The Business(es) of the Chinese State

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* The views contained in this paper are those of the author’s alone and do not necessarily reflect the views of the World Bank Group, its member countries or its Board.

Keywords: industrial organization, transition, institutional development
Abstract. The State industrial sector is the Achilles heel of China’s otherwise remarkable economic performance over the past two decades. Most other countries in transition from socialism have transformed SOEs into commercial entities through systematic, market-driven restructuring and privatization to become more efficient and competitive. In China, a series of innovative, if often administrative, institutional reforms since 1978 have begun to achieve the Chinese authorities’ goal of “separating government from businesses.” But the Chinese State still maintains ownership of key enterprises, and government agencies carry out shareholder functions typically performed by private owners in a market economy. Although privatization and restructuring of SOEs is occurring, it mostly pertains to small and medium sized firms. For the principal businesses, by contrast, the creation of large state enterprise groups and holding companies (and experiments in other forms of “state asset management”) have become the main form of restructuring. Today, China’s SOEs still account for more than one-quarter of national production, two-thirds of total assets, more than half of urban employment and almost three-quarters of investment. While direct budgetary subsidies have declined, explicit and implicit subsidies are still making their way to prop up loss-making SOEs through the financial system and other routes. At the same time, SOEs are still producing non-marketable products, resulting in a sizeable inventory overhang. These inefficiencies and distortions represent a drain on the country’s resources and thus present a challenge to the Chinese leadership for reform. This paper sheds light on these challenges by analyzing the incentives and constraints on China’s SOE reform program. Four critical aspects of the reforms are highlighted and evaluated against the backdrop of international experience: clarification of property rights; establishment of large group/holding companies and other new organizational structures; improved corporate governance incentives; and implementation of international financial accounting and auditing practices. The paper concludes with policy recommendations.
The Business(es) of the Chinese State

Introduction

It is increasingly recognized—both within and outside China—that the SOE sector is the Achilles heel of China’s otherwise remarkable economic performance over the past two decades. Most other countries in transition from socialism have transformed SOEs into commercial entities through systematic, market-driven restructuring and privatization to become more efficient and competitive. In China, a series of innovative, if often administrative, institutional reforms since 1978 have begun to achieve the Chinese authorities’ goal of “separating government from businesses.” But the Chinese State still maintains ownership of key enterprises, and government agencies carry out shareholder functions typically performed by private owners in a market economy. Although privatization and restructuring of SOEs is occurring, it mostly pertains to small and medium sized firms. For the principal businesses, by contrast, the creation of large state enterprise groups and holding companies (and experiments in other forms of “state asset management”) have become the main form of restructuring. Today, China’s SOEs still account for more than one-quarter of national production, two-thirds of total assets, more than half of urban employment and almost three-quarters of investment. While direct budgetary subsidies have declined, explicit and implicit subsidies are still making their way to prop up loss-making SOEs through the financial system and other routes. At the same time, SOEs are still producing non-marketable products, resulting in a sizeable inventory overhang. These inefficiencies and distortions represent a drain on the country’s resources and thus present a challenge to the Chinese leadership for reform. With China’s accession to the WTO, the inefficient SOE sector will be particularly vulnerable to international competition, heightening the leadership’s need to deal with these problems.

This paper sheds light on these challenges by analyzing the incentives and constraints on China’s SOE reforms. It begins with a description of China’s industrial structure and the role played by SOEs in the economy. This is followed by an analysis of the ‘SOE problem’ that continues to confront the Chinese leadership. The paper then turns to an assessment of how China’s authorities are seeking to implement the modern corporate form as the centerpiece of their reform initiative for a “socialist market economy”. Four critical aspects of the reforms are highlighted and evaluated against the backdrop of international experience: clarification of property rights; establishment of large group/holding companies and other new organizational structures; improved corporate governance incentives; and implementation of international financial accounting and auditing practices. The paper concludes with policy recommendations.

China’s Industrial Structure

China’s enterprise landscape is comprised of several different ownership forms (see Table 1). The total number of enterprises in the industrial sector is about 8 million. Although recent re-classification of the data on enterprise ownership by China’s statistical authorities makes comparisons imprecise, of the 8 million industrial firms there are: (i) approximately 61,000 “SOEs”, defined as firms with at least 51% state ownership and with annual sales income above 5 million yuan; (ii) 1.7 million “Collectives”, including urban collectives and rural “township and village enterprises” (TVEs); (iii) 6 million “Individually Owned” firms, defined as private firms that have no more than seven employees; and (iv) 92,000 “Other” firms.

defined as private firms with more than seven employees, Sino-foreign joint ventures and fully foreign-funded businesses.

Table 1: Ownership Structure of Chinese Enterprises
(Number of enterprises)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>SOEs</th>
<th>Collectives</th>
<th>Individually Owned</th>
<th>“Other”†</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>9.91mn</td>
<td>100.5th</td>
<td>1.80mn</td>
<td>7.97mn</td>
<td>32.1th</td>
</tr>
<tr>
<td>1994</td>
<td>10.00mn</td>
<td>102.2th</td>
<td>1.86mn</td>
<td>8.01mn</td>
<td>44.5th</td>
</tr>
<tr>
<td>1995</td>
<td>7.34mn</td>
<td>118.0th</td>
<td>1.48mn</td>
<td>5.69mn</td>
<td>60.3th</td>
</tr>
<tr>
<td>1996</td>
<td>7.99mn</td>
<td>127.6th*</td>
<td>1.59mn</td>
<td>6.21mn</td>
<td>70.2th</td>
</tr>
<tr>
<td>1997</td>
<td>7.93mn</td>
<td>110.0th**</td>
<td>1.77mn</td>
<td>5.97mn</td>
<td>77.3th</td>
</tr>
<tr>
<td>1998</td>
<td>7.97mn</td>
<td>64.7th***</td>
<td>1.80mn</td>
<td>6.03mn</td>
<td>85.7th</td>
</tr>
<tr>
<td>1999</td>
<td>7.93mn</td>
<td>61.3th***</td>
<td>1.66mn</td>
<td>6.13mn</td>
<td>91.8th</td>
</tr>
</tbody>
</table>

* The 1998 China Statistical Yearbook reports the number of SOEs in 1996 as 113.8t, and the 1999 China Statistical Yearbook reports the number of SOEs in 1996 as 127.6t. The upward revision is due to adding to the number of wholly state owned firms, enterprises for which the state holds at least a majority controlling interest.

** The 1998 China Statistical Yearbook reports the number of SOEs in 1997 as 98.6t, and the 1999 China Statistical Yearbook reports the number of SOEs in 1997 as 110.0t. The upward revision is due to adding to the number of wholly state owned firms, enterprises for which the state holds at least a majority controlling interest.

*** Refers to only SOEs (i) with annual sales income of over 5 million yuan and (ii) where the state holds the majority of shares.

† “Other” refers to private firms with more than 7 employees, Sino-foreign joint ventures and fully foreign-funded businesses.

