td>
</tr>
<tr>
<td>1992</td>
<td>14.2</td>
<td>5.4</td>
</tr>
<tr>
<td>1993</td>
<td>13.5</td>
<td>13.2</td>
</tr>
<tr>
<td>1994</td>
<td>11.8</td>
<td>21.7</td>
</tr>
<tr>
<td>1995</td>
<td>10.2</td>
<td>14.8</td>
</tr>
<tr>
<td>1996</td>
<td>9.7</td>
<td>6.0</td>
</tr>
<tr>
<td>1997</td>
<td>10.5&lt;sup&gt;e&lt;/sup&gt;</td>
<td>8.5&lt;sup&gt;e&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

<sup>e</sup> Estimates
Source: China Statistical Yearbook

Figure 2
Industrial Sales as % of Output January 1995-July 1996

Source: J.P. Morgan
via credit rationing and administered price controls. By 1996 a soft landing had been achieved, with inflation less than GDP growth for the first time since 1993. During the austerity period, however, sluggish domestic demand, low levels of new investment and a slump in exports hit Chinese companies hard. One sign of this pain has been the falling ratio of industrial sales to output, a proxy for gauging stock levels (see Figure 2). A falling ratio implies that stocks of goods are accumulating. The problem was made worse by the state owned firms that maintained production and employment while accumulating losses or experiencing reduced profits. The SOEs were able to do this despite tight credit policies, because the country’s state owned commercial banks were called upon to increase fixed investment loans to large state enterprises. By, for example, an inflation adjusted 18% in 1995. The more dynamic non state sector, meanwhile, found its access to credit increasingly more difficult with its share of commercial bank loans plunging by a real 28% in 1995. Hence despite the austerity measures, credit remained plentiful for the economy’s least efficient sector. The government is anticipating channelling a further 71.5% of fixed asset investment, US$305 billion, into state enterprises in 1997. This has led many economists to question the Chinese authorities’ willingness to reform the SOEs and to wean them off subsidies and easy credit.

For some time China has tried to simply grow out of the SOE problem, by letting overall GDP expansion, and a relatively faster growth rate of the nonstate sector, reduce the size of the state sector (see Table 3). From 78% in 1978 the contribution of China’s 118,000 SOEs has shrunk rapidly, accounting for under a third of industrial output by 1995. Picking up the slack is the non state sector which is increasingly absorbing the roughly 15% of the urban work force which the government concedes is superfluous. Playing a leading role in the nonstate sector is that of the collective enterprises, consisting of both urban and rural
enterprises. The collective sector has seen its share of industrial output increase from 22% in 1978 to 43% in 1995. There has been a particularly impressive growth of the rural enterprises, the so-called TVEs. In 1978 some 1.52 million TVEs employed 28.3 million workers, which expanded dramatically to 25 million TVEs employing 120 million workers by 1994. Unlike the SOEs they are: small in size, averaging about 5 workers each; sufficiently nimble enough to respond to market changes in a way which the SOEs cannot; and are subject to hard budget constraints. Despite ambiguous property rights, they have been a remarkable and somewhat unanticipated successful consequence of China’s economic reforms. Table 4 indicates that the productivity performance of the collective sector, and most notably the TVEs, has been noticeably superior to that of the state sector. In addition many thousands of private companies, both domestic and foreign owned, and joint ventures have also developed, and they now account for a little over 25% of industrial output⁵. The impressive growth of this sector is likely to be maintained, although the extent of this will be dependent upon its access to scarce financial resources. Yet despite these developments the SOEs still consume a far greater share of scarce state financial resources than those in the non-state sector, approximately three quarters of state industrial investment. As a consequence the government is increasingly investing scarce resources in declining industries, which will ultimately contribute to a decline in economic growth should this remain unchanged.

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⁵ The ‘other’ category in Table 3.
Table 3
Real Gross Value of Industrial Production (GVIO) 1990-95

<table>
<thead>
<tr>
<th>Year</th>
<th>GVIO Total</th>
<th>% Growth Rate</th>
<th>GVIO SOEs</th>
<th>GVIO Collective</th>
<th>GVIO Other*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>5.2</td>
<td>2.7</td>
<td>6.2</td>
<td>47.4</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>12.8</td>
<td>7.6</td>
<td>17.3</td>
<td>40.7</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>21.4</td>
<td>13.1</td>
<td>32.9</td>
<td>50.6</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>23.8</td>
<td>9.1</td>
<td>39.9</td>
<td>59.5</td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>21.6</td>
<td>2.1</td>
<td>30.5</td>
<td>43.5</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>16.0</td>
<td>9.0</td>
<td>25.0</td>
<td>30.0</td>
<td></td>
</tr>
</tbody>
</table>

* GVIO of private, foreign invested and other enterprises.
Source: State Statistical Bureau

Table 4
Estimated Rates of Annual Productivity Growth in Chinese Industry (% change)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Total Factor Productivity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State sector</td>
<td>1.8</td>
<td>3.0</td>
<td>2.5a</td>
</tr>
<tr>
<td>Collective sector</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Urban and township</td>
<td>3.4</td>
<td>5.9</td>
<td>4.9a</td>
</tr>
<tr>
<td>Township-Village</td>
<td>7.3a</td>
<td>6.6a</td>
<td>6.9a</td>
</tr>
<tr>
<td><strong>B. Labour Productivity (real terms)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State sector</td>
<td>3.8</td>
<td>6.2</td>
<td>4.7</td>
</tr>
<tr>
<td>Collective sector</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Urban and township</td>
<td>8.6</td>
<td>7.0</td>
<td>13.8</td>
</tr>
<tr>
<td>Township-Village</td>
<td>5.8</td>
<td>14.4</td>
<td>17.7</td>
</tr>
</tbody>
</table>

* Preliminary results.
Sources: Taken from Jefferson and Rawski (1994), p.56.
Although many reformers have recommended widespread bankruptcies or privatisation of the SOEs, this could create major social unrest and the government has already rejected large scale privatisation. Indeed the government still views the state owned sector as the backbone of the economy. With seven of every 10 Chinese industrial workers employed in state enterprises, over 100 million workers, the potential fall out from extensive bankruptcy would be immense. In many areas they are the sole employers and providers of social services, from housing to transport to health care and education. This would also have adverse consequences for already widening regional income disparities. Thus, even if sustaining the loss makers among them with loans is inflationary and wasteful, the alternative of mass shutdown could be a recipe for mass social unrest. More recently a middle ground has emerged, described as to “grasp the large and sacrifice the small”. This involves a three pronged approach which will essentially involve leasing, selling or closing small failing companies, restructuring the robust ones, and sustaining with state funds those enterprises of national importance. These alternative models and their application in China is discussed in the following section.

The continuing weakness of SOE performance has arisen from a number of factors. Administrative control on the prices of key products such as coal, oil, grain, and other essential products. With the recent further liberalisation of prices, losses because of this are likely to be greatly reduced. A more important reason has been the organisational structure of the SOEs, which is characterised by insufficient managerial autonomy and accountability, the lack of hard budget constraints, rigidities in wages and employment, overstaffing (many economists believe that SOEs have about a third more employees than they require),

6 The so called 'pillar industries' as described by Premier Li Peng.
a heavy burden of social benefits for their workers (housing, education, health and pensions) and the use of obsolescent technology. In a number of these areas progress has been made, but the recent experience of 1996 in which the SOEs were extended easy credit by the commercial state banks and further subsidies by the government undermines the attainment of managerial accountability and the credible imposition of a hard budget constraint. It also makes it impossible to develop indirect policy instruments operating through financial markets as a means of attaining macroeconomic control in a market oriented economy. For example, in 1995 when the government twice raised interest rates in an attempt to reduce the demand for loans, this had little effect on the SOEs. The linkage between the SOEs and the commercial state banks needs to be broken, or else further reform will be impossible. There is considerable resistance to such a development. For example by the end of 1996 the Chinese authorities had to retreat from transforming large scale state enterprises, mostly because their managers resisted efforts at accountability. The government had planned to corporatise 100 large scale enterprises by converting them into shareholding or limited liability companies. As it turned out, more than 80 preferred the form of solely state owned enterprises, a far cry from the goal of the experiment. With easy access to credit and little accountability this is a much easier option for an SOE manager.

Such problems make reform in other key sectors, such as the financial sector, much more difficult. State industry owes the state banking system a great deal of money. For a start, the 5 trillion yuan (US$600 billion) of bank loans outstanding in China, nine-tenths of it to state industry, account for an unusually high proportion of all financing, equivalent to about 70% of GDP. China has only one private bank, and no meaningful capital markets, hence the job of financing investment rests almost wholly
with the state banks. The Chinese save the equivalent of over 40% of GDP, nearly all of which is deposited with state banks because of the lack at present of alternatives. The stockmarket still remains very small. As much as nine-tenths of bank loans go to the state sector, hence domestic savings are not being used most efficiently. Household and corporate savings are drawn off in the prosperous coastal areas and, through the state credit plan, recycled to those parts of the country to support relatively inefficient SOEs. The money lent by banks to the state sector has risen, from 500 billion yuan (US$86 billion) at the end of 1993 to over 1 trillion yuan (US$120 billion) by the end of 1996. Conservative estimates put the increase in bad debts each year at 50-60 billion yuan, with total bad debts amounting to more than 25% of the banks' assets. In addition to SOE debt to the state banks there is also SOE debts to other SOEs. Such debts between the SOEs the government and the state banks is known as triangular debt. This could amount to over 800 billion yuan by the end of 1996.

It is clear from the discussion in this section the extent of the task facing the authorities. However further reform of the economy, and the movement towards a market economy, requires action to be taken in the area of loss making SOEs and the financial sector. Should such reforms not be forthcoming there will be an inevitable slow down in the growth of the economy, a loss of jobs and the development of social unrest which the authorities all along have been concerned with avoiding.

3. REFORMING THE STATE OWNED ENTERPRISES

Enterprise reforms prior to 1993

Until reforms were initiated, the SOEs had little autonomy. Their production, pricing, and investment decisions were subject to the planning process, they transferred all surplus funds to the state
budget, and they relied on the budget for subsidies to cover losses and grants for investment. Few incentives were available to workers or management, wages were set by centrally determined scales, and the managers' main responsibility was to fulfill production quotas. Early reforms aimed to increase enterprise autonomy and accountability. In this regard the issuance of the "Provisional Regulations on the Enlargement of Autonomy of State Industrial Enterprises" in 1984 represented an important step. These regulations permitted an increase in autonomy for above target output in terms of price setting, output sales, and input purchases. Also, in 1984-85, an enterprise income tax on SOEs was introduced, and these tax payments replaced profit remittances as the main source of fiscal revenue from enterprises. Enterprises were allowed to retain most of their after tax profits and their depreciation funds. In 1986 the Contract Responsibility System (CRS) was introduced, for medium sized and larger SOEs. Under this targets were specified for the enterprise over a three or four year period for its performance in terms of output, profit remittances and taxes to the government. An enterprise's income tax liability under the CRS was determined by the provisions of the enterprise's contract instead of by law, leading to a strong element of bargaining in the fiscal process. The first generation of these contracts, signed by at least 90% of the SOEs, was in place by 1988. To accompany these changes, a bankruptcy law was enacted in 1986 and became effective in 1988, but until recently it was hardly used against SOEs. In 1988 the authorities also enacted an Enterprise Law, which sought to transform the SOEs into fully autonomous legal entities responsible for their own profits and losses. In July 1992, the implementing regulations of the Enterprise Law of 1988, entitled "Regulations on Transforming the Operating Mechanisms of SOEs", were issued by the State Council. These regulations explicitly provided for non interference by the government in the operations of the
enterprises, which were endowed with a set of 14 rights (see below), including the right to decide what to produce and how to price and market their products, how to invest their funds, the right to hire and fire workers and to decide on wage policy, with the objective of transforming the SOEs into autonomous legal entities responsible for their own profits and losses. Inefficient and loss making ones were to be reconstructed or closed down in accordance with the Bankruptcy Law. The role of the state as owner of the enterprises is delegated to the State Asset Management Bureau. Enterprises had, in summary, the right to enjoy the following:

- to make production and business decisions
- to set their own prices
- to market their own products
- to purchase materials
- to import and export
- to make investment decisions
- to decide on the use of retained earnings
- to dispose of assets in accordance with production requirements
- to form partnerships and mergers
- to assign labour
- to have personnel management
- to set wages and bonuses
- to determine internal organisations
- to refuse arbitrary levies and charges

Although the initial impact of these reforms was a recovery in the output of SOEs, price controls persisted, production quotas for sale to the state remained part of the contracts, the SOEs had access to certain amounts of cheap raw materials, credit was readily available for investment or working capital, the budget
continued to provide support for loss-making enterprises, and little advantage was taken of reforms to wage and employment practices. In short the SOEs continued to face a soft budget constraint.

The incompleteness of the reforms jeopardised macroeconomic management, with SOEs contributing to the rapid rate of credit expansion in the late 1980s and early 1990s, reflecting mounting demands on the state budget to cover enterprise losses, low revenue buoyancy, the accumulation of large inventories of unmarketable products (either because of excess production or low quality), and the associated growth of inter-enterprise arrears. To address these problems, the authorities during 1991 announced some 20 measures, 12 of which were to improve the operations and external environment of the SOEs, and the others were aimed at facilitating the operation of market forces on the SOEs. Some measures, such as reducing mandatory planning, were further steps toward a market economy, but others, such as preferential access to credit and tax concessions, continued existing interventionist policies. Indeed, during the rectification program of 1988 and 1989, a large number of SOEs were given preferential access to credit and raw materials under a “mutual pledge” or “double guarantee” system, which obliged them to deliver specified amounts of output to the state.

Another key area of enterprise reform was aimed at changing the governance structure, accounting procedures and ownership rights, in addition to the previously mentioned management rights, of SOEs, to make them more appropriate in the context of a market economy. A number of experiments in this regard were applied primarily to large SOEs:

1. reforms establishing the formation of “enterprise groups” along the lines of the Japanese keiretsus, but more closely so to that of the South Korean chaebols, integrated through a parent-subsidiary relationship. Some of these groups have
been required to take over loss making enterprises to help rationalise their operations,

2. another development in the restructuring of SOEs involved the "grafting" of SOEs with foreign investment. In such an arrangement, an SOE would typically invite foreign participation in certain lines of production, and a joint venture would be formed, under which the SOE would provide the land, buildings, and labour, and the foreign partner the equipment, technology and marketing expertise. This was later increasingly used by the Chinese authorities as a means of foreign investors gaining access to the Chinese market,

3. another experiment in reforming the governance structure of enterprises was the introduction of corporate forms of ownership and management. Provisions for limited liability private companies were introduced in 1990, and the shareholding experiment was formally sanctioned for SOEs. In late 1990, stock exchanges were established in Shanghai and Shenzhen, although provisional regulations on the issuance of securities were made public by the Shanghai and Shenzhen municipal governments only in 1992.

In addition reforms of the labour and employment system were also initiated to provide for greater flexibility at the enterprise level in terms of worker selection, task definition and wages. Reform in terms of the social benefits system, including unemployment benefits, pensions, and health care, aimed at establishing pooled benefits schemes and a separation of the provision of benefits from specific enterprises were also begun. Reforms aimed at commercialising the housing market have also been recently launched. Some SOEs have separated service activities from enterprise operations, creating autonomous units that are responsible for their own profits and losses. Other
reforms during this period affecting SOEs have included price liberalisation, the reduction of the scope of the mandatory plans, the introduction of markets for land use rights, the liberalisation of the foreign exchange market, the opening of new sectors and regions to foreign trade and investment, and the deepening of financial markets.