Source: China Statistical Yearbook, various years

In Chinese statistical terminology, “nonstate” enterprises include all ownership forms other than SOEs. Most “Collectives” are also public enterprises, with ownership structures generally dominated by local government shares, mixed in with other shareholders, including labor unions, groups of individuals and SOEs. “TVEs” (generally Collectives located in rural areas and suburbs) were envisaged in the late 1980s and early 1990s as the key to China’s future industrial prosperity. But due in part to their fuzzy property rights and competitive disadvantage vis a vis SOEs (which enjoyed subsidies and other protections), they have had trouble transforming themselves into efficient enterprises.²

China’s bona fide private sector usually encompasses firms in the “Individually Owned” and “Other” categories. In broad terms, Table 1 indicates that since 1993 while the number of “Collectives” has changed relatively little and there has been a modest decrease in the number of “Individually Owned” firms, the number of enterprises in the private sector “Other” category has markedly increased. This reflects a substantial emergence of the private sector in China, especially beginning in 1998—an apparently pivotal year in enterprise restructuring.

The data also indicate there has been a substantial decrease in the number of firms classified as “SOEs”—again, particularly since 1998. In part, this is due to changes in the statistical classification of “SOEs”, where firms are not included in this category if they have state ownership shares below 51 percent and annual sales less than 5 million yuan. But the decrease in the number of registered SOEs also

² See World Bank (1999).
reflects changes in ownership forms of SOEs, including contracting out, leasing, and sale—that is, privatization—as well as enterprise liquidation and closures. While the official statistics do not allow for ascertaining with any certainty the relative or absolute magnitudes of these ownership changes, privatizations of SOEs (and sizeable employee layoffs) are occurring—such actions have been widely reported in the press with increasing frequency in the last 2-3 years and reflected in survey data—but such transformations largely pertain to smaller SOEs located in the small- and medium-sized cities. Indeed, in some provinces almost 50 percent of small SOEs have been divested. Yet total SOE assets continue to grow: as Table 2 indicates, the value of fixed assets of industrial SOEs as a whole has been steadily increasing in recent years.

<table>
<thead>
<tr>
<th>Table 2: Fixed Assets of Industrial State Owned Enterprises</th>
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<tbody>
<tr>
<td>Total Fixed Assets (Yuan)</td>
</tr>
<tr>
<td>n/a</td>
</tr>
<tr>
<td>Annual Change</td>
</tr>
</tbody>
</table>

Source: *China Statistical Yearbook*, various years

Table 3 shows the trend over time of the changing composition of industrial output among the various enterprise forms since 1993. The national share of output produced by SOEs has declined from just under one-half to just over one-quarter. At the same time, the share accounted for by Collectives rose slightly from 34 percent then decreased to 35 percent. Taken together, today, Chinese public enterprises account for more than 60 percent of national industrial output. In contrast, the growth in the output shares by the private sector—“Individually Owned” and “Other” firms—has more than doubled: at present the share of the Chinese private sector is more than 40 percent. These data, in combination with those in Table 1, indicate that while by number, the vast majority of enterprises in China are those in the private sector and of relatively small scale, the lion’s share of output is produced by relatively larger, public sector firms.

<table>
<thead>
<tr>
<th>Table 3: Share of Gross Output Value of Chinese Industrial Enterprises</th>
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<tbody>
<tr>
<td>SOEs</td>
</tr>
<tr>
<td>Collectives</td>
</tr>
<tr>
<td>Individually Owned</td>
</tr>
<tr>
<td>“Other”†</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Note: the shares data do not sum to 100% exactly due to rounding and statistical changes in the authorities’ reporting tables.

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The 1998 China Statistical Yearbook reports the share of GVIO of SOEs in 1996 as 29%, and the 1999 China Statistical Yearbook reports the share of GVIO of SOEs in 1996 as 36%. The upward revision is due to adding to the number of wholly state owned firms, enterprises for which the state holds at least a majority controlling interest.

** The 1998 China Statistical Yearbook reports the share of GVIO of SOEs in 1997 as 26%, and the 1999 China Statistical Yearbook reports the share of GVIO of SOEs in 1997 as 32%. The upward revision is due to adding to the number of wholly state owned firms, enterprises for which the state holds at least a majority controlling interest.

*** Refers to only SOEs (i) with annual sales income of over 5 million yuan and (ii) where the state holds the majority of shares.

† “Other” refers to private firms with more than 7 employees, Sino-foreign joint ventures and fully foreign-funded firms.

Source: China Statistical Yearbook, various years

The distribution of employment of staff and workers across the different enterprise classes in the industrial sector is depicted in Table 4. Although there has been a decline in SOE employment shares since 1993—marked by a substantial drop-off in 1998—today the majority of industrial workers—55%—are still employed in SOEs. Importantly, the share of workers employed in the private sector has quintupled since 1993. In 1999, workers employed in private sector firms were paid the highest average wage, followed by workers employed in SOEs; among the three enterprise categories, workers in Collectives were paid the lowest average wage.

<table>
<thead>
<tr>
<th>Table 4: Employment in Chinese Industrial Enterprises</th>
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</thead>
<tbody>
<tr>
<td>(Staff and workers)</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>1993 1995 1997 1998 1999</td>
</tr>
<tr>
<td>------------------------------------------------------</td>
</tr>
<tr>
<td>SOEs Share</td>
</tr>
<tr>
<td>45.0m 44.0m 40.4m 27.2 24.1</td>
</tr>
<tr>
<td>68% 67% 65% 57% 55%</td>
</tr>
<tr>
<td>Collectives Share</td>
</tr>
<tr>
<td>17.0m 15.0m 13.3m 8.0 6.7</td>
</tr>
<tr>
<td>26% 23% 21% 17% 15%</td>
</tr>
<tr>
<td>“Others” Share</td>
</tr>
<tr>
<td>4.3m 7.1m 8.5m 12.3 13.4</td>
</tr>
<tr>
<td>6% 10% 14% 26% 30%</td>
</tr>
<tr>
<td>Total Share</td>
</tr>
<tr>
<td>66.3m 66.1m 62.2m 47.5 44.2</td>
</tr>
<tr>
<td>100% 100% 100% 100% 100%</td>
</tr>
</tbody>
</table>

* “Others” here refers to all private sector firms, including “individually owned” enterprises, private firms with more than seven employees, Sino-foreign joint ventures and fully foreign-funded firms.

Source: 2000 China Statistical Yearbook

China’s ‘SOE Problem’

The sizeable market share attained by China’s private sector has been a significant achievement in the country’s enterprise reform program. Propelled by the authorities’ deliberate strategy of liberalized market entry, removal of price controls, eased investment restrictions, increased tax neutrality across enterprise forms, and exposure of the domestic market to international competition, the emergence of private firms has been the engine of China’s growth. It has been estimated that private sector firms have created more jobs since 1994 than have SOEs, Collectives and Joint Ventures combined. The aggregate 40 percent national market share of the private sector masks the fact that in some sectors, such as light

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4 Rawski (1999).
manufacturing (toys, footwear, and garments) and retail consumer goods, the share of sales by nonstate firms now greatly exceeds that of SOEs.