Despite the numerous experiments with SOE reforms in the 1980s their performance remained weak, with about one third of SOEs estimated to be making losses, and another one third were breaking even. Autonomy and financial accountability remained weak. SOEs still operated predominantly under the direct supervision of the central or local governments. The retrenchment period of the late 1980s and early 1990s highlighted the weakness of the SOEs sector. However beginning in 1991, several large SOEs were transformed into joint stock companies and listed their shares on both domestic and international stock exchanges. This was to be given further impetus with reforms after 1993.

_A new phase of SOE reform after 1993_

The thrust of the new phase of reforms is to change enterprise governance, with the objective of establishing a modern enterprise sector consistent with the attainment of a socialist market economy as proclaimed by the Chinese authorities in October 1992. This aim is to be achieved through the corporatisation of SOEs, that is, the conversion of SOEs into shareholding companies through the implementation of a new Company Law enacted in December 1993 and which became effective in July 1994. The new companies will be vested with a corporate governance structure that generally follows international practice. Through this, the authorities aim to achieve a separation of the ownership functions of the state from the management of the
enterprises, within a framework of greater autonomy and accountability. Specifically, the new framework will:

1. clarify the rights of enterprises as legal entities entitled to make decisions concerning assets entrusted to them by owners and investors,
2. separate government ministries and departments from enterprise management to eliminate government interference in enterprise management,
3. relieve SOEs of the obligation to provide social services while expanding the government's role in the provision of these services,
4. establish market based relations between enterprises, so as to avoid the recurrent accumulation of inter-enterprise debt,
5. reduce the government's control over wage and employment policies while limiting its role in this sphere to a supervisory one.

In this new framework, a system for the management of state owned assets by state holding companies, state asset management companies, and enterprise groups would be introduced. To permit enterprises in the new system to function effectively, supporting measures were to be introduced, including the implementation of Company Law, the enactment of a national securities law, the implementation of a new accounting system, and the development of factor markets. In addition, to support enterprise reform, the authorities set up in 1994 a fund of Yuan 7 billion designated for debt repayment.

In early 1994, shortly after the Third Plenum of the 14th Central Committee of the Communist Party of China in November 1993, the government launched a pilot project, or experiment, for the establishment of a modern enterprise system. This project involved 10,000 medium sized and large SOEs in a program that
included asset valuation, the granting of financial autonomy, and the adoption of a new accounting system. Of these, 1,000 enterprises, deemed to be critical to the economy, were selected for an experiment that would delegate to asset management firms the authority to oversee the management of these enterprises' assets with the objective of increasing their value over time. Another 100 enterprises were to become corporatised and thereby to participate in an expansion of the existing shareholding system. Finally, ten major cities, later increased to eighteen, were selected for a comprehensive enterprise reform program including pension pooling; staff lay-off and bankruptcies. The whole project was initially expected to take two to three years to complete. The medium term goal of such reform was to transform most SOEs into autonomous, competitive, legal entities fully accountable for their profits and losses, and in the process of which to create a level playing field for all enterprises.

While the new phase of enterprise reform places a heavy emphasis on the maintenance of public ownership as the cornerstone of the economy, it does represent a fundamental change in the concept of ownership of SOEs. A distinction was to be drawn between the ownership of an enterprise and its management, the rights of ownership are circumscribed by law, and enterprises are regarded as legal entities with their own rights and responsibilities. Such a clarification of the concept of ownership was seen as being necessary for a fundamental restructuring of the SOEs. This, in conjunction with the implementation of a standardised accounting system, would lay the foundations for the possibility of privatisation at a later date. In addition, the predominance of public ownership in this new ownership system was to be confined to certain strategic sectors of the economy. Considerable diversification in the ownership structure of the Chinese economy as a whole over a number of years has taken place. This has occurred through the promotion of
a dynamic, collectively owned enterprise sector, joint ventures, foreign funded enterprises, private and individually owned businesses, the shareholding or corporatisation experiments, the divestiture by SOEs of some of their ancillary activities by selling or leasing part of enterprise assets to individuals or groups of individuals, and the divestiture by the state of enterprises themselves. The Company Law of 1994 therefore represented a major step in the SOE reform process, enabling for the first time a unified legal framework for the establishment and operation of companies as independent identities.

Despite these developments in ownership structure the message from the government remains clear, however, that reform of the state sector will have clear limits. Public ownership of the largest state firms will remain sacrosanct and bankruptcies will be isolated. As reiterated at the National People’s Congress in March 1996, the state sector will remain the backbone of the economy. Under the Ninth Five Year Plan (1996-2000) reform of the state sector is seen as being a top priority, and the State Commission for Restructuring the Economy (SCRES) has indicated that reform of the Chinese economy will lead to the loss of 18 million jobs at state owned firms during the period of it.

In the remainder of this section a number of experiments relating to improving the performance of the SOEs will be discussed. These will focus upon: corporatisation, the establishment of enterprise groups; approaches to improving the performance of small and medium sized SOEs, approaches to loss making enterprises.

**Corporatisation**

The major thrust of SOE reforms has been to focus on their corporatisation and commercialisation, with the objective of separating government administration from enterprise
management. In this regard the shareholding system is an important experiment in enterprise reform that has major ramifications for the ownership structure of enterprises and has received widespread interest. Under this system, enterprises are allowed to restructure themselves into limited liability companies by issuing shares. The shareholding system (or corporatisation) provides for a clear separation between the ownership and management of the enterprises and is therefore a way of restructuring the relationship between the government and the enterprises under its control. Several thousand enterprises are participating in this exercise. For example by the end of 1993 there were about 11,600 of such companies in China, of which 8,300 were limited liability companies and 3,300 were joint stock companies. All of these companies can apply for listing in the country’s two stock exchanges of Shanghai and Shenzhen. The authorities, however, do not regard the conversion of SOEs into shareholding companies as “privatisation”. Instead they see this as a means of raising funds for restructuring and of introducing a more effective management system, while the state retains a significant ownership share and ultimate control over companies.

The development of the shareholding system has been boosted by the establishment of stock exchanges in Shanghai and Shenzhen, to list the shares of approved joint stock companies. These are shareholding companies that issue shares to the general public and that may apply for listing on the two stock exchanges. In the restructuring, the proportion of the shares belonging to the state, municipality, or township is determined by an appraisal company according to the net value of the assets in the enterprise accruing to the state, municipality or township.

With regard to the extent of state participation in shareholding companies, four levels of government ownership were envisaged:
1. in certain priority sectors, defined as those characterised by market failures or that produced goods deemed to be of national strategic significance, enterprises will remain wholly owned by the government,

2. the second level will consist of enterprises with majority government ownership,

3. the third level will comprise enterprises with minority shareholding by the government,

4. finally, some small enterprises engaged primarily in commercial activities will be auctioned or leased to individuals, with the state not being represented in the ownership structure.

After an enterprise has been turned into a shareholding company, the state’s position as the sole owner will disappear in cases 2, 3 and 4. As one among many owners with equity rights, the state will only participate in the decision making to the extent of its representation. The authorities envisage that, even in enterprises in which the state is the majority shareholder, the effective separation of ownership from management will be achieved by requiring the government act according to the statutes of the new company/enterprise law.

Considerable progress was made during 1993 and in 1994 with the new Company Law, in extending and formalising the shareholding system. Although experiments with the issuance of stocks as a means of raising capital began in the early 1980s, these stocks had no legal standing and, hence, were restricted in terms of ownership rights and transferability. Since 1990, a number of important measures have been taken to legalise the corporate form of enterprises and the issuance of stock, leading to, as mentioned above, the establishment of stock exchanges in
Shanghai and Shenzhen7. The 1994 Company Law provided a legal and unified basis for the establishment and operations of companies in China. Under it two forms of companies may be established, a limited liability company and a joint stock company. Specifically, the law covers all forms of ownership — private, public and FFEs and; does not provide for a mandatory minimum state shareholding in a company; eliminates the distinction between state held, corporate owned and individual private person shares; specifies a framework of corporate governance in the form of a board of directors and board of supervisors; prohibits government officials from serving as company directors, supervisors, or general managers; stipulates minimum capital requirements for various types of companies; and clearly defines conditions for share transfer or sale. Also, it outlines procedures for corporate mergers, bankruptcy, and the liquidation of companies.

While the emergence of joint stock companies and equity markets is still of limited significance from an economic standpoint, they do represent a major change in the ideological framework of reforms in China. They are an important constituent part of a broader process of ownership change, and the growth of the stock exchanges have provided an important impetus for new accounting standards to replace the existing accounting standards which were not adequate to support public trading in shares. In addition they are no longer seen as being at odds with the institutional underpinnings of a “socialist” economy, since there will still be the predominance of public ownership. At first, the shares of the companies listed on the stock exchanges were issued only to domestic residents (A shares). Since 1991, however, some

7 A decision was taken in 1993 to extend the right to list shares of joint stock companies to cities other than Shanghai and Shenzhen.
companies have been permitted to issue B shares\(^8\), denominated in local currency, but purchased by foreigners with payment in foreign exchange. Foreign investors are guaranteed convertibility of their investment and earnings into foreign exchange at the swap market rate. Indeed some SOEs have been listed on stock exchanges overseas.

At the end of 1993, as part of the SOE reform process, a decision was made to select a batch of 100 large state enterprises, from among the 1000 or so large enterprises that have a significant bearing on the economy, for conversion to limited liability joint stock companies, Primary ownership would remain with the state, but with corporate organisation otherwise completely restructured. The pilot program was started in 1995 with a further 300 enterprises due to join in 1996. This indicated that the authorities were moving in the direction of a batch by batch commercialisation of firms, which could potentially be followed by privatisation if and when political constraints allowed.

A number of advantages arising from this shareholding arrangement were seen by the authorities:

1. it facilitated the separation of government ownership from management,
2. it facilitated the mobilisation and rational allocation of financial resources,
3. it facilitated the provision of greater financial and decision making autonomy, so that enterprises could become more efficient and respond dynamically to changing market opportunities.

\(^8\) In addition, and more recently, there are the so called ‘red chip’ shares and H shares. The former are shares of mainland China owned enterprises listed on the Hong Kong stock exchange, while the latter are the shares of subsidiaries of mainland China owned enterprises listed on the Hong Kong stock exchange and based in Hong Kong.
While the major incentive from the perspective of enterprises to list on the stock exchanges is the ability to raise equity funds for restructuring and upgrading, over the longer run the greater discipline on enterprise management that is likely to result from the scrutiny that listed companies are subject to from both shareholders and investors will be more significant. This is particularly the case with those enterprises that are listed abroad, where public disclosure requirements are more stringent, and the scrutiny from institutional investors more rigorous. Nevertheless, the transformation of enterprises into corporations cannot, alone, ensure greater operational efficiency or profitability. Complementary and supplementary changes in other areas are essential to create a competitive environment for SOEs, such as the enforcement of a hard budget constraint through the commercialisation of the banking sector and a wider application of the Bankruptcy Law to non profitable enterprises. In addition it is essential to further liberalise prices and develop competitive markets for goods and factors of production. In this sense, the supporting changes that are under way in the areas of taxation, banking, housing markets, and the provision of social security are at least as important for bringing about a lasting improvement in SOE performance as the process of corporatisation itself.

Several problems still remain to be resolved with respect to such an enterprise experiment. The first concerns the establishment of a strong legal framework governing the issuance and trading of shares. Second, asset valuation and accounting practices need to be standardised across enterprises. Third the pace of reform of the social security system needs to be quickened to enable fundamental restructuring of the SOE sector. Fourth, financial sector reforms need to be accelerated so that, unlike in 1996, banks can no longer be prevailed upon by central and local authorities to grant loans to uncreditworthy enterprises, which, in
turn, has important implications for hardening enterprise budget constraints. Finally, some questions remain on whether a true separation of the state’s role as an owner and as a manager can be achieved as long as the majority, or even the largest minority of shareholders, are agents of the state. In addition the corporatisation reforms have been met by much resistance by SOE managers, especially over the issue of accountability. The initial results from the batch of 100 large SOEs to be corporatised has been very disappointing. The intention of the Chinese authorities was to corporatise these enterprises by converting them into shareholding or limited liability companies by the end of 1996. As it turned out, however, more than 80 of them preferred the form of solely state owned enterprises, and continued financial support from the state, a far cry from the goal of the trial. This is perhaps not surprising given the easing of access to credit for “pillar industries” through the state banking system which occurred in 1996, without the need for accountability by managers to shareholders.

Enterprise groups

Another experiment that is being encouraged is the formation of large enterprise groups, with the aim of rationalising the industrial structure by taking advantage of economies of scale and promoting the optimum use of resources. In China each locality was encouraged to be fully self-reliant during the pre-reform period. Furthermore, enterprises within one branch of an industry were normally not allowed to diversify into related fields. As a result, from a national perspective, there is much duplication, a lack of specialisation, and strong local barriers to inter-regional trade. The aim of the authorities is to break down the departmental, regional, and ownership barriers in the economy.
and create large conglomerates that are efficient and internationally competitive.

Several hundred "enterprise groups" were formed in the early 1990s, and a review concluded that 431 of these qualified as genuine enterprise groups, with effective control exerted directly over branch plants by a large core firm, thus breaking down the bureaucratic and administrative barriers that had made enterprises appendages of the bureaucratic apparatus. Many of these groups have diversified interests, and often hold foreign trade rights. Indeed, the Chinese government designated 100 of these enterprise groups to receive government support. The stated objective is to create a nucleus of large corporate groups like the Japanese keiretsu or Korean chaebol. These groups will have diversified production interests and substantial financial depth, and will be encouraged to operate internationally. These firms operate with substantial autonomy, sometimes aided by political patronage ties with top politicians and military figures. They can be clearly distinguished from limited experiments with enterprise groups and "horizontal linkages" in the 1980s, as the new enterprise groups of the 1990s seem to be genuine corporations with substantial autonomy and international outlook.

In the past two years the government has selected 55 large enterprise groups for restructuring to strengthen the role of the parent or core enterprise within each group, particularly its management of the subsidiary enterprises. Preferential treatment such as trading rights or the right to diversify into other fields of activity are being provided to these enterprise groups, to encourage their development into competitive conglomerates. Since there is much duplication in Chinese industry, with hundreds of inefficient small factories often making the same things, this does make economic sense. In this regard lessons can be learned from the Japanese keiretsu system, in which individual Japanese companies, often with their own stockmarket listings,
are linked together through cross shareholdings. At the core is a bank which, in conjunction with other firms in the family, support one another and favour each other in their business dealings. However in the context of China the real model for the development of enterprise groups is that provided by the South Korean chaebols, which are far less structured in their range of business than the big Japanese companies and, to some extent, more closely linked to the state. In South Korea the ten leading chaebols control around two thirds of the economy, and they have underpinned the country’s rapid rate of economic development since the 1960s. The Chinese appear to be impressed by the fact that the chaebol helped to transform South Korea from a poor hungry nation into a rich one within a generation, and that the chaebol are now transforming themselves into multinationals. It is however ironic that just as South Korea’s government is trying to reduce the influence that the chaebol exert on the domestic economy, that China’s policy makers are contemplating the development of their own chaebol.