Nonetheless, SOEs generally dominate key portions of China’s industrial economy and remain firmly entrenched despite the growth of the private sector. SOEs provide essential raw materials and are the major producers in such capital-intensive sectors as power, steel, chemicals and machinery. In heavy industry and in certain manufacturing sectors, SOE output shares remain very high and have changed little over the decade. In services and infrastructure, there is virtually no private sector in banking, telecommunications, wholesale distribution, and certain transport activities, among others. In many markets, SOEs are protected from market pressures and able to abuse their dominant market positions and prevent entry by new firms—aided by a variety of measures, such as provision of subsidies, restrictions on licenses to new business startups, loose bank credit and repayment terms and below-market energy and other input prices sanctioned by government and Party officials, particularly at the local level where vested interests are strongest. Overall, by the start of 2000 China’s industrial SOEs accounted for 70 percent of fixed assets, 69 percent of total assets, and 51 percent of sales revenues.5

Several historical factors give rise to China’s ‘SOE problem’. Typically, most Chinese SOEs were established by administrative fiat during the period of strong central planning rather than by market forces. As a result, many SOEs suffer from artificially determined location, size, product mix, technology and capital/labor combinations. Many also are handicapped by: (i) rigid patterns of horizontal and vertical integration that engenders an excessive degree of self-sufficiency, with firms locked-in to “internally” producing their own inputs and distributing their own outputs; (ii) a prevalence of plant designs at less-than-minimum efficient scale and limited realization of economies of scope especially across geographic markets, giving rise to excessive regional duplication of facilities—for example, there are over 120 vehicle manufacturers that are fragmented and inefficient; (iii) redundant workers, where overstaffing is generally thought to be at least 30 percent; and (iv) use of obsolete, inefficient and heavily-polluting technologies. The SOE problem is also rooted in the system under which enterprises’ productive objectives have been co-mingled with social objectives of government. Thus the typical SOEs bears the obligation to provide “cradle-to-grave” social services—employee housing, hospitals, schools, stores, restaurants, among other facilities. These attributes of SOEs are not unique to China, but reflect the legacy of central planning that has been common among other transition economies.6

History of Reforms. Dealing with this legacy has been the central challenge facing the Chinese authorities since 1978 in their reform of SOEs.7 In addition to enabling the growth of private firms, numerous administrative and institutional reforms have been pursued focused on modifying the State’s role as SOE shareholder. These reforms have included the use of SOE incentive contracting; giving SOE managers greater autonomy; corporatization of SOEs; and transforming SOEs into joint stock companies.

A centerpiece of these experiments has been decentralization of governmental authority over SOEs, with all but about 2-3,000 industrial SOEs placed under the supervision of local governments rather than under the central authorities in Beijing. At the same time, large-scale national enterprise groups or holding companies, entrusted to manage directly state assets, are being established. Experiments have also

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5 2000 China Statistical Yearbook
6 For example, Russia. See Broadman (2000).
7 For a history of China’s SOE reforms see Broadman (1995).
been undertaken in establishing a multi-tiered organizational network of state asset management bureaus, state asset operating companies and state asset supervisory committees. These various entities are to be the representatives of the State as owner of SOEs, as sector line bureaus and ministries, which have been the traditional hallmarks of the planned economy, are either phased out or limited to carry out trade association or non-ownership, governmental regulatory functions.

The initial thrust of the Government’s current SOE reform program was launched by the “Decision on the Socialist Market Economy,” adopted in November 1993 by the Communist Party’s 14th Congress. The Decision outlined the general parameters for establishing a “modern enterprise system”, with a central focus on reform of SOE property rights. Subsequent to the watershed Decision, several high-level SOE reforms were initiated, including the “10,000-1000-100-10” experiment begun in 1994 (where the numbers refer to the count of enterprises and cities undergoing various reforms), and more importantly, the Ninth Five-Year Plan (1996-2000). The Ninth Five-Year Plan set in motion a program to “grab and reinvigorate” 1,000 large “priority” SOEs selected by the central authorities, and “letting go” of small SOEs through a special fund to encourage their “reorganization, bankruptcy, debt write-offs, merger into partnerships, leasing, contractual operation or sales, as their specific circumstances permit.”

President Jiang Zemin’s widely reported speech during the 15th National Congress of the Communist Party in the fall of 1997 contained a more formal embrace of ownership diversification of SOEs than heretofore had been the case. When he declared that “even if the state-owned sector accounts for a smaller proportion of the economy, this will not affect the socialist nature of our country”, many observers concluded that China’s leadership had turned to embrace widespread SOE privatization, marking a watershed shift of the SOE reform strategy. But Jiang also announced in the same speech that public ownership of enterprises should retain the dominant position in the Chinese economy. With a new government under the leadership of Prime Minister Zhu Rongji installed in March 1998, reform of SOEs received renewed attention, with a focus on creation of inspection teams to monitor and improve performance in 512 large enterprises, establishment of trade fairs in several cities to dispose of small SOEs, and restructuring of government agencies dealing with enterprises, including the reduction of the number of sector ministries and commissions from 40 to 29. In the summer of 1998 Jiang sought to clarify the leadership’s position on SOE reform, noting that “without a state-owned industrial sector, there can be no socialism.” The Constitution was amended in March 1999 to give greater emphasis to the private sector. Article 11 was modified such that the clause “the private economy is a supplement to public ownership” was replaced with “the non-public sector, including individual and private businesses, is an important component to the socialist market economy.”

The most recent refinements of the SOE reform program are incorporated in (i) the “Decision on Major Issues Concerning the Reform and Development of State-Owned Enterprises” (hereafter “Decision”) adopted by the Fourth Plenum of the 15th Communist Party Central Committee in September 1999, (ii) a Policy Statement issued by the State Development Planning Commission (SDPC) in January 2000, and (iii) the 10th Five Year Plan (2001-2005) presented at the Fifth Plenary Session of the 15th Congress of the Communist Party in October 2000 and approved by the Ninth National People’s Congress in March 2001.

The September 1999 Decision specified that while state ownership would be reduced in many industrial sectors, SOEs would remain dominant in (i) “pillar industries and backbone enterprises in high technology sectors”; (ii) non-renewable natural resource sectors; (iii) public utility and infrastructure services sectors; and (iv) sectors vital to the country’s national security. Although the Decision urged
greater corporatization of SOEs, it also reiterated the importance of the Communist Party retaining its leading role in SOEs, including the control of enterprise personnel and cadres.

The January 2000 SDPC policy statement indicated that the government would “actively guide and encourage private investment” and would “eliminate all restrictive and discriminatory regulations that are not friendly towards private investment and private economic development in taxes, land use, business start-ups, and import-and-export.” The SDPC statement, which is intended to put the private sector on equal footing with SOEs, has been widely regarded as one of China’s strongest endorsements ever to free enterprise.