Small/medium sized SOEs

The Chinese government appears, as previously indicated, to be concentrating its reform efforts on some 1,000 of the biggest SOEs. The remaining 117,000 consist primarily of smaller and medium sized SOEs, where the plan is to turn the majority of these firms into:

1. mixed ownership through the creation of joint ventures
2. private enterprises through sales to private domestic individuals/firms
3. private foreign enterprises through sales to foreign private individuals/firms as wholly foreign funded enterprises
4. allowed to go bankrupt.
Both central and local government in China have been attempting to reinvigorate small and medium sized SOEs through ad hoc experiments with management control. The objective being to enable the development of sufficient managerial skills enabling these enterprises to operate profitably before they are released from state control. A number of “models” for the development of these state enterprises can be found particularly at the local government level, when they were given renewed authority to experiment with their own firms after 1991. With the renewed pressure of enterprise losses it was felt that local governments were in a better position to deal with loss making smaller enterprises. In this regard a number of examples can be identified, which show the kind of experiments taking shape in the state sector:

1. In Zhucheng city, Shandong province, the sale of enterprises/plants to their workers is taking place. This experiment has been used extensively with workers compulsorily buying shares in their enterprises, electing a board of directors and supervisory committee. All but a handful of Zhucheng’s 288 state owned enterprises have been sold, mostly to their workers, producing a remarkable improvement in profits according to local officials. Vice Premier Zhu Rongji toured the city in March 1996 to approve its reforms,

2. in Henan province workers have been involved in electing managers in nearly 1,000 factories. Some 85% of them are now reported to be making profits.

3. the giving away of state assets to new owners has also happened in Zhucheng city,

4. sale of small state run factories, which had occurred on a very limited scale during the 1980s, increased rapidly from 1992-
93. For example, the city of Wuhan announced a program to sell off small state firms to any buyers, including private enterprises or groups of investors. This was designed to unload loss making enterprises, and included substantial tax breaks for buyers who took over firms making large losses or with debts greater than assets.

5. Foisting off a weak SOE upon a would-be joint venture partner as a precondition for entry into the Chinese market, thereby gaining access to capital and technology to enhance its efficiency and profitability,

6. Leasing on the basis of a “transfer operate transfer” basis, whereby an investor runs an SOE for a period of time, earning profits, while returning it to profitability and ultimately back to the appropriate authority.

Loss making enterprises

The Chinese authorities are taking special measures to deal with loss making enterprises according to the nature of their losses, and bearing in mind the current low level of development of the social safety net. It is estimated that about 70% of the losses of SOEs are policy induced, mainly arising from price control. These enterprises are mainly concentrated in the transportation and energy sectors. If these enterprises are to be financially independent, it is necessary to liberalise the prices of the goods and services they produce. It is intended to liberalise the prices of coal and other energy products over the next three-five years to avoid major disruption to the rest of the economy. In the interim before profitability, or reduced losses, are ultimately achieved, the policy induced losses of those enterprises will continue to be subsidised through the budget.

For remaining enterprises that are experiencing losses because of poor management, the authorities are providing fiscal and
financial incentives for them to restructure or move into other lines of production. Several thousands of smaller enterprises have been either closed or merged with profitable ones to rationalise their operations. In some cities, experiments are being carried out to allow foreign investors to buy into and restructure existing loss making SOEs. Finally, the authorities are cautiously applying the bankruptcy law to the enterprises.

Despite the revival of SOE reform since 1993, China has clearly not undertaken large scale privatisation of state assets. The bulk of the change in ownership structure in the Chinese economy has occurred through the growth of non state producers — collectives, private and foreign invested companies — rather than through the transformation of the state sector. A key question facing reformers in China, is whether the continuation of predominant public ownership represents an insuperable barrier to the functioning of markets and efficient resource allocation. The authorities have consistently maintained their preference for public ownership as a means of achieving its vision of a socialist market economy. Such a system would be characterised by increased competition and the elimination of mandatory planning, but not necessarily with “private ownership” as in a capitalist system. The objective is to retain the predominance of public ownership, supplemented by nonstate and private ownership, while achieving an effective separation between state ownership and control of enterprises. Although the development of a socialist market economy is a recent goal (1992), marking an important change in the ideology of economic reform in China, throughout the reform process ownership structures have been modified in a number of important respects with major implications for enterprise management. In particular, these modifications might be viewed as an attempt to simulate market conditions by encouraging profit maximisation behaviour.
Important changes have taken place at both ends of the spectrum of state ownership. As previously discussed the larger and more modern and profitable state firms are increasingly being "corporatised" into modern corporate forms of various types, including limited liability joint stock companies. At the same time, local governments have been given greater freedom to deal with the smaller and less profitable state firms, and one of the methods they have adopted, as indicated previously, is to sell them off. As a result the traditional state owned sector is being reduced from both ends of the spectrum. In addition many of the financial and other preconditions for ownership reform and privatisation are being created. In this regard China's two stock exchanges in Shanghai and Shenzhen can be viewed as an indication of fundamental change. However it is also important to recognise that this has been a tightly controlled experiment, and substantial limitations have been imposed on their development. The number of companies listed on the two exchanges has been tightly controlled by administrative decisions. Moreover, ownership of joint stock companies continued to be held overwhelmingly by government bodies. For example, of all Shanghai joint stock companies at the end of 1992, 62% of the share value was held by the government, 24% was held by "legal persons" (predominantly other state enterprises), 7% by domestic individuals, and 7% by foreign capital. Virtually every individual corporation is securely controlled by the government or its agents. Thus, the share system, as yet, has not been the vehicle for a significant divestment of SOEs, but it has the potential to be so in the future.

4. OTHER SOE REFORM RELATED ISSUES

To make the SOEs financially accountable, to judge them by strictly economic criteria, and to abide by a hard budget
constraint, it has been necessary to change the old system of employment, social benefits, and housing so that enterprises are not burdened with social responsibilities. In this regard a number of important developments have already taken place.

**Employment**

Under the traditional employment system, the state assigned workers to enterprises that were obliged to provide jobs. The workers were guaranteed lifetime employment and were provided with housing, medical, and retirement benefits, and a basic salary that depended on the worker’s years of service. Such a system was: highly rigid; resulted in overstaffing in most SOEs; resulted in virtually no labour mobility; produced little correspondence between the remuneration of workers and their productivity. Employment reform in China is often characterised as trying to break the three irons, namely, the iron rice bowl (guaranteed employment, housing, and other benefits such as that relating to health), the iron chair (job security) and the iron wage (wages that are not related to performance). In 1986 a labour contract system was first introduced, for all newly recruited workers in the SOEs. Under this system, the terms and conditions of employment are determined by a contract signed between the employee and the enterprise. On the expiration of the contract, both the enterprise and the employer are free to choose whether to continue or terminate the contract. However, progress in introducing the system was slow. For example at the end of 1992 it was estimated that the system covered only about 16 million workers, about 21% of the total number of employees in the SOEs.

In 1992, the authorities announced that reform of the employment system would be accelerated. A modified version of the labour contract system was to be encouraged for adoption by all enterprises as soon as possible. Under this modified system,
all employees, including managers, technicians and operators, must sign a contract with their enterprises to decide their duties, rights and benefits. The maturity of the contracts can either be fixed or open ended. Under this system, certain distinctions among employees such as permanent versus contract and cadres versus workers will be ended. To replace the system of job assignment by the state, employment agencies are being established to help place the new entrants in the labour force.

The problem of surplus labour in SOEs is one of the most difficult issues in reforming the enterprise system. It is estimated that excess workers in the government and SOEs may be as high as 20 million workers out of a total work force of over 100 million. To avoid massive unemployment, the authorities are encouraging the development of the tertiary sector to absorb this surplus labour. Under the old planning system, tertiary activities were considered unproductive and therefore not encouraged. As a result, many of the services that are essential in the smooth functioning of a market system were neglected. Since the onset of the reform process, the tertiary sector has grown from about 21% to 27% of GNP, but it is still small in comparison with the average of 60% in most developed countries. In July 1992, the authorities announced several policies to stimulate the development of this sector, including: encouraging the use of foreign capital and know how; transforming most tertiary businesses into profit oriented enterprises; encouraging staff in government organisations and SOEs to resign and establish businesses in the service sector; decontrolling the prices of most products and services; and providing financial and tax incentives. The tertiary sector is viewed by the authorities as having great potential for absorbing surplus labour, because this sector is generally more labour intensive, comprising, for example, retailing and wholesaling, catering, teaching, consulting, and social services. It is envisaged that the tertiary sector will play a role analogous to that played
by the TVEs in absorbing the surplus labour in the agricultural sector during the 1980s.