The 10th Five Year Plan pinpoints SOE reform for 2001-05 as the key link in China’s structural adjustment and calls for “large and medium sized SOEs to deepen their reforms to establish a modern corporate system characterized by clear ownership, explicit rights and responsibility, disconnection between the government and enterprises.” Still, the current Five Year Plan continues the leadership’s thematic that the Chinese state is to maintain a key role in business. Moreover, while it stresses the beneficial role of the private sector, like the 15th Party Central Committee Decision and the SPDC statement, there is no formal embrace of privatization of large SOEs. In short, there is continuation of the type of balancing act with regard to the place of private enterprise in China that has become the hallmark of the reform program. This is perhaps best epitomized in Prime Minister Zhu Rongji’s speech on the plan delivered at the March 2001 National People’s Congress: “We need to uphold the dominance of the public sector of the economy, let the state-owned sector play a leading role, develop various forms of collective undertakings, and support, encourage and guide a healthy development of private and individual sectors of the economy.”

Remaining Challenges. There is little question that some of China’s SOE reform experiments have been genuinely creative. Indeed, the judicious application of market incentives has increased SOE factor productivity growth rates (although the magnitude of the increase has been difficult to measure with precision). Clearly, as well, the emergence of the private sector has played a key role in fostering inter-enterprise competition. But as important as China’s SOE institutional reforms have been, they have been largely administratively determined and excessively incremental in their approach. Few have squarely tackled the fundamental problems that public enterprise poses to any economy, especially one where such firms constitute the industrial backbone. While some of the reforms have provided temporary relief, few have been enduring successes. Worse still, some of the experiments have been contradictory and have engendered wholly new—indeed unanticipated—problems, including asset-stripping, tax evasion, de-capitalization, wage manipulation, privatization of assets whilst the socialization of liabilities, and corruption. It appears that much of what privatization of SOEs has occurred has not markedly improved corporate governance and efficiency, and there are reports of workers being pressured to purchase shares in their firms’ privatizations.

The result is that despite China’s record economic growth, SOE pre-tax profits as a share of GDP have declined since 1993—although they have begun to turn around since 1998, as shown in Table 5. Still, in 1999 the rate of return for industrial SOEs of pre-tax profits on total assets was only 6.4 percent. At the same time, an increasing proportion of SOEs are losing money: official data indicate that at least one-


9 For the debate over the impact of Chinese SOE reform on total factor productivity see Groves, Hong, McMillan, and Naughton (1994); Jefferson and Rawski (1996); and Woo, Hai, Jin, and Fan (1994).
half of industrial SOEs incur net losses—up from one-third just a few years ago; including underreported losses—often uncovered in audits—would raise current official figures even higher.\textsuperscript{10} While absolute losses have increased substantially since 1993, as a share of GDP they have essentially stayed in the 1 percent range, as shown in Table 5.

Loss-making SOEs are largely concentrated among the small and medium sized firms, and in recent years generally only large SOEs have registered profits. Not surprisingly, inventories of unsold SOE products have been an increasing problem. The 1995 industrial census revealed that factory capacity utilization rates for major consumer and industrial products of SOEs stood at about 60 percent; a 1999 official report suggested further deterioration; and in March 2000 Prime Minister Zhu Rongji noted in his annual speech to the National People’s Congress that SOEs should “limit the production of non-marketable products.”\textsuperscript{11} Overcapacity spans a broad range of industries, including steel, glass, cement, chemicals, machinery, motor vehicles, fertilizer, textiles, garments, appliances, paper, coal, and oil refining.\textsuperscript{12}

\begin{table}[h!]
\centering
\caption{Losses and Profits of Chinese Industrial State Owned Enterprises *}
\begin{tabular}{|c|c|c|c|c|c|c|c|}
\hline
\hline
Losses (Yuan) & 45.3 bn & 48.3 bn & 64.0 bn & 79.1 bn & 83.1 bn & 85.1 bn & 76.9 bn \\
\hline
As a Share of GDP & 1.3 % & 1.0% & 1.1% & 1.1% & 1.1% & 1.1% & 0.09% \\
\hline
Pre-Tax Profits (Yuan) & 245.4 bn & 287.6 bn & 287.4 bn & 273.7 bn & 290.7 bn & 337.1 bn & 407.9 bn \\
\hline
As a Share of GDP & 7.1 % & 6.2% & 4.9% & 4.0% & 3.9% & 4.3% & 5.0% \\
\hline
\end{tabular}
\end{table}

*Officially reported losses and pre-tax profits. “Pre-tax profits” is the sum of what the Chinese statistical authorities define as “total profits”, sales taxes, sales tax surcharges, and value-added taxes (since “total profits” is net of all such taxes but gross of income of taxes).
Source: China Statistical Yearbook (various years); 2000 Statistical Communiqué; China Statistical Information Network (December 2000).

To be sure, many SOEs in China are probably bankrupt, and in a market economy they would either exit or be taken over and drastically restructured. In the past, substantial fiscal subsidies from the budget have helped artificially prop up loss-making enterprises. Such subsidies as a percentage of GDP or of central budgetary expenditures have declined in recent years, although in absolute amounts they have remained relatively stable, as Table 6 indicates. Still, other aspects of a “hard budget constraint”—such as commercial credit discipline from the financial sector or implementation of bankruptcy proceedings—on SOEs are not systemically applied.

\begin{flushleft}
\textsuperscript{10} In 1998 an audit of 162 key loss-making enterprises found that losses were twice as high as reported; see World Bank (1999).
\textsuperscript{11} China Daily (2000).
\textsuperscript{12} See Rawski (1999).
\end{flushleft}
Table 6: Budgetary Subsidies To Loss-Making Chinese Industrial Enterprises

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Subsidies</strong></td>
<td>41.1 bn</td>
<td>36.6 bn</td>
<td>32.8 bn</td>
<td>33.7 bn</td>
<td>36.9 bn</td>
<td>33.4 bn</td>
<td>29.0 bn</td>
</tr>
<tr>
<td>As a Share of GDP</td>
<td>1.2%</td>
<td>0.8%</td>
<td>0.6%</td>
<td>0.5%</td>
<td>0.5%</td>
<td>0.4%</td>
<td>0.4%</td>
</tr>
<tr>
<td>As a Share of Government Expenditures</td>
<td>8.9%</td>
<td>6.3%</td>
<td>4.8%</td>
<td>4.2%</td>
<td>4.0%</td>
<td>3.1%</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

Source: 2000 China Statistical Yearbook

Exacerbating these “real sector” inefficiencies, China’s SOEs absorb more than three-fourths of domestic bank credit. Their low level of profits translate into small retained earnings, and as a result, SOEs rely heavily on credit—perhaps 90 percent—to finance working capital needs. At the same time, investment by SOEs continues to be substantial. Yet because profits are so low, they face a large investment-savings deficit, which in recent years has comprised about 60 percent of the total nonfinancial public sector deficit. The sizeable demand on bank borrowing undermines an already weak state-dominated banking system. Official estimates place at least 20 percent of bank portfolios as constituting non-performing loans, largely to SOEs. Perhaps most important, the large demand on bank borrowing crowds out access to credit and thus investment by private sector firms, even though it is widely known that private firms in China have far stronger loan payback rates than do SOEs, for whom unpaid loans are often rolled over.

Overall, the essence of the ‘SOE problem’ is that China has a relatively concentrated industrial structure—where the top approximately one percent of firms accounts for just over one-quarter of national output—dominated by many inefficient, badly-structured and poorly-run SOEs. This situation leads to misallocation of resources and macroeconomic imbalances—most notably in recent years the problem of overcapacity and deflation. The distribution of resources is distorted in that government authorities still play a role in the allocation of investment funds, and capital does not necessarily move to sectors where it is most productive. Social services are tied to enterprises making the provision of such services inefficient and hindering workers’ ability to move easily to where employment demand is strongest. Macroeconomic imbalances arise because SOEs are able to finance only a small share of their investment and their borrowings absorb a disproportionately large share of bank credit. China’s relatively high savings and low domestic debt as a share of GDP have made it possible to absorb these inefficiencies in the short- to medium-term. But the long term impact on the government's discretionary expenditure capacity, on banks’ portfolios, and on the pattern of resource allocation makes such a burden unsustainable. By spilling over to the financial and fiscal sectors, China’s ‘SOE problem’ jeopardizes other critical elements of the government’s economic reform program.

Against this backdrop, it is not surprising that the SOE reform experiments carried out to date have not met the policy aspirations of the Chinese leadership. In part this is reflected in the authorities’ continuation of such experiments, although still in their now-traditional evolutionary pattern of fits and starts. Perhaps more important, it is reflected in the Chinese leadership’s November 1999 WTO

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13 See Lardy (1999).
accession agreement with the U.S.\textsuperscript{14} If fully implemented—particularly at the local level—it would exert greater competitive pressure on SOEs than heretofore has been the case and potentially usher in a watershed transformation of China’s overall enterprise sector.

**The Chinese Corporate Form**

China’s authorities have called for establishing a “modern enterprise system” in the SOE sector. In many respects, the model for reform on which the Chinese program is based is the modern corporation.\textsuperscript{15} Within the context of the “socialist market economy,” the Chinese corporate form—as set out in the 1994 Company Law—has effectively become the vehicle for (i) “separating” governmental and business functions and (ii) “state asset preservation and increase.” These are the two policy goals that lie at the heart of China’s SOE reforms.\textsuperscript{16}

The universal problem of a modern corporation’s owners—whether in China or elsewhere—is how to establish an *internal* incentive structure of the enterprise so that managers attain owners’ goals, and at the same time ensure that the firm is exposed to various *external* incentives that influence the conduct of managers in such a way to enhance firm performance. The extent of China’s ‘SOE problem’ suggests that implementation of the modern corporate form in China is still evolving. Figure 1 illustrates the situation today for the typical large Chinese SOE. Internal incentives are blunted because of the ill-defined relationship between an enterprise’s owners (the state, represented by government) and its management (also the government) and the co-mingling of social and productive functions. Discipline from external incentives is not fully operable due to insulation from market pressures, including competition in product markets, weak labor mobility, a nascent “market for corporate control”, banks that do not operate fully according to commercial principles, and poor implementation of bankruptcy procedures.

\textsuperscript{14} The agreement contains many provisions. Among the more important from the perspective of SOE reform are the following measures: average import tariffs would be cut to 17 percent from 22.1 percent; export subsidies would be eliminated; all manufacturers would be able to import and export freely and have freedom to establish distribution, retail and after-sales networks; local content and other trade-related investment measures (TRIMs) would be phased out; protection in the key automobile sector would be significantly reduced, with import tariffs on cars phased down from 80 percent to 25 percent over six years and foreign car producers would have full distribution, trading and auto financing rights; foreign investment in telecommunications and internet enterprises would be liberalized, with 49 percent ownership permitted at the time of accession, rising to 50 percent (with management control) within two years; trade and investment in other services sectors, such as management consulting, accounting and auditing, insurance, financial information, and computer services, would be liberalized; and foreign banks would be able to conduct local currency business with Chinese enterprises two years after accession and retail business five years after accession. Equally important, following accession, the country’s overall trade policy framework would be subject to WTO’s rules-based system, transparency standards, and dispute resolution procedures, which will engender further discipline on the enterprise sector. Space does not permit a complete description of the November 1999 agreement. Summaries of the agreement can be found at, among other places, USTR’s Press Statements (http://www.ustr.gov/releases/1999/11/99-95.pdf and http://www.ustr.gov/releases/1999/11/cbchina.pdf); China Online (http://www.chinaonline.com/issues/wto/newsarchive/secure/1999/november/e9111521.asp); and *The Economist* (1999).

\textsuperscript{15} For a classic description of the modern corporation see Berle and Means (1932; reprinted in 1967).

\textsuperscript{16} For a more complete description of these objectives see World Bank (1997).
Chinese SOE Property Rights

One of the main thrusts of China’s SOE reforms has been to clarify property rights. This effort has focused on delineating the roles of the State and SOEs through introducing managerial autonomy; corporatizing SOEs; clarifying the role of the State as SOE owner; and defining the role of the State as regulator.

Some degree of managerial autonomy has been introduced. In 1992 a regulation was issued to cede to SOE managers *Fourteen Autonomous Management Rights*. These include the right to set prices, the right to hire and fire workers, the right to make investments, and so on. The results of a World Bank survey\(^\text{17}\) of 156 large SOEs in five different cities participating in one of the high-level reform experiments a few years ago indicate implementation of the *Fourteen Autonomous Management Rights* has been highly uneven. As Table 7 shows, few of the surveyed industrial SOEs enjoy all such rights.

Government agencies often exercise both the shareholder and regulator roles. This creates conflicts of interest. Moreover there are often multiple government agencies exercising the role of owner, overlapping with one another. The result is that across agencies—both horizontally and vertically—there is fragmentation and partial exercise of the ownership function, with no single entity responsible for an SOE’s “bottom line.” Consequently SOE managers are *de-facto* enjoying more autonomy than otherwise formally indicated. But they are doing so largely not by design, but because property rights are poorly defined. The result is that to the extent subsidies make their way to SOEs, to the extent SOEs are protected from competition in product and factor markets by policy barriers to entry or similar institutional constraints, or to the extent that debt-service obligations go unmet because the state-owned banks themselves do not yet fully operate according to commercial principles, SOE managers face few checks and balances in abiding by property rights.

Corporatization of SOEs is proceeding, but only gradually. The business license registration process illustrates why, absent policy changes, transforming Chinese SOEs into *bona fide* companies is likely to proceed slowly. Identification of an SOE’s “investor,” which must be specified in the articles of

\(^{17}\) See World Bank (1996).
association under the Company Law, is often a difficult task. This is not simply a problem of tracing funds; it is a political economy problem of assigning property rights. The competing claimants—the various government departments and agencies, including line bureaus and ministries—often cannot reach consensus as to who is (or shall be) the “investor.” This property rights assignment problem is exacerbated when an SOE has large liabilities (a common feature) and an asymmetry in the allocation of rights and obligations for good and bad assets: everybody wants the valuable assets, but nobody wants the liabilities.