Social security

To enforce a hard budget constraint on SOEs without adverse social consequences, an adequate social safety net has to be developed. An unemployment insurance scheme was set up in 1986 to provide benefits to the unemployed. To be eligible, the unemployment must have resulted from the following causes — 1. bankruptcy of an enterprise, 2. restructuring of an enterprise, 3. termination of a labour contract, 4. firing because of violation of rules. In addition to cash relief, the unemployment scheme provided training to the unemployed and assistance in setting up their own businesses. At present the unemployment insurance scheme covers more than 70 million employees in the SOEs. In some regions, it extends to employees in collective firms, joint ventures and private enterprises. To extend the social safety net, the authorities are formulating new regulations and plans to improve benefits and expand the coverage of the unemployment insurance system in the near future. In particular, unemployment benefits will be provided to all involuntary unemployment regardless of cause, and the coverage will be extended to employees in collectively owned and foreign enterprises. Further, to facilitate enterprise restructuring, some of the funds will be used both to provide training for the surplus labour in the SOEs and to develop new jobs.

In the past, retirement benefits were also provided by enterprises out of current revenue. In recent years, retirement funds have been set up whereby workers and employers are required to contribute a certain percentage of the payroll toward the funds. At present, such funds are established at the municipal level in most cities and counties and at the provincial level in
about 12 provinces. The intention is to establish a unified national retirement fund at an appropriate time in the future. The retirement funds have improved the conditions for labour mobility, and have relieved enterprises of the burden of providing for their retired workers.

**Housing**

Traditionally housing is an integral part of the employment system, and is distributed to workers at a highly subsidised rate on an administrative basis. Such a system discourages the mobility of labour because the worker will generally not be able to keep his/her apartment if he/she leaves the work unit. This means that a worker will only leave if the new employer is able to provide similar housing. This is a major constraint on labour mobility and the establishment of a labour market. To encourage the development of a housing market, the authorities have announced a program of rent adjustment aimed at reducing the subsidy element in housing. This development should lead to the commercialisation of the housing sector. Encouragement of the sale of housing is another component of housing reform.

5. PRIVATISATION EXPERIENCES OF OTHER ECONOMIES IN TRANSITION

Much of the literature on economic transition from a planned to market economy focuses upon the need to implement changes that will: impose financial discipline upon enterprises, through the imposition of a hard budget constraint by eliminating access to soft finance in the form of bank credits on easy non commercial terms and the accumulation of inter enterprise arrears; lead to the opening up of markets to competition; enable the entry of new firms and exit of non viable firms to and from such markets; and
bring about decentralised ownership change. Such changes would encourage the necessary conditions for enterprise restructuring, and especially amongst state enterprises. As a means of increasing competition and improving performance in markets and enterprises, decentralisation of ownership, in particular, is seen as being a key ingredient. In the context of the Central and Eastern European transition economies, as well as the Newly Independent States of the former Soviet Union, most have made the unambiguous decision to move to decentralised ownership by having the majority of their economies under private sector control. This has been achieved through the privatisation of state assets and, for many the most important way, through the entry of new private businesses both domestically and foreign owned.

The imposition of financial discipline, as well as the intensification of competition in markets for the products of SOEs in these transition economies, has forced them to restructure, with the objective of improving their efficiency and profitability. However the initial implication of such developments has been major labour shedding and a fall in real wages, or a combination of the two. For example, in the three leading transition economies of Central Europe, the Czech Republic, Hungary and Poland, their largest 150 to 200 SOEs reduced their work forces by 32, 47 and 33 percent respectively between 1989 and 1993 as their sales fell by 40 to 60 percent on average. Evidence from the transition economies suggest that once SOEs are subject to financial discipline show: a more aggressive attitude towards the collection of receivables; a much stronger link between profitability and investment; a re-orientation of goals from output targets to profits; more managerial focus on marketing and product quality.

A key question of concern for the transition economies, and of particular interest to China, is whether privatisation is essential for imposing financial discipline on enterprises with the objective of stimulating their restructuring and enhancing their
competitiveness. Could such favourable developments also be achieved with public or mixed ownership. Empirical literature primarily from the 1980s for industrial market economies, concludes in general, although not uniformly, that private firms exhibit higher productivity and better performance than public enterprises. In the transition economies of Central and Eastern Europe and the Newly Independent States, because it is quite recent, judgment on the impact of privatisation has only recently emerged. The first signs are encouraging in many cases, less so in others. Evidence from Hungary, Poland Russia and Slovenia, suggest that newly privatatised firms behave differently from, and better than, state firms, exhibiting more dynamism and generating higher profits. This of course may in part be a reflection of the fact that only the more productive and profitable state firms were the first to be privatised.

Such evidence from these transition economies suggest that private ownership can make a difference in terms of enterprise performance. However the urgency and speed with which it has been conducted, has varied significantly across these economies. While it may not represent an optimal solution, a slower process of privatisation is likely to be more feasible in an economy where the authorities, or workers, are able to exercise enough control over state enterprises to prevent managers from absconding with state assets, and where domestic saving and growth in the non state sector are high. Such conditions would be representative of the situation in China and to a much more limited extent in Vietnam. On the other hand where enterprise managers are strong but the authorities and workers are weak, and where available funds are insufficient to meet restructuring needs, it is likely to be the case that privatisation will be more urgent. This is more representative of the situation arising from the fall of Communist governments in Europe in the late 1980s and early 1990s. In a number of these European countries this led to the undesirable
development of "spontaneous" privatisation, in which managers purchased state assets very cheaply or simply absconded with them, and often in collusion with the former nomenclature elite. This occurred in countries such as Belarus, Bulgaria, Hungary, Russia and the Ukraine, creating much resentment to many from such an illegal form of privatisation.

The transition economies' experience with privatising large enterprises

For many of the European transition economies the primary objective of the economic reforms was to bring about market economies with predominant private ownership as rapidly as possible. This was especially the case for the Czech Republic, Hungary and Poland, who have been at the forefront of development in the transition process. The initial predominance of SOEs in their economies, inevitably, therefore, required moves towards their privatisation. However each country has found that privatising large and medium size enterprises has been more difficult than originally anticipated. The process has not been easy due to: policy makers having to weigh up complex and often competing goals; the need to satisfy a multitude of competing stakeholders; coping with the administrative difficulties involved in privatising thousands of firms in a relatively short time; the lack of mature and functioning domestic capital markets.

A number of alternative approaches towards privatisation by transition economies can be identified, including sales to strategic owners, insider buy-outs, and voucher programs involving the creation of new financial intermediaries. These efforts are often complemented by extensive programs of restitution to pretransition owners and by smaller programs of debt equity conversions or public offering of shares on newly emerging stock markets. As summarised in Table 5 these approaches create trade offs among the various objectives set by government from the
process of privatization. The major objectives include: improving corporate governance and the efficiency of asset usage; depoliticising firms by cutting their links to the state; establishing new ownership rapidly; increasing firms' access to capital and expertise; generating government revenue; and ensuring a fair distribution of benefits. The various transition economies have adopted an approach to privatisation which best suits their own differing priorities and urgencies. In the case of Hungary, for example, with its sizeable foreign debt, the need to generate government revenue, particularly in the form of hard currency, has been viewed as of critical importance. For the Czech Republic this has been of considerably less significance. For the Russian authorities priority was given to the need to break rapidly from the past, while fairness was seen as being more important in the case of Poland. The Czechs have consistently stressed the significance of privatisation in breaking the link between an enterprise and the government, while Estonia’s privatisation program sought out “real” owners capable of bringing new money and management skills to bear. Table 6 presents a summary of the major methods of privatisation of medium sized and large enterprises which have been adopted in seven transition economies as at the end of 1995.