Table 7: Incidence of Management Autonomy in Chinese SOEs

<table>
<thead>
<tr>
<th>MANAGEMENT RIGHTS</th>
<th>PERCENT</th>
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</thead>
<tbody>
<tr>
<td>1. Production Autonomy</td>
<td>97</td>
</tr>
<tr>
<td>2. Pricing autonomy</td>
<td>72</td>
</tr>
<tr>
<td>3. Selling Autonomy</td>
<td>96</td>
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<tr>
<td>4. Purchasing Autonomy</td>
<td>93</td>
</tr>
<tr>
<td>5. Import and Export Rights</td>
<td>43</td>
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<tr>
<td>6. Investment Autonomy</td>
<td>49</td>
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<tr>
<td>7. Use of Retained Earnings</td>
<td>78</td>
</tr>
<tr>
<td>8. Right to Dispose of Assets</td>
<td>38</td>
</tr>
<tr>
<td>9. Autonomy to Establish Joint-Ventures; Mergers; Acquisitions</td>
<td>42</td>
</tr>
<tr>
<td>10. Right to Hire Workers</td>
<td>61</td>
</tr>
<tr>
<td>11. Right to Manage Personnel</td>
<td>57</td>
</tr>
<tr>
<td>12. Right to Determine Wages and Bonuses</td>
<td>63</td>
</tr>
<tr>
<td>13. Right to Decide on Organizational Structure</td>
<td>79</td>
</tr>
<tr>
<td>14. Right to Refuse Unregulated Government Collections</td>
<td>19</td>
</tr>
</tbody>
</table>

Percentage of surveyed SOEs indicating “full implementation” of each management right

Not surprisingly in this environment, SOEs resist independent regulatory organs as they fear erosion of their rights. This gives rise to disputes between stakeholders. There are, however, no formal, transparent mechanisms to settle these disputes and build a body of case law to interpret the SOE legal framework. The resulting unchecked insider control leads to asset stripping, with the State as owner assuming the liabilities of loss-making SOEs. The socialization of the liabilities, in turn, ultimately translates into greater national debt via further subsidies either from the budget or the state banking system. Society as a whole thus bears not only the direct liabilities of the loss-making SOEs but also the extra costs of macroeconomic distortions.

Organizational Reforms

Organizational changes have been some of the most visible aspects of China’s SOE reform process. The key structural manifestation of these changes has been the establishment of large state enterprise groups and holding companies; in addition there have been experiments with other state asset management entities. Organizational reforms have also focused on de-linking social services from enterprises.

State Enterprise Groups and Holding Companies and other State Asset Management Entities. These organizational reforms have concentrated on different ways of discharging State shareholder functions in SOEs. The State Council (or Cabinet) acts as the “ultimate owner” of SOE assets on behalf of the people of China. The administrative arm of the State Council to carry out its state ownership functions is the National Administrative Bureau of State Owned Property (NABSOP). For
enterprise groups and holding companies, the representation of the state’s ownership interests is often direct: a ministerial-level official serves as chairman of the board or as chief executive or both.

But there have also been more elaborate shareholder schemes—which have begun to substantially decline in importance—where at each branch of government (national, provincial, municipal and district) state asset management had typically encompassed three levels of institutions: (a) an “upper-tier” state asset management organization, operating as an executive body; (b) an “intermediate tier” state asset management organization, entrusted by the upper-tier institution to manage the state-owned assets; and (c) the “operational enterprises”—the SOEs. Analogous to NABSOP, upper-tier executive bodies were established at subcentral levels of government, such as municipal-level state asset management bureaus (SAMBS). Intermediate tiers, generally comprised of provincial- and municipal-level State Asset Operating Companies (SAOCs), modeled on the concept of the modern holding company, also were established.

Figure 2 illustrates how China’s enterprise group and other organizational reforms have evolved, including the most recent phasing out of sector and line bureaus and ministries, and the objective of bringing in new SOE stakeholders.

Extensive fieldwork and case studies of these new organizations and interviews of SOE managers shed light on the features of the emerging organizational framework. In general, the new structures and holding companies tend to lack clear internal lines of authority. The boards of directors and the senior executives are often the same people. In addition, board members typically are nominated not by a commercially-oriented owner, but by governmental or Party bodies. With a few exceptions, sector line bureaus are transforming into holding companies without introducing a modern corporate form or developing modern matrix management structures. In virtually all cases, these entities retain governmental

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18 World Bank (1997).
Figure 2: Organizational Reforms of China’s SOEs

(a) In the past, line ministries/departments managed state assets in SOEs.

(b) At present, enterprise groups (and other state asset management entities) are being introduced.

(c) China’s authorities plan to continue to phase out line ministries/departments; enterprise groups, other state asset management entities and other stakeholders will participate in SOE governance.

Source: author
as well as business ownership functions. In fact, many of the underlying SOEs see little difference between the old sector line bureaus and the new structures—other than a name change.

The general impression that emerges is that the new organizational forms are burdened by overlapping functions that prevent the effective separation of business from government and inadequate structures for sound corporate governance incentives (see the next section). This is particularly true for the large enterprise holding groups being formed, which also appear to suffer from diseconomies of scale. At a minimum, the organizational network and its component bodies need to be greatly simplified and their multiple layers eliminated. The recent problems of Korea’s chaebol provide a lesson in this regard.

In addition, greater use should be made of “outsiders”—that is participation from the nonstate sector—in the organizational structures. For example, nonstate participation could be increased through: (a) appointing nonstate representatives to SOE boards of directors; (b) contracting out the provision of services (e.g., transport, accounting, social services) to the nonstate sector; and (c) perhaps most important, diversifying ownership of these structures so as to bring about passive minority state ownership, with the state’s shares managed by independent, nonstate professional custodians. At the same time, measures should be taken so that SOE board members come from different regions and have diverse professional backgrounds. Cross-sectoral and cross-regional diversification of managers as well as of the shares held by enterprise groups and the other state asset management organizations should also be instituted.

Reorganizing Social Functions. Chinese authorities recognize that SOE organizational reforms must include the transfer of many of the social service burdens SOEs carry to municipal or regional governments or to new or existing nongovernmental entities. Separating these social functions from SOEs’ productive functions is critical because their continuance, especially enterprise-provided housing, which is the largest component of the typical SOE’s social costs, hinders the mobility of workers and managers. As long as housing remains linked to jobs, agile labor markets, which are key to the establishment of a modern corporate system in China, cannot develop.

China’s current policy regarding the disposition of surplus workers emphasizes maintaining social stability. “On-the-job-layoffs”, which began in earnest in 1993, have accelerated since 1996. It has been estimated that 12 million workers were furloughed in 1998.19 The Government reported that 6.53 million SOE workers were laid-off in 1999, and 6.57 were laid-off in 2000.20 In implementing SOE restructuring measures, local governments carefully monitor the socially affordable level of unemployment in light of the strength of the local economy. Government policymakers recognize that this is inefficient, but the social security system is not yet adequately developed to handle significantly larger open unemployment rates.

Corporate Governance Incentives

When corporate governance incentives—the rules and institutions that determine the extent to which managers act in the best commercial interest of shareholders—are weak, the tendency for managers to engage in opportunistic behavior is strong and enterprise performance suffers. This is

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especially true for firms with significant or complete state ownership, where, generically, there is often little effective separation between objectives of government and those of business. Providing systems for and exercising sound corporate governance is a challenge that all large modern corporations the world over must meet.\textsuperscript{21}

Different types of corporate governance systems have been used to solve the underlying principal-agent problem. The United States and the United Kingdom rely heavily on shareholders’ actions in stock markets. Japan utilizes a bank-based system. Germany’s governance framework is centered on institutional investors (other companies and banks). There is no obvious ranking as to which of these three, or any other, corporate governance system is best for promoting efficient corporations in China. But there is a clear consensus worldwide that all of the most successful corporate governance systems make judicious use of commercially-based incentives.\textsuperscript{22}

The Chinese State as owner—or its representative organs—has, in general, weak organizational structures to provide clear information about SOE managers’ actions and enterprise performance. The lack of clear ownership identification of SOEs undermines corporate governance as it leaves open the issue of who exactly should be monitoring the managers. The difficulty in identifying owners—and specifying who will be responsible for SOE liabilities—is typically one of the key constraints on Chinese SOE corporate governance. The commingling of SOE commercial and social functions and the fact that the ultimate owner of SOEs—the State—is also the regulator of SOEs also give rise to conflicted governance incentives.

Effective corporate governance is also difficult to exercise when few state asset management institutions regularly receive timely, accurate and useful information about the financial performance of the firms they control. Relatively few outside monitors, especially banks, exercise strong discipline on China’s SOEs. The four specialized banks are mainly other agents of the State, making the concept of “limited liability” of little relevance for SOEs, as the owner and creditor are one and the same. The banks are attempting to transform into commercial entities, as called for by the Commercial Banking Law. But they have still a way to go in establishing their independence.\textsuperscript{23} In contrast, China’s private sector enterprises, either acting as legal-person institutional investors in SOEs or as suppliers to and customers of SOEs, are providing for some degree of external SOE governance.

Without the fundamental reorientation in governance incentives toward market principles, China’s SOEs will either continue to be ruled by the old procedures—which will undoubtedly retard enterprise restructuring—or they will continue to find themselves in a corporate governance vacuum. The result, as noted earlier, is that managers (and other insiders) end up with de facto control over the enterprises. The evidence from many transition economies is that insider-dominated corporate control has many costs and risks: asset-stripping, poor investment decisions, decapitalization through excessive wage increases, and increases in other private benefits.

The application of hard budget constraints—that is, enterprises pay the full economic costs for all their inputs and charge market-determined prices for their outputs—can be a powerful driver for corporate

\textsuperscript{21} For a survey see Shleifer and Vishny (1997).

\textsuperscript{22} See Aoki and Kim (1995).

\textsuperscript{23} Lardy (1998).
governance and restructuring. As noted above, fiscal (or budgetary) subsidies to Chinese SOEs have decreased as a percentage of GDP steadily in recent years. However, in 2000 the Finance Ministry was issuing special treasury bonds (following similar issues in 1999 and 1998), part of the proceeds of which would provide interest-free loans for the technological upgrading of SOEs. This initiative is part of an administered investment program to reduce over-capacity. The program also includes criteria for government authorization for selected enterprises to proceed with planned investments and an announced list of specific products for which new-capacity investments would not be approved. Such measures likely benefit incumbent producers, the majority of which are SOEs, because they can still get authorization—and perhaps subsidies—to modernize existing capacity. These policies are difficult to defend from a market reform perspective: they tend to protect inefficient SOEs at the expense of potentially more viable private sector competitors.

Dealing with subsidies provided through China’s financial system has been more problematic. They are less transparent than fiscal subsidies and therefore are less easy to monitor and reduce. While some reduction has taken place, it has principally come through the tightening of credit under inflation control programs. However, the four main state-owned banks still often automatically roll-over unpaid credits (principal and interest) to SOEs. Interest rates also have not been liberalized enough for the banks to differentiate terms among enterprises according to credit risks, giving rise to cross-subsidies. Clearly the banks need to step up their governance involvement with SOEs, especially in calling on debt-service obligations. More specifically, the banks need to be empowered to obtain more frequent and better financial information from SOEs, including the requirement to request independent audits.

International experience points to the importance of reforms that enhance competition as way of engendering better SOE governance. As a result of the legacy of a planned economy and substantial decentralization, in some market niches (notably heavy industry), SOEs enjoy regional autarky and face few private sector competitors. The World Bank survey of 156 industrial SOEs in five cities reveals that the average provincial market share for each firm’s principal product was 53 percent. The survey also suggests that on both the input and output sides of many markets SOEs are interlocked with one another: the average share of inputs purchased from each SOE’s largest supplier was 60 percent, and 78 percent of the surveyed SOEs said their largest supplier was another SOE. By the same token, the average share of sales made to each of the surveyed SOE’s largest customer was 41 percent, and 60 percent of the surveyed SOEs indicated their largest customer was another SOE.24

Implicit and explicit policy barriers to entry—especially among would-be rivals based in different regions of China—are being reduced, but they are still substantial. Local government business licensing procedures, for example, deter new entrants from “foreign” provinces. In some key industrial sectors, inter-provincial market share patterns have not altered appreciably in the past several years, particularly at the wholesale level; in “downstream” retail sectors, however, cross-market penetration is becoming more pronounced. New private sector entry has been made more difficult as a result of the government campaign to reduce excess inventories. Voluntary output restraints and price cartels have been sanctioned by the authorities as a way of rationalizing industry structure. For example, eight TV tube producers, accounting for 90 percent of national output, stopped production in mid-1999 to reduce inventories and price declines. The incidence of such programs tends to fall most heavily on potential new competitors rather than on inefficient incumbents.

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Much less progress has been made in fostering exit, bankruptcy and liquidation of commercially nonviable SOEs. On the one hand, this is due to weaknesses in the bankruptcy legal framework: while the insolvency law *per se* recognizes banks and other creditors as high priority claimants—in line with international bankruptcy practice—conflicting regulations issued by the State Council cede priority to pension and social service obligations, thereby undermining the ability of creditors to exercise their rights and weakening the overall bankruptcy policy regime.