Table 5 provides only a partial view of the trade-offs arising from the alternative approaches to privatisation. An additional objective which should be given importance is each options' ability to achieve long term institutional building in the context of an economy in transition. While the process of privatisation in general can stimulate the development fundamental market institutions such as capital markets, legal systems, and business related professions, each approach to privatisation sets off a complex process of institutional and ownership change whose long run results may differ considerably from the shorter run picture. For example, mass privatisation may not produce the
best owners in the short run, but it might lead to a better corporate governance in the long run if it promotes the development of capital markets (and subsequent rearrangements of ownership) and of intermediary monitoring institutions for the economy as a whole. This should also be borne in mind.

**Table 5**

<table>
<thead>
<tr>
<th>METHOD</th>
<th>OBJECTIVE</th>
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<tr>
<td></td>
<td>Better corporate governance</td>
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<tr>
<td>Spontaneous privatisation</td>
<td>?</td>
</tr>
<tr>
<td>Sale to outside owners</td>
<td>+</td>
</tr>
<tr>
<td>Management-employee buyout</td>
<td>-</td>
</tr>
<tr>
<td>Equal-access voucher privatisation</td>
<td>?</td>
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### Table 6
Methods of Privatisation for Medium-Size and Large Enterprises in Seven Transition Economies
(percentages of total)

<table>
<thead>
<tr>
<th>Country</th>
<th>Sale to outside owners</th>
<th>Management-employee buyout</th>
<th>Equal-access voucher privatisation</th>
<th>Restitution</th>
<th>Other</th>
<th>Still in state hands</th>
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<tr>
<td>Czech Republic</td>
<td>By number&lt;sup&gt;b&lt;/sup&gt;</td>
<td>32</td>
<td>0</td>
<td>22&lt;sup&gt;c&lt;/sup&gt;</td>
<td>9</td>
<td>28</td>
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<tr>
<td></td>
<td>By value&lt;sup&gt;d&lt;/sup&gt;</td>
<td>5</td>
<td>0</td>
<td>50</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Estonia&lt;sup&gt;e&lt;/sup&gt;</td>
<td>By number</td>
<td>64</td>
<td>30</td>
<td>0</td>
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<td></td>
<td>By value</td>
<td>60</td>
<td>12</td>
<td>3</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Hungary</td>
<td>By number</td>
<td>38</td>
<td>7</td>
<td>0</td>
<td>0</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>By value</td>
<td>40</td>
<td>2</td>
<td>4</td>
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<tr>
<td>Lithuania</td>
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<tr>
<td></td>
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<td>&lt;1</td>
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<td>60</td>
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<tr>
<td>Mongolia</td>
<td>By number</td>
<td>0</td>
<td>0</td>
<td>70</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>By value</td>
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<td>0</td>
<td>55</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Poland</td>
<td>By number</td>
<td>3</td>
<td>14</td>
<td>6</td>
<td>0</td>
<td>23</td>
</tr>
<tr>
<td></td>
<td>By number</td>
<td>0</td>
<td>55</td>
<td>11</td>
<td>0</td>
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</tbody>
</table>

Note: Bold numbers show the dominant method of each country. Data are as of the end of 1995.

- **a.** Includes transfers to municipalities or social insurance organisations, debt-equity swaps, and sales through insolvency proceedings.
- **b.** Number of privatised firms as a share of all formerly state-owned firms. Includes parts of firms restructured prior to privatisation.
- **c.** Includes assets sold for cash as part of the voucher privatisation program through June 1994.
- **d.** Value of firms privatised as a share of the value of all formerly state-owned firms. Data for Poland and Russia are unavailable.
- **e.** Does not include some infrastructure firms. All management buyouts were part of competitive, open tenders. In thirteen cases citizens could exchange vouchers for minority shares in firms sold to a core investor.

Source: Gray, background paper; World Bank data.
Privatisation options for medium and large SOEs

A brief elaboration of the potential advantages and disadvantages of each of the previously identified methods of privatisation is now conducted.

1. Spontaneous privatisation

This is most likely to occur early on in the transition process, during the period of time of transfer from Communist government control to the establishment of a democratically elected government. During this turbulent period state enterprise managers can acquire state assets very cheaply by selling the assets they control to themselves, or simply abscond illegally with them, usually in collusion with members of the former nomenclature elite. This occurred extensively in Hungary and Russia and resulted in widespread resentment about its unfairness, ultimately leading to its eventual abandonment. There are major ambiguities over its benefits in terms of better corporate governance and its feasibility and desirability. It is also unlikely to improve enterprise access to capital and skills, and because such enterprises are sold off so cheaply do not generate much revenue to government. This is an approach to privatisation which should, overall, be avoided.

2. Sales to outsiders

In the early days of transition most of the Central and Eastern European countries hoped to privatise by selling state enterprises as going concerns on a case by case basis, based upon the experiences of the UK and other middle level income countries like Chile. Sales to “outside” or “core” investors were also favoured since they would bring in revenue and turn the firm over to “real” owners possessing the knowledge and incentives to
govern the company efficiently, as well as having the necessary capital to restructure it. Although sales to outside investors have largely achieved expected performance improvements, they have proved to be disappointing in that they have been: costly and slow; more difficult to implement than anticipated; and relatively few in number. The latter is primarily due to the limited availability of domestic capital, as well as political concerns arising from a large dependence on foreign capital. Even where domestic capital is sufficient, insiders (managers and other employees) have been able to block sales. More generally, the process is held back by the sheer enormity of the task of evaluating and negotiating deals one by one, and then of following up to be sure that the buyers fulfill contract provisions. For example, in Germany it is reported that 20% of the thousands of privatisation contracts signed by the Treuhandanstalt (the privatisation agency) are in dispute. Other difficulties relate to: problems with placing a value on firms to be offered for sale; appraising and assigning responsibility for past environmental damage; its perceived unfairness. Many ordinary citizens cannot participate and find the process non transparent and arbitrary if not corrupt. Among other transition economies, only Hungary and Estonia have privatised a significant share of their enterprises through direct sales. In Poland the power of workers to block privatisation has considerably slowed progress. The conclusion is that such sales, although a useful element in the privatisation process, cannot in most circumstances be the sole or even the primary method.

A second form of sale to outsiders involves floating shares on public stock exchanges. The infancy of stock exchanges limits this approach in all the transition economies. Furthermore, the method works only for firms with good financial prospects and strong reputations. Even Poland, which has had the most success with this approach, has privatised fewer than thirty firms in this
manner. Hungary has had no greater success. Initial public offerings are clearly not the answer to the need for rapid, large scale privatisation, although at the margin they can help develop capital markets and share trading.

3. Management-employee buyouts

Management-employee buyouts are a widely used alternative to sales, notably in Croatia, Poland, Romania and Slovenia. Many of the firms privatised through Lithuania’s and Mongolia’s voucher programs effectively became management-employee buyouts, as employees and their families used vouchers and cash to buy major stakes in their own firms. Such buyouts are relatively fast and easy to implement, both politically and technically. In theory they could also be better for corporate governance if insiders have better access to the information needed to monitor managers. However the risks and disadvantages are many, particularly in large-scale buyout programs that include many unprofitable firms in need of restructuring. One disadvantage is that the benefits are unevenly distributed, since employees in good firms get valuable assets while those in money losers get little or nothing of value. Another is that governments typically charge low prices to insiders and thereby realise little revenue. In addition management-employee buyouts may weaken corporate governance, particularly in transition economies, where controls on managers are less developed than in a fully fledged market economy and product and capital markets cannot be counted upon to enforce discipline. Insiders are generally unable to bring in new skills and new capital, yet may deter outsiders who can from investing. Managers or employees may simply prevent outsiders from buying shares. Or outsiders may hesitate to invest in firms with significant insider ownership because of potential conflicts of interest between inside and outside owners. Management-
employee buyouts can, therefore, lead to managerial and worker entrenchment that blocks further reform. Russia’s mass privatisation program of 1992-94, although it used vouchers, was basically a management-employee buyout program because of its preferential treatment of managers and workers. In the end insiders acquired about two thirds of the shares in the 15,000 privatised firms. Outsiders obtained 20 to 30% (about 10 to 15% each went to investment funds and individual investors), and the rest remained in government hands.