On the other hand, many governmental authorities, enterprise managers, bankers and workers are unaccustomed to or reluctant to pursue bankruptcy or other competitive forms of exit. Unions and local officials, in particular, lack faith in job creation through the disposal and reallocation of assets. Instead, guided mergers and acquisitions are the preferred routes for dealing with money-losing SOEs. Within 56 “experimental reform cities” there were 472 industrial SOEs identified for bankruptcy in 1997, but procedures had begun for only 161 of them, and only 58 firms had been declared bankrupt. More generally the picture that emerges is that exit of money-losing SOEs is not widely practiced in China, except in cases of small or (to a lesser extent) medium-size SOEs.25

China’s experience in diversifying SOE ownership (to both individuals and legal-person institutional investors) suggests that ownership diversification could provide an important opportunity for improving governance. It is not enough, however, simply to diversify ownership. Without the proper institutional safeguards, ownership diversification may compound rather than help existing insider control problems and create perceptions of unfairness. Implementing and managing SOE ownership diversification should, therefore, be done with well-defined institutional responsibilities and through transparent and competitive procedures. In this regard, international experience suggests that the keys to success are to ensure ownership diversification is both cross-regional and cross-sectoral; that there is transferability of ownership shares; and, most importantly that investments on behalf of the State are supervised or managed by independent professionals—nonstate custodians or trustees—whose remuneration is incentive-linked to investment performance. Like other transition economies, China’s authorities need to recognize that there is a trade-off between maintaining control of SOEs and enhancing their asset values. Fundamentally reorienting SOEs’ incentives toward the market may well entail reducing the state’s involvement in SOEs to passive minority ownership.

The restructuring of large and medium industrial SOEs through mergers and acquisitions, through participation in domestic and foreign joint ventures, and through other forms of integration and consolidation is in full swing in China. Mergers and acquisitions of debt-ridden SOEs have been promoted by the granting of five-year suspensions on loan payments of interest to the acquiring firm (for the debts of the acquired entity). Conversion of inter-enterprise debts (payables and receivables) into equity shares is also resulting in increased mergers and consolidations of money-losing SOEs. But these mergers are for the most part administratively arranged by government, which plays the key role in identifying the parties and arranging for the transaction.

In general, the increased attention being paid to SOE mergers, acquisitions and other forms of consolidation of operational enterprises is to be encouraged—to the extent that the resulting integration of SOEs serves to maximize economies of scale and scope. These initiatives are important, in part, because

25 A recent large-firm bankruptcy case involved a 90-year old state owned mine in Benxi, Liaoning Province, with 36,000 workers.
they help solve the problem of duplication of facilities and suboptimal plant scale that exists as a result of the earlier decentralization drive, which engendered artificial regional self-sufficiency.

Accounting and Auditing of SOEs Financial Performance

Accounting and auditing reforms are prerequisites to provide SOE owners, boards of directors and managers with reliable information to monitor enterprise performance. Without accurate, transparent and commercially meaningful financial information on enterprise performance, all other aspects of Chinese SOE reform could be for naught. China’s rules for financial accounting (issued in 1993) and International Accounting Standards (IAS) differ in several respects: on the policy basis of the accounting framework; the intended audience; and the definition and application of terms.

Most other national accounting standards identify “investors and creditors” as the primary users of accounting information. China’s accounting standards generally do not. China’s standards give priority to administrative control, which conflicts with the goal of separating government and enterprises. Newly drafted Chinese accounting standards are more precise and comprehensive than the general principles embodied in the 1993 rules. If they are fully implemented, accounts prepared under Chinese and international standards will become more similar.

But even with the issuance of improved accounting standards, there are other barriers to implementing meaningful accounting practices. Many of China’s SOEs lack the capacity to prepare such accounts. At the same time, tertiary businesses’ assets, costs and implicit liabilities, especially social obligations, are unclear. Inconsistencies also exist within a single enterprise group. Moreover, costs are often determined arbitrarily. In many SOEs, different independent profit center workshops or production units still rely on an “internal banking system.” Each unit writes checks and makes demands on the central finance department with little coordination. Most units and the “internal bank” lack sufficient information to plan or to deal with working capital shortages. Exacerbating the problem is that many SOEs are heavily indebted to other SOEs. Perhaps most importantly, in general SOE financial accounts are not subject to audits carried out by bona fide independent auditors, nor are such audits made publicly available.

The amount of resources at stake through improved checks and balances on SOE financial accounts, including public disclosure of professional independent audits, is large. In late 1999 an investigation conducted by the Ministry of Finance revealed that nearly 90 percent of 100 selected SOEs had intentionally altered their financial statements and inflated their profits by a total of 2.7 billion yuan. The Ministry reported that in many cases, the auditors assigned to review the balance sheet and profit and loss statements of the SOEs were often unqualified to conduct audits, and even frequently conspired with the SOEs to alter and fabricate such statements. The Ministry indicated that both the SOEs in question and the auditors who assisted them would be prosecuted for their fraudulent actions.

The fact is that most of the accounts and the financial control mechanisms in China’s industrial SOEs are still aimed at counting rather than financial management. This does not create strong incentives

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for transparency and efficiency. Sound accounting standards and independent audits will enhance the incentive framework. Cash-flow forecasts also need to be issued on a semiannual or quarterly basis. Control systems to manage inter-enterprise debts also need to be strengthened.

**Conclusion**

China’s initiatives for improving the performance of SOEs reflect a serious commitment to reform within the context of the “socialist market economy” framework. But if China’s SOEs are to operate competitively—especially following the country’s accession to the WTO, whose disciplines will exact competitive pressure on Chinese industry—more than marginal adjustments to current policies are necessary. The agenda is long, so priorities must be set. Most critically what is required is to:

- extensively diversify ownership, allowing for passive state minority shares managed on behalf of the state by independent professional custodians;
- simplify organizational structures, including enterprise groups and holding companies;
- integrate cross-regional and cross-sectoral shareholding;
- further develop property right/asset exchanges, and establish a “market for corporate control”;
- eliminate policy-induced barriers to entry and exit in inherently competitive sectors;
- intensify incentives so that bank-enterprise debt-service obligations are scrupulously met;
- create a market for managerial talent; and
- require independent audits of financial accounts based on international standards and make them publicly available.

Decisively reorienting enterprise incentives toward the market means reducing the state’s fundamental involvement in SOEs. The authorities have already stated their intention to loosen controls on them and to give equal footing to the private sector. But the government could go further and faster. It could do so by orchestrating a complete withdrawal of state involvement in all inherently competitively structured industries. This would signal a credible commitment by government for deeper SOE reform in a portion of the economy where state ownership brings few benefits and many costs. More important it would change expectations and behavior on the part of remaining SOE managers and the international community that the authorities are even more serious about embracing private sector competition as a way of fostering stronger business performance in China.

China has amply demonstrated that it is willing to act pragmatically in the interests of economic development. In this regard there is great promise in China’s WTO accession in compelling further SOE reform: locking-in international commitments will help induce efficiency gains in SOEs and make these and other public enterprises behave in ways similar to those of private industry. Yet the effectiveness of the competitive discipline engendered by WTO accession on furthering SOE reform will largely depend on the within-border reach of the competitive pressure. Not only do sub-national governments effectively control the bulk of SOEs, they also protect them from new entrants, give to them subsidies and influence
heavily the privileged access they have to credit. But by the same token, sub-national governments can provide the policy framework for dealing with SOEs’ redundant labor and implement programs for de-bundling SOE social services from productive operations. In this sense, implementation of SOE reforms at the local level will be the key determinant of the Chinese leadership’s success in meeting the goal of establishing a “modern enterprise system”.


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