4. Equal Access voucher privatisation

The final form of privatisation to be discussed distributes vouchers across the population, and attempts to allocate assets approximately evenly among voucher holders. Such programs have proven to excel in terms of both speed and fairness. On the negative side they raise no revenue for government, and have unclear implications for corporate governance. Mongolia, Lithuania and the former Czechoslovakia were the first to implement this form of privatisation. Albania, Armenia, Kazakstan, Moldova, Poland, Romania (in its 1995 program), and Ukraine have followed, and Bulgaria is now preparing such a program. Some countries (such as Georgia and Russia) have used vouchers but given strong preference to insiders. A few countries (Estonia and Romania in its 1991 program) have used vouchers to transfer only minority stakes in certain firms. Hungary, FYR Macedonia and Uzbekistan are among the few privatising transition economies that have specifically rejected the use of vouchers.

It is widely accepted that the Czech Republic’s mass privatisation program has been the most successful to date. In two successive waves (the first while part of Czechoslovakia), the Czechs transferred more than half the assets of state enterprises
into private hands. Citizens were free to invest their vouchers directly in the firms being auctioned. However, to encourage more concentrated ownership and so create incentives for more active corporate governance, the program allowed the free entry of intermediary investment funds to pool vouchers and invest them on the original holders' behalf. More than two-thirds of voucher holders chose to place their vouchers with these competing funds. The ten largest obtained more than 40% of all vouchers in both waves (about 72% of all vouchers held by such funds), leading to concentrated ownership of the Czech industrial sector by these large funds. This is in stark contrast to the experience of Mongolia, which forbade the entry of intermediary funds and ended up with heavy inside ownership.

Such intermediary funds are represented on company boards, and are demanding better financial information and imposing financial discipline on the firms they own. They trade large blocks of shares among themselves or sell them to strategic investors. As a result a moderately active share market has developed on the Prague stock exchange, but is much larger in the over the counter system. Clearly, however, patterns of ownership in the Czech Republic are still in a state of flux. Some observers hope that the intermediary funds, together with banks or in place of them, will become the cornerstone of the financial infrastructure, which is essential for capital allocation and corporate governance in a market economy. Others expect the funds' influence to dwindle rapidly as strategic investors pick up controlling blocks of shares. In either case the longer term goal of institution building is operating well by this approach to privatisation. Hence the Czech experience illustrates how a well designed voucher privatisation program can overcome many problems. It can depoliticise restructuring, stimulate development of capital markets, and quickly create new stakeholders with an interest in reform. A critical determinant of the longer run success of any reform
program is the extent to which ownership rights can evolve into more efficient forms. Programs that stimulate the growth of capital and asset markets, such as the Czech Republic’s privatisation program, have a distinct advantage. In addition, Governments need also to implement complementary reforms, for example regarding the supervision of financial intermediaries and the regulation of natural monopolies. In this context the voucher privatisation model is one which could be given serious consideration by the Chinese authorities, should they wish to take the next step of privatising many of the large SOEs.

The transition economies’ experience with privatising small enterprises

Small firms have proved much easier to privatise than large ones. Most small firms are engaged in trade and service activities with simple technology and easy entry. None of the major obstacles to privatisation of large entities, such as high capital requirements, major restructuring needs and regulatory and governance weaknesses, apply to small firms. Local authorities can take charge of transferring small units and, because they are easier to value, many parties can gain access to enough information for open auctions to succeed. Privatised small businesses can serve as important schools for entrepreneurs and investors, and can absorb labour being shed from large scale enterprises. The former Czechoslovakia, Hungary and Poland were the first countries to achieve widespread ownership of small businesses, using very different approaches. The Czechs implemented a centrally conceived but locally administered system of open, competitive auctions. Poland’s program, like its large scale privatisation program, was somewhat ad hoc and gave large concessions to employees. Hungary had a reasonably sized trade and services sector even under central planning, with strong, decentralised managerial control through leasehold. This sector grew less
through widespread privatisation than through the entry of new private competitors. Following these leaders, most other transition economies have carried out substantial small scale privatisation, and Albania, the Baltic states, Croatia, Russia, and Slovenia have caught up with the earlier starters in terms of the percentage of small firms divested.

The lessons of experience from enterprise reform are quite clear and applicable across the range of transition economies. Firms surviving from the era of central planning need major restructuring of their production and reorientation of their incentives. Entities that face strict financial discipline and competition and have clear owners are most likely to undertake the needed restructuring or to exit, leaving room for new and better firms. In the short run financial discipline can be fostered through stabilisation and liberalisation measures, but in the longer run decentralised ownership, preferably private, clearly defined property rights and supporting institutions are needed to sustain financial discipline, to respond to market oriented incentives, and to provide alternative forms of corporate finance and governance. This in conjunction with the desire for long term institution building appropriate for a market economy, would suggest that China could learn a great deal from the equal access voucher approach to privatisation should, or when, this becomes politically expedient.

6. SUMMARY AND CONCLUSIONS

This paper has conducted a review of the more recent performance of China’s SOEs. Despite reforms initiated in the mid 1970s it became clear after the retrenchment period of 1988-91 that the performance of the SOEs remained weak, and that further reform was required. The adoption of the goal of attaining a socialist market economy by the Communist Party in 1992,
spurred a renewed phase of SOE reform. Emphasis was to be given to the corporatisation of SOEs through an intensification of the shareholding experiment begun in the 1980s, the establishment of enterprise groups along the lines of Korea’s chaebols, and small and medium sized SOEs were to be sold, leased or in the case of loss making enterprises allowed to go bankrupt.

The performance of the SOEs has shown further deterioration over the past few years and this has been intensified by the implementation of a three year austerity program, implemented with the objective of reducing inflation and achieving a more sustainable growth rate. The deteriorating performance of the large SOEs in 1995 and 1996 led to an expansion of bank loans to them, which led many economists to question the government’s real commitment to SOE reform. However progress is being made albeit slowly. Reform has been implemented in areas which have adversely affected SOE profits, including that of price liberalisation, greater flexibility in the hiring and firing of workers and social security reform. The latter reducing the financial burden which SOEs face in regard to the provision of housing, health, and pensions, and in addition a more widespread unemployment insurance scheme. These are essential if further reform of SOEs are to be implemented, and most crucially that relating to the need to impose financial discipline and to eliminate the link between them and the commercial state banking sector. Unless this is done further reform of the financial sector will be difficult, including the development of instruments for indirect macroeconomic control so urgently required in China’s emerging market economy. This will mean job losses in the state sector. However, the encouraging rapid development of the non state sector, and in particular the tertiary sector, suggests that some of the anticipated 18-20 million workers who will lose their jobs in the state sector over the next five years, will be absorbed by the dynamic non state sector.
The experience from other transition economies is that the imposition of financial discipline, in conjunction with an opening up of markets and increased competition, is the best way to bring about an improved performance of SOEs. Decentralisation of ownership, also seen as essential, has been achieved in most of the other transition economies through both the privatisation of SOEs and the entry of new private businesses. In the case of China, decentralisation of ownership has been occurring primarily through the expanding significance of the non state sector as well as limited “privatisation” of large SOEs and the selling off of small and medium sized SOEs. In China, however, public ownership of the pillar industries of the economy will remain for the foreseeable future at least. However reforms in terms of corporatisation, the development of stock exchanges, standardisation of accounting practices suggest that a framework for the future privatisation of large SOEs is being put in place.

A number of privatisation methods adopted in the other transition economies were outlined. Some of these could be utilised in the context of China’s large SOEs at a future date. Spontaneous privatisation should be avoided, sales to “core” investors of large SOEs may be politically possible in China as long as they were to domestic rather than foreign owners, management-employee buyouts may be difficult at the large SOE level but more practical at the medium to small SOE level, while equal access voucher privatisation may provide the most appropriate framework of all. The latter would fit well with China’s institution building in terms of the development of strong financial intermediaries.
